# HSBC Bank Middle East Limited

## Annual Report and Accounts 2018

HSBC

# Contents


| | | Page |
|---|---|---|
| **Report of the Directors** | | **2** |
| **Independent Auditor's Report to the Shareholder of HSBC Bank Middle East Limited** | | **3** |
| **Financial Statements** | | |
| Consolidated income statement | | **8** |
| Consolidated statement of comprehensive income | | **9** |
| Consolidated statement of financial position | | **10** |
| Consolidated statement of cash flows | | **11** |
| Consolidated statement of changes in equity | | **12** |
| **Notes on the Financial Statements** | | |
| 1 | Legal status and principal activities | **13** |
| 2 | Basis of preparation and significant accounting policies | **13** |
| 3 | Changes in fair value of long-term debt and related derivatives | **24** |
| 4 | Operating profit | **25** |
| 5 | Employee compensation and benefits | **25** |
| 6 | Auditors' remuneration | **29** |
| 7 | Tax | **29** |
| 8 | Dividends | **30** |
| 9 | Segment analysis | **31** |
| 10 | Trading assets | **32** |
| 11 | Fair values of financial instruments carried at fair value | **32** |
| 12 | Fair values of financial instruments not carried at fair value | **37** |
| 13 | Derivatives | **38** |
| 14 | Financial investments | **39** |
| 15 | Assets charged as security for liabilities, and collateral accepted as security for assets | **40** |
| 16 | Interests in associates and joint arrangement | **40** |
| 17 | Investments in subsidiaries | **40** |
| 18 | Prepayments, accrued income and other assets | **41** |
| 19 | Assets held for sale and liabilities of disposal groups held for sale and intangible assets | **41** |
| 20 | Trading liabilities | **41** |
| 21 | Financial liabilities designated at fair value | **41** |
| 22 | Debt securities in issue | **41** |
| 23 | Accruals, deferred income and other liabilities | **42** |
| 24 | Provisions | **43** |
| 25 | Maturity analysis of assets, liabilities and off-balance sheet commitments | **43** |
| 26 | Offsetting of financial assets and financial liabilities | **44** |
| 27 | Foreign exchange exposure | **45** |
| 28 | Called up share capital and share premium | **45** |
| 29 | Notes on the statement of cash flows | **46** |
| 30 | Effect of reclassification upon adoption of IFRS 9 | **47** |
| 31 | Risk management | **49** |
| 32 | Contingent liabilities, contractual commitments and guarantees | **75** |
| 33 | Lease commitments | **76** |
| 34 | Legal proceedings and regulatory matters | **76** |
| 35 | Related party transactions | **77** |
| 36 | Events after the balance sheet date | **79** |


## Presentation of Information

This document comprises the *Annual Report and Accounts 2018* for HSBC Bank Middle East Limited ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Accounts, together with the Auditor's report. References to 'HSBC' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries.

## Board of Directors

David Eldon, Chairman
Georges Elhedery, Chief Executive Officer and Deputy Chairman
Dr. Raja Al Gurg
Abdul Hakeem Mostafawi
David Dew
Sir William Patey
Abdulfattah Sharaf
John Bartlett
Chris D Spooner

## Change in Directors

- A M Keir resigned as a Director on 28 February 2018.

## Principal activities

The group through its branch network and subsidiary undertakings provides a range of banking and related financial services in the Middle East and North Africa.

The group has established a branch in Abu Dhabi Global Markets ('ADGM') in 2018. The licence was granted on 31 October 2018 and the purpose of the branch is to provide advisory services (arranging and advising on investment deals) to clients based in Abu Dhabi.

## Attributable profit and dividends

The profit attributable to the shareholders of the parent company amounted to US$541 million (2017: US$545 million) as set out in the consolidated income statement on page 8.

During the year, a fourth interim dividend for 2017 and first interim dividend for 2018 of US$140 million and US$50 million (2017: U$430 million) were declared on 13 February 2018 and 03 May 2018 respectively.

A second interim dividend for 2018 of US$100 million was declared by the Directors on 12 February 2019.

## Registered office

The bank is a "Company Limited by Shares" incorporated in the Dubai International Financial Centre ('DIFC') under the Companies Law (DIFC Law No. 2 of 2009) on 30 June 2016 with registered number 2199. Its head office and registered office is located at Level 1, Gate Village Building 8, Dubai International Financial Centre, Dubai, United Arab Emirates.

## Auditor

PricewaterhouseCoopers Limited has expressed its willingness to continue in office and the Board recommends that it be reappointed. A resolution proposing the reappointment of PricewaterhouseCoopers Limited as auditor of the group and giving authority to the Directors to determine its remuneration will be submitted to the forthcoming Annual General Meeting.

On behalf of the Board

**J A Tothill**

Secretary

## Report on the audit of the consolidated financial statements

### Our opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of HSBC Bank Middle East Limited (the 'company') and its subsidiaries (the 'group') as at 31 December 2018, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards ('IFRS') as endorsed by the European Union.

**What we have audited**

The group's consolidated financial statements comprise:

- the consolidated statement of financial position as at 31 December 2018;
- the consolidated income statement for the year then ended;
- the consolidated statement of comprehensive income for the year then ended;
- the consolidated statement of changes in equity for the year then ended;
- the consolidated statement of cash flows for the year then ended; and
- the notes to the consolidated financial statements, which include a summary of significant accounting policies.

**Basis for opinion**

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

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

Independence

We are independent of the group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants ('IESBA Code') and the requirements of the Dubai Financial Services Authority (the 'DFSA'). We have fulfilled our other ethical responsibilities in accordance with these requirements and with the IESBA Code.

**Our audit approach**

Overview

| Materiality | Overall group materiality: USD 32 million, which represents 5% of profit before tax. |
|---|---|
| Group scoping | The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of the components and other qualitative factors. Full scope audits were carried out at two of the five locations. |
| Key audit matters | The Key Audit Matters identified during the year are:<br>• Impairment of loans and advances<br>• Valuation of unquoted equity instruments<br>• Valuation of unquoted debt instruments with significant unobservable inputs<br>• IT access management |

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the consolidated financial statements. In particular, we considered where management made subjective judgements; for example, in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits, we also addressed the risk of management override of internal controls, including among other matters, consideration of whether there was evidence of bias that represented a risk of material misstatement due to fraud.

How we tailored our group audit scope

We tailored the scope of our audit in order to perform sufficient work to enable us to provide an opinion on the consolidated financial statements as a whole, taking into account the structure of the group, the accounting processes and controls, and the industry in which the group operates.

Given the geographically dispersed nature of the group's operations in the Middle East and North Africa and the diversity of its banking activities, our approach was designed to cover each of the significant locations, being the United Arab Emirates ('UAE') and Qatar. We audited the operations of the group in the UAE and instructed a PwC member firm to perform work and issue an audit opinion to us in respect of the group's operations in Qatar. Each location that was not individually significant was assessed for any significant risks or material balances and, where appropriate, we instructed PwC member firms in those locations to perform and report on specific procedures relating to matters which were judgemental in nature and/or material to the overall group. The work in these locations was carried out by applying standard benchmarks on materiality and reflected the size and complexity of the operations.

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PricewaterhouseCoopers Limited is registered with the Dubai Financial Services Authority.

*Our audit approach (continued)*

### How we tailored our group audit scope (continued)

A significant amount of the group's operational processes which are critical to financial reporting are undertaken in shared service centres run by HSBC Operations Services and Technology (HOST) across 11 individual locations. The audit work over the shared service centre processes and controls was performed by PwC member firms in each of the global shared service centre locations and coordinated by the PwC member firm in the UK, with oversight from us. This work enabled us to evaluate the effectiveness of the controls over key processes that supported material balances, classes of transactions and disclosures within the group consolidated financial statements, and to consider the implications on our audit work.

In aggregate, the audit work performed across the locations above provided us with the audit evidence required to form an opinion on the group consolidated financial statements.

### Materiality

The scope of our audit was influenced by our application of materiality. An audit is designed to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement. Misstatements may arise due to fraud or error.

They are considered material if individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the consolidated financial statements.

Based on our professional judgement, we determined certain quantitative thresholds for materiality, including the overall group materiality for the consolidated financial statements as a whole as set out in the table below. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and in aggregate on the consolidated financial statements as a whole.

| | |
|---|---|
| Overall group materiality | USD 32 million |
| How we determined it | 5% of profit before tax |
| Rationale for the materiality benchmark applied | We chose profit before tax as the benchmark because, in our view, it is the benchmark against which the performance of the group is most commonly measured by users, and is a generally accepted benchmark. We chose 5% which is within the range of acceptable quantitative materiality thresholds in auditing standards. |

We agreed with those charged with governance that we would report to them misstatements identified during our audit above USD 1.6 million as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

## Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

| Key audit matter | How our audit addressed the key audit matter |
|---|---|
| Impairment of loans and advances We focused on the impairment of loans and advances due to the materiality of the loan balances and the associated impairment allowances. In addition, the compliance with IFRS in this area requires considerable judgement and interpretation in their application.<br>As disclosed in note 31, as at 31 December 2018, the group has recognised a provision for impairment of loans and advances of USD 1.094 billion. The largest loan portfolios and significant impairment allowances are in the UAE, Qatar and Bahrain.<br>IFRS requires the use of forward looking, expected credit loss (ECL) impairment models which take into account reasonable and supportable forward-looking information.<br>There are a number of significant judgements which are required in measuring ECL, including:<br>determining the criteria for a significant increase in credit risk ('SICR');<br>the application of future economic guidance; and<br>techniques used to determine the Probability of Default ('PD') and Loss Given Default ('LGD').<br>As this is the first year of adoption of IFRS 9 - Financial Instruments (IFRS 9), there is limited experience available to back-test the charge for expected credit losses with actual results. There is also a large increase in the data inputs required in the impairment calculation. The data is sourced from a number of systems that have not been used previously for the preparation of the accounting records. This increases the risk of completeness and accuracy of the data. For defaulted exposures, the Group exercises judgement to estimate the expected future cash flows related to individual exposures, including the value of collateral. | We assessed and tested the design and operating effectiveness of the key controls that management has established to support their impairment calculations. This includes testing the key controls over model performance monitoring and validation with the assistance of our experts, including back testing of performance.<br>We tested the controls over the inputs of critical data, into source systems, and the flow and transfer of data between source systems to the impairment calculation engine. This includes testing of the key reconciliations over the completeness and accuracy of data, including substantiation of material exceptions noted for these reconciliations.<br>Further, the PwC member firm in the UK tested the review and challenge of multiple economic scenarios by an internal expert panel and internal governance committee, and assessed the reasonableness of the multiple economic scenarios and variables using their experts.<br>The PwC member firm in the UK also assessed management's user acceptance testing over the automated calculation of ECL to ensure it is performed in line with business requirements, as well as independently reviewed the underlying script to validate that the calculation operated in accordance with their expectations.<br>We have reviewed the work performed by the PwC member firm in the UK.<br>We observed challenge forums to assess the ECL output and approval of post model adjustments.<br>We also tested the approval of the key inputs, assumptions and discounted cash-flows that support the significant individual impairments, and substantively tested a sample of individually assessed loans. We assessed the consolidated financial statements disclosures to assess compliance with IFRS. |

*Our audit approach (continued)*

## Key audit matters (continued)

| Key audit matter | How our audit addressed the key audit matter |
|---|---|
| **Valuation of unquoted equity instruments** | |
| We focused on the valuation of unquoted equity instruments due to the materiality of the instruments and the subjective nature of their valuation which involve the use of judgemental assumptions.<br>As disclosed in note 14, as at 31 December 2018 the group has unquoted equity instruments of USD 39 million. These instruments are classified and measured at fair value through other comprehensive income. | We assessed and tested the design and the operating effectiveness of the key controls that management has established to support the review and approval of the model design, key model inputs and valuation.<br>We assessed the appropriateness of the valuation method used by management with the assistance of our valuation experts. The key inputs used in the determination of assumptions within the model were challenged by our experts and corroborating information was obtained. The mathematical accuracy of the model was also tested. |
| **Valuation of unquoted debt instruments with significant unobservable inputs** | |
| We focused on the valuation of unquoted debt instruments with significant unobservable inputs due to the materiality of the instruments and the subjective nature of their valuation which involves the use of judgemental assumptions.<br><br>As of 31 December 2018 the group has investments in unquoted debt instruments with significant unobservable inputs of USD 298 million. | We assessed and tested the design and operating effectiveness of the key controls that management has established to support the review and approval of the valuations, including fair value adjustments.<br><br>We assessed the appropriateness of the valuation method used by management with the assistance of our valuation experts. Our valuation experts also performed an independent valuation of the debt instruments. |

| Key audit matter | How our audit addressed the key audit matter |
|---|---|
| **IT access management** | |
| We focused on this area as the audit relies extensively on automated controls and therefore on the effectiveness of controls over IT systems.<br>In previous years, we identified and reported that controls over access to applications, operating systems and databases in the financial reporting process required improvement.<br>Access management controls are critical to ensure that changes to applications and underlying data are made in an appropriate manner. Appropriate access controls contribute to mitigating the risk of potential fraud or errors as a result of changes to applications and data.<br>Over the past 4 years, management implemented remediation activities that have contributed to reducing the risk over access management in the financial reporting process.<br>However, issues related to privileged access to parts of the technology infrastructure and business user access to applications remain unresolved, requiring our audit approach to respond to the risks presented. | We received regular briefings from management on the progress made in remediating weaknesses in HSBC Group-wide systems and we communicated with other PwC member firms in respect of their validation of remediated controls.<br>We reviewed formal reporting on the results of work performed in relation to group-wide systems used by the HSBC Group.<br>Access rights were tested over applications, operating systems and databases relied upon for financial reporting.<br>Specifically, the audit tested that:<br>• New access requests for joiners were properly reviewed and authorised;<br>• User access rights were removed on a timely basis when an individual left or changed role;<br>• Access rights to applications, operating systems and databases were periodically monitored for appropriateness; and<br>• Highly privileged access is restricted to appropriate personnel.<br>Other areas that were independently assessed included password policies, security configurations, controls over changes to applications and databases and that business users, developers and production support did not have access to change applications, the operating system or databases in the production environment.<br>As a consequence of the deficiencies identified, a range of other procedures were performed:<br>• Where inappropriate access was identified, the PwC member firm in the UK performed procedures to understand the nature of the access, and, where possible, obtained additional evidence on the appropriateness of the activities performed;<br>• We performed additional substantive testing in respect of selected year-end reconciliations (i.e. custodian, bank account and suspense account reconciliations) and confirmed balances with external counterparties;<br>• We performed testing on other compensating controls such as business performance reviews;<br>• Testing of toxic combination controls was performed by the PwC member firm in the UK; and<br>• We obtained a list of users' access permissions from the PwC member firm in the UK and manually compared these to other access lists where segregation of duties was deemed to be of higher risk, for example users having access to both core banking and payments systems. |

**Other information**

The Board of Directors is responsible for the other information. The other information comprises the Report of the Directors (but does not include the consolidated financial statements and our auditor's report thereon).

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

If, based on the work we have performed on the other information, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

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

The Board of Directors is responsible for the preparation of the consolidated financial statements that give a true and fair view in accordance with IFRS as endorsed by the European Union and in accordance with the applicable regulatory requirements of the DFSA, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

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

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

## Auditor's responsibilities for the audit of the consolidated financial statements

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

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

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of the Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

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

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

## Report on other legal and regulatory requirements

As required by the applicable provisions of the DFSA Rulebook, we report that the consolidated financial statements have been properly prepared in accordance with the applicable requirements of the DFSA.

PricewaterhouseCoopers

Dubai, United Arab Emirates

19 February 2019

Audit Principal: David R Cox

## Consolidated income statement

### for the year ended 31 December

| | Notes | 2018 US$000 | 2017 US$000 |
|---|---|---|---|
| Net interest income | | **985,963** | 906,492 |
| – interest income | | **1,209,267** | 1,062,823 |
| – interest expense | | **(223,304)** | (156,331) |
| Net fee income | | **407,300** | 435,045 |
| – fee income | | **513,402** | 530,756 |
| – fee expense | | **(106,102)** | (95,711) |
| Net income from financial instruments held for trading or managed on a fair value basis | | **207,796** | 216,248 |
| Changes in fair value of long-term debt and related derivatives | 3 | **1,558** | 4,988 |
| Changes in fair value of other financial instruments mandatorily measured at fair value through profit or loss | | **(2,081)** | N/A |
| Net (losses)/gains from financial investments | | **(7,064)** | (5,015) |
| Dividend income | | **1,242** | 3,872 |
| Other operating income, net | | **87,197** | 126,320 |
| **Net operating income before change in expected credit losses and other credit impairment** | | **1,681,911** | 1,687,950 |
| Change in expected credit losses and other credit impairment charges | 4 | **(127,620)** | N/A |
| Loan impairment charges and other credit risk provisions | 4 | **N/A** | (149,912) |
| **Net operating income** | | **1,554,291** | 1,538,038 |
| Employee compensation and benefits | 5 | **(548,790)** | (522,261) |
| General and administrative expenses | | **(342,803)** | (359,683) |
| Depreciation and impairment of property, plant and equipment | | **(14,045)** | (13,364) |
| Amortisation and impairment of intangible assets | | **(6,109)** | (5,663) |
| **Total operating expenses** | | **(911,747)** | (900,971) |
| **Operating profit** | 4 | **642,544** | 637,067 |
| Share of profit in associates | 16 | **475** | 290 |
| **Profit before tax** | | **643,019** | 637,357 |
| Tax expense | 7 | **(101,869)** | (92,004) |
| **Profit for the year** | | **541,150** | 545,353 |
| Attributable to: | | | |
| – shareholders of the parent company | | **541,092** | 545,212 |
| – non-controlling interests | | **58** | 141 |
| **Profit for the year** | | **541,150** | 545,353 |

The accompanying notes on pages 13 to 79 form an integral part of these financial statements.

## Consolidated statement of comprehensive income

### for the year ended 31 December

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| Profit for the year | **541,150** | 545,353 |
| **Other comprehensive income/(expense)** | | |
| **Items that will be reclassified subsequently to profit or loss when specific conditions are met:** | | |
| Available-for-sale investments | **N/A** | (5,324) |
| – fair value losses | **N/A** | (7,225) |
| – fair value gains/(losses) reclassified to the income statement | **N/A** | (801) |
| – amounts reclassified to the income statement in respect of impairment losses | **N/A** | 2,652 |
| – income taxes | **N/A** | 50 |
| Debt instruments at fair value though other comprehensive income | **(6,434)** | N/A |
| – fair value losses | **(6,762)** | N/A |
| – fair value losses transferred to the income statement on disposal | **160** | N/A |
| – expected credit losses recognised in income statement | **(161)** | N/A |
| – income taxes | **329** | N/A |
| Cash flow hedges | **(12,043)** | (3,997) |
| – fair value losses | **(13,381)** | (4,441) |
| – income taxes | **1,338** | 444 |
| Exchange differences | **(7,399)** | (10,662) |
| **Items that will not be reclassified subsequently to profit or loss:** | | |
| Remeasurement of defined benefit asset/liability | **23,859** | (15,162) |
| – before income taxes | **23,859** | (16,553) |
| – income taxes | **—** | 1,391 |
| Equity instruments designated at fair value through other comprehensive income | **(20,819)** | N/A |
| – fair value losses | **(20,819)** | N/A |
| – income taxes | **—** | N/A |
| Changes in fair value of financial liabilities designated at fair value upon initial recognition arising from changes in own credit risk | **18,801** | (3,577) |
| – fair value gain/(losses) | **18,801** | (3,577) |
| – income taxes | **—** | — |
| Other comprehensive expense for the year, net of tax | **(4,035)** | (38,722) |
| **Total comprehensive income for the year** | **537,115** | 506,631 |
| Attributable to: | | |
| – shareholders of the parent company | **537,057** | 506,490 |
| – non-controlling interests | **58** | 141 |
| **Total comprehensive income for the year** | **537,115** | 506,631 |

The accompanying notes on pages 13 to 79 form an integral part of these financial statements.

## Consolidated statement of financial position

### at 31 December

| | Notes | 2018 US$000 | 2017 US$000 |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances at central banks | | **1,170,359** | 671,440 |
| Items in the course of collection from other banks | | **81,984** | 64,419 |
| Trading assets | 10 | **246,156** | 440,624 |
| Financial assets designated and otherwise mandatorily measured at fair value through profit or loss | | **47,839** | N/A |
| Derivatives | 13 | **953,222** | 963,102 |
| Loans and advances to banks | 25 | **5,057,308** | 6,203,202 |
| Loans and advances to customers | 25 | **20,073,375** | 18,316,780 |
| Reverse repurchase agreements – non-trading | | **755,076** | 1,387,254 |
| Financial investments | 14 | **5,734,776** | 6,746,504 |
| Prepayments, accrued income and other assets | 18 | **1,170,067** | 657,894 |
| Current tax assets | | **19** | 1,383 |
| Interests in associates | 16 | **2,423** | 1,948 |
| Intangible assets | 19 | **31,465** | 10,502 |
| Deferred tax assets | 7 | **204,982** | 205,857 |
| **Total assets** | | **35,529,051** | 35,670,909 |
| **Liabilities and equity** | | | |
| **Liabilities** | | | |
| Deposits by banks | 25 | **1,582,477** | 1,798,474 |
| Customer accounts | 25 | **21,823,507** | 22,583,649 |
| Repurchase agreements – non-trading | | **2,999** | – |
| Items in the course of transmission to other banks | | **263,907** | 87,502 |
| Trading liabilities | 20 | **59,023** | 1,309,860 |
| Financial liabilities designated at fair value | 21 | **2,017,966** | 739,425 |
| Derivatives | 13 | **951,976** | 952,332 |
| Debt securities in issue | 22 | **2,490,371** | 2,092,390 |
| Accruals, deferred income and other liabilities | 23 | **1,615,180** | 1,619,693 |
| Current tax liabilities | | **106,394** | 110,141 |
| Provisions | 24 | **66,151** | 71,608 |
| **Total liabilities** | | **30,979,951** | 31,365,074 |
| **Equity** | | | |
| Called up share capital | 28 | **931,055** | 931,055 |
| Share premium account | 28 | **61,346** | 61,346 |
| Other reserves | | **(190,204)** | (132,153) |
| Retained earnings | | **3,742,607** | 3,441,349 |
| **Total shareholders' equity** | | **4,544,804** | 4,301,597 |
| Non-controlling interests | | **4,296** | 4,238 |
| **Total equity** | | **4,549,100** | 4,305,835 |
| **Total liabilities and equity at 31 Dec** | | **35,529,051** | 35,670,909 |

The accompanying notes on pages 13 to 79 form an integral part of these financial statements.

**G Elhedery**

Chief Executive Officer and Deputy Chairman

## Consolidated statement of cash flows

### for the year ended 31 December

| | Notes | 2018 US$000 | 2017 US$000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| **Profit before tax** | | **643,019** | 637,357 |
| Adjustments for: | | | |
| Net gain from investing activities | | **56** | (14,450) |
| Share of profits in associates | | **(475)** | (290) |
| Gain on disposal of branches and associates | | **–** | (55,438) |
| Other non-cash items included in profit before tax | *29* | **241,422** | 250,656 |
| Change in operating assets | *29* | **(4,045,453)** | 1,460,278 |
| Change in operating liabilities | *29* | **689,332** | (2,514,965) |
| Elimination of exchange differences[1] | | **(8,639)** | (80,498) |
| Tax paid | | **(104,252)** | (121,794) |
| **Net cash used in operating activities** | | **(2,584,990)** | (439,144) |
| **Cash flows from investing activities** | | | |
| Net cash flows from purchase and sale / maturity of financial investments | | **886,115** | (424,081) |
| Net cash flows from the purchase and sale of property, plant and equipment | | **(264,685)** | 18,359 |
| Net investment in intangible assets | | **(27,098)** | (4,061) |
| Net cash outflow from increase in investment in associates | | **(386)** | – |
| Net cash flow on disposal of businesses and associates | | **–** | 123,347 |
| **Net cash generated from / (used) in investing activities** | | **593,946** | (286,436) |
| **Cash flows from financing activities** | | | |
| Dividends paid to shareholders of the parent company | *8* | **(190,000)** | (430,000) |
| **Net cash used in financing activities** | | **(190,000)** | (430,000) |
| **Net decrease in cash and cash equivalents** | | **(2,181,044)** | (1,155,580) |
| Cash and cash equivalents at 1 Jan | | **3,860,788** | 4,969,505 |
| Exchange differences in respect of cash and cash equivalents | | **213** | 46,863 |
| **Cash and cash equivalents at 31 Dec** | *29* | **1,679,957** | 3,860,788 |

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

The accompanying notes on pages 13 to 79 form an integral part of these financial statements.

## Consolidated statement of changes in equity

### for the year ended 31 December

| | | | Other reserves | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Called up share capital and share premium** | **Retained earnings** | **Financial assets at FVOCI reserves1** | **Cash flow hedging reserve** | **Foreign exchange reserve** | **Merger and other reserves** | **Total share-holders' equity** | **Non-controlling interests** | **Total equity** |
| | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** |
| **At 31 Dec 2017** | **992,401** | **3,441,349** | **6,433** | **(7,354)** | **(115,911)** | **(15,321)** | **4,301,597** | **4,238** | **4,305,835** |
| Impact on transition to IFRS 9 | **–** | **(92,650)** | **(12,725)** | **–** | **–** | **–** | **(105,375)** | **–** | **(105,375)** |
| **At 1 Jan 2018** | **992,401** | **3,348,699** | **(6,292)** | **(7,354)** | **(115,911)** | **(15,321)** | **4,196,222** | **4,238** | **4,200,460** |
| Profit for the year | **–** | **541,092** | **–** | **–** | **–** | **–** | **541,092** | **58** | **541,150** |
| Other comprehensive income (net of tax) | **–** | **42,698** | **(27,258)** | **(12,042)** | **(7,433)** | **–** | **(4,035)** | **–** | **(4,035)** |
| – debt instruments at fair value through other comprehensive income | **–** | **–** | **(6,434)** | **–** | **–** | **–** | **(6,434)** | **–** | **(6,434)** |
| – equity instruments designated at fair value through other comprehensive income | **–** | **–** | **(20,819)** | **–** | **–** | **–** | **(20,819)** | **–** | **(20,819)** |
| – cash flow hedges | **–** | **–** | **–** | **(12,043)** | **–** | **–** | **(12,043)** | **–** | **(12,043)** |
| – changes in fair value of financial liabilities designated at fair value arising from changes in own credit risk | **–** | **18,801** | **–** | **–** | **–** | **–** | **18,801** | **–** | **18,801** |
| – remeasurement of defined benefit asset/liability | **–** | **23,859** | **–** | **–** | **–** | **–** | **23,859** | **–** | **23,859** |
| – exchange differences | **–** | **38** | **(5)** | **1** | **(7,433)** | **–** | **(7,399)** | **–** | **(7,399)** |
| **Total comprehensive income for the year** | **–** | **583,790** | **(27,258)** | **(12,042)** | **(7,433)** | **–** | **537,057** | **58** | **537,115** |
| Ordinary share issued | | | | | | | | | |
| Dividends to shareholders | **–** | **(190,000)** | **–** | **–** | **–** | **–** | **(190,000)** | **–** | **(190,000)** |
| Exercise and lapse of share options and vesting of share awards | | **(6,037)** | | | | | **(6,037)** | | **(6,037)** |
| Cost of share-based payment arrangements | **–** | **10,801** | **–** | **–** | **–** | **–** | **10,801** | **–** | **10,801** |
| Other movements | **–** | **(4,646)** | **1,407** | **–** | **–** | **–** | **(3,239)** | **–** | **(3,239)** |
| **At 31 Dec 2018** | **992,401** | **3,742,607** | **(32,143)** | **(19,396)** | **(123,344)** | **(15,321)** | **4,544,804** | **4,296** | **4,549,100** |

| | Called up share capital and share premium | Retained earnings | Available for-Sale fair value reserve[1] | Cash flow hedging reserve | Foreign exchange reserve | Merger and other reserves | Total share-holders' equity | Non-controlling interests | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| At 1 Jan 2017 | 931,055 | 3,345,703 | 17,139 | (3,358) | (105,220) | (15,321) | 4,169,998 | 4,098 | 4,174,096 |
| Profit for the year | – | 545,212 | – | – | – | – | 545,212 | 141 | 545,353 |
| Other comprehensive income (net of tax) | – | (18,804) | (5,231) | (3,996) | (10,691) | – | (38,722) | – | (38,722) |
| – available-for-sale investments | – | – | (5,324) | – | – | – | (5,324) | – | (5,324) |
| – cash flow hedges | – | – | – | (3,997) | – | – | (3,997) | – | (3,997) |
| – changes in fair value of financial liabilities designated at fair value arising from changes in own credit risk | – | (3,577) | – | – | – | – | (3,577) | – | (3,577) |
| – remeasurement of defined benefit asset/liability | – | (15,162) | – | – | – | – | (15,162) | – | (15,162) |
| – exchange differences | – | (65) | 93 | 1 | (10,691) | – | (10,662) | – | (10,662) |
| Total comprehensive income for the year | – | 526,408 | (5,231) | (3,996) | (10,691) | – | 506,490 | 141 | 506,631 |
| Ordinary share issued (Note 28) | 61,346 | – | – | – | – | – | 61,346 | – | 61,346 |
| Dividends to shareholders | – | (430,000) | – | – | – | – | (430,000) | – | (430,000) |
| Exercise and lapse of share options and vesting of share awards | – | (9,377) | – | – | – | – | (9,377) | – | (9,377) |
| Cost of share-based payment arrangements | – | 9,627 | – | – | – | – | 9,627 | – | 9,627 |
| Other movements | – | (1,012) | (5,475) | – | – | – | (6,487) | (1) | (6,488) |
| At 31 Dec 2017 | 992,401 | 3,441,349 | 6,433 | (7,354) | (115,911) | (15,321) | 4,301,597 | 4,238 | 4,305,835 |

1 *US$6.4 million at 31 December 2017 represents the IAS 39 Available-for-sale fair value reserves as at 31 December 2017.*

The accompanying notes on pages 13 to 79 form an integral part of these financial statements.

## 1 Legal status and principal activities

The group has its place of incorporation and head office in Dubai International Financial Centre ('DIFC'), in the United Arab Emirates, under a category 1 licence issued by the Dubai Financial Services Authority ('DFSA').

The group's registered office is Level 1, Gate Village Building 8, Dubai International Financial Centre, Dubai, United Arab Emirates.

The group through its branch network and subsidiary undertakings provides a range of banking and related financial services in the Middle East and North Africa.

The immediate parent company of the group is HSBC Middle East Holdings BV and the ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

## 2 Basis of preparation and significant accounting policies

### 2.1 Basis of preparation

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

The consolidated financial statements of the group and the separate financial statements of the group have been prepared in accordance with IFRSs as issued by the IASB, including interpretations issued by the IFRS Interpretations Committee, and as endorsed by the European Union ('EU'). At 31 December 2018, there were no unendorsed standards effective for the year ended 31 December 2018 affecting these consolidated and separate financial statements, and HSBC's application of IFRSs results in no differences between IFRSs as issued by the IASB and IFRSs as endorsed by the EU.

##### Standards adopted during the year ended 31 December 2018

The group has adopted the requirements of IFRS 9 'Financial instruments' from 1 January 2018, with the exception of the provisions relating to the presentation of gains and losses on financial liabilities designated at fair value, which were adopted from 1 January 2017. The effect of its adoption is not significant. IFRS 9 includes an accounting policy choice to remain with IAS 39 hedge accounting, which the group has exercised. The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application. As permitted by IFRS 9, the group has not restated comparatives. Adoption reduced net assets at 1 January 2018 by US$105.4 million as set out in Note 30.

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

##### IFRS 9 transitional requirements

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

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

The results of these changes are included in the reconciliation set out in Note 30.

##### Changes in accounting policy

While not necessarily required by the adoption of IFRS 9, the following voluntary changes in accounting policy and presentation have been made as a result of reviews carried out in conjunction with its adoption. The effect of presentational changes at 1 January 2018 is included in the reconciliation set out in Note 30 and comparatives have not been restated.

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

#### (b) Future accounting developments

##### Minor amendments to IFRSs

The IASB has published a number of minor amendments to IFRSs which are effective from 1 January 2019, some of which have been endorsed for use in the EU. The group expects they will have an insignificant effect, when adopted, on the consolidated financial statements of the group.

### Major new IFRSs

The IASB has published IFRS 16 'Leases' and IFRS 17 'Insurance contracts'. IFRS 16 has been endorsed for use in the EU and IFRS 17 has not yet been endorsed. In addition, an amendment to IAS 12 'Income Taxes' is not yet endorsed.

*IFRS 16 'Leases'*

IFRS 16 'Leases' has an effective date for annual periods beginning on or after 1 January 2019. IFRS 16 results in lessees accounting for most leases within the scope of the standard in a manner similar to the way in which finance leases are currently accounted for under IAS 17 'Leases'. Lessees will recognise a right of use ('ROU') asset and a corresponding financial liability on the balance sheet. The asset will be amortised over the length of the lease, and the financial liability measured at amortised cost. Lessor accounting remains substantially the same as under IAS 17. At 1 January 2019, the group expects to adopt the standard using a modified retrospective approach where the cumulative effect of initially applying the standard is recognised an adjustment to the opening balance of retained earnings and comparatives are not restated.

The implementation is expected to increase assets (ROU assets) by US$ 52.7 million and increase financial liabilities by the same amount with no effect on net assets or retained earnings.

*IFRS 17 'Insurance contracts'*

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

*Amendment to IAS 12 'Income Taxes'*

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

### (c) Foreign currencies

The group's consolidated financial statements are presented in US dollars because the US dollar and currencies linked to it form the major currency bloc in which the group transacts and funds its business. The US dollar is also the group's functional currency because the US dollar and currencies linked to it are the most significant currencies relevant to the underlying transactions, events and conditions of its subsidiaries, as well as representing a significant proportion of its funds generated from financing activities.

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

In the consolidated financial statements, the assets and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not US dollars, are translated into the group's presentation currency at the rate of exchange at the balance sheet date, while their results are translated into US dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net assets, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate at the period end, are recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements and in other comprehensive income in consolidated accounts. On disposal of a foreign operation, exchange differences previously recognised in other comprehensive income are reclassified to the income statement as a reclassification adjustment.

### (d) Critical accounting estimates and judgements

The preparation of financial information requires the use of estimates and judgements about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items highlighted as the critical accounting estimates and judgements in section 2.2 below, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different conclusions from those reached by management for the purposes of these financial statements. Management's selection of the group's accounting policies which contain critical estimates and judgements reflects the materiality of the items to which the policies are applied and the high degree of judgement and estimation uncertainty involved.

### (e) Segmental analysis

The group's chief operating decision-maker is the Board. Operating segments are reported in a manner consistent with the internal reporting provided to the Board.

Measurement of segmental assets, liabilities, income and expenses is in accordance with the group's accounting policies. Segmental income and expenses include transfers between segments, and these transfers are conducted at arm's length. Shared costs are included in segments on the basis of the actual recharges made.

### Products and services

The group manages products and services to its customers in the geographical regions through global businesses.

- Retail Banking and Wealth Management ('RBWM') serves its customers through four main businesses: Retail Banking, Wealth Management, Asset Management and Insurance. The HSBC Premier and Advance propositions are aimed at mass affluent and emerging affluent customers who value international connectivity and benefit from the global reach and scale. For customers with simpler banking needs, RBWM offers a full range of products and services reflecting local requirements.
- Commercial Banking ('CMB') customers range from small enterprises focused primarily on their domestic markets through to corporates operating globally. CMB support customers with tailored financial products and services to allow them to operate efficiently and grow. Services provided include working capital, term loans, payment services and international trade facilitation, as well as expertise in mergers and acquisitions, and access to financial markets.
- Global Banking and Markets ('GB&M') supports major government, corporate and institutional clients. GB&M product specialists continue to deliver a comprehensive range of transaction banking, financing, advisory, capital markets and risk management services.
- Global Private Banking ('GPB') serves high net worth individuals and families, including those with international banking needs. GPB provides a full range of private banking services, including Investment Management, which includes advisory and brokerage services, and Private Wealth Solutions, which comprises trusts and estate planning, to protect and preserve wealth for future generations.
- Corporate Centre comprises Central Treasury, including Balance Sheet Management ('BSM'), interests in associates and central stewardship costs that support our businesses.

## 2.2 Summary of significant accounting policies

### (a) Consolidation and related policies

#### Investments in subsidiaries

The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Control is initially assessed based on consideration of all facts and circumstances, and is subsequently reassessed when there are significant changes to the initial setup.

Where an entity is governed by voting rights, the group would consolidate when it holds, directly or indirectly, the necessary voting rights to pass resolutions by the governing body. In all other cases, the assessment of control is more complex and requires judgement of other factors, including having exposure to variability of returns, power over the relevant activities or holding the power as agent or principal.

Business combinations are accounted for using the acquisition method. The amount of non-controlling interest is measured at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

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

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are treated as transactions between equity holders and are reported in equity.

Entities that are controlled by the group are consolidated from the date the group gains control and cease to be consolidated on the date the group loses control of the entities.

The group performs a re-assessment of consolidation whenever there is a change in the facts and circumstances of determining the control of all entities.

All intra-group transactions are eliminated on consolidation.

#### The group sponsored structured entities

The group is considered to sponsor another entity if, in addition to ongoing involvement with the entity, it had a key role in establishing that entity or in bringing together the relevant counterparties to a structured transaction. The group is not considered a sponsor if the only involvement with the entity is to provide services at arms' length and it ceases to be a sponsor once it has no ongoing involvement with that structured.

#### Interests in associates and joint arrangements

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

The group recognises its share of the assets, liabilities and results in a joint operation. Investments in associates are recognised using the equity method. The attributable share of the results and reserves of associates are included in the consolidated financial statements of group based on either financial statements made up to 31 December or pro-rated amounts adjusted for any material transactions or events occurring between the date of financial statements available and 31 December. Investments in associates are assessed at each reporting date and tested for impairment when there is an indication that the investment may be impaired.

### (b) Income and expenses

#### Operating income

*Interest income and expense*

Interest income and expense for all financial instruments except for those classified as held for trading or designated at fair value (except for debt securities issued by the group and derivatives managed in conjunction with those debt securities) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

*Non-interest income and expense*

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

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

The group recognises fees earned on transaction-based arrangements at a point in time when we have fully provide the service to the customer. Where the contract requires services to be provided over time, income is recognised on a systematic basis over the life of the agreement.

Where group offers a package of services that contains multiple non-distinct performance obligations, such as those included in account service packages, the promised services are treated as a single performance obligation. If a package of services contains distinct performance obligations, such as those including both account and insurance services, the corresponding transaction price is allocated to each performance obligation based on the estimated stand-alone selling prices.

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

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

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

### (c) Valuation of financial instruments

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

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

### Critical accounting estimates and judgements

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

### (d) Financial instruments measured at amortised cost

Financial assets that are held to collect the contractual cash flows and that contain contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest, such as most loans and advances to banks and customers and some debt

securities, are measured at amortised cost. In addition, most financial liabilities are measured at amortised cost. The group accounts for regular way amortised cost financial instruments using trade date accounting. The carrying value of these financial assets at initial recognition includes any directly attributable transactions costs. If the initial fair value is lower than the cash amount advanced, such as in the case of some leveraged finance and syndicated lending activities, the difference is deferred and recognised over the life of the loan through the recognition of interest income.

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

### Non-trading reverse repurchase, repurchase and similar agreements

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

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

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

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

### (f) Equity securities measured at fair value with fair value movements presented in OCI

The equity securities for which fair value movements are shown in OCI are business facilitation and other similar investments where the group holds the investments other than to generate a capital return. Gains or losses on the derecognition of these equity securities are not transferred to profit or loss. Otherwise equity securities are measured at fair value through profit or loss (except for dividend income which is recognised in profit or loss).

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

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below and are so designated irrevocably at inception:

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

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

Under the above criterion, the main classes of financial instruments designated by the group are:

- Long-term debt issues.

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

### (h) Derivatives

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

Where the derivatives are managed with debt securities issued by the group that are designated at fair value, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt.

### Hedge accounting

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

#### *Fair value hedge*

Fair value hedge accounting does not change the recording of gains and losses on derivatives and other hedging instruments, but results in recognising changes in the fair value of the hedged assets or liabilities attributable to the hedged risk that would not otherwise be recognised in the income statement. If a hedge relationship no longer meets the criteria for hedge accounting, hedge accounting is discontinued; the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement on a recalculated effective interest rate, unless the hedged item has been derecognised, in which case it is recognised in the income statement immediately.

#### *Cash flow hedge*

The effective portion of gains and losses on hedging instruments is recognised in other comprehensive income; the ineffective portion of the change in fair value of derivative hedging instruments that are part of a cash flow hedge relationship is recognised immediately in the income statement within 'Net income from financial instruments held for trading or managed on a fair value basis'. The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the same periods in which the hedged item affects profit or loss. In hedges of forecast transactions that result in recognition of a non-financial asset or

liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability. When a hedge relationship is discontinued, or partially discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the income statement.

*Net investment hedge*

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

### Derivatives that do not qualify for hedge accounting

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

### Critical accounting estimates and judgements

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

## (i) Impairment of amortised cost and FVOCI financial assets

Expected credit losses are recognised for loans and advances to banks and customers, non-trading reverse repurchase agreements, other financial assets held at amortised cost, debt instruments measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is required for ECL resulting from default events that are possible within the next 12 months (or less, where the remaining life is less than 12 months) ('12-month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL'). Financial assets where 12-month ECL is recognised are considered to be 'stage 1'; financial assets which are considered to have experienced a significant increase in credit risk are in 'stage 2'; and financial assets for which there is objective evidence of impairment so are considered to be in default or otherwise credit-impaired are in 'stage 3'. Purchased or originated credit-impaired financial assets (POCI) are treated differently as set out below.

### Credit-impaired (stage 3)

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

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

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

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

### Write-off

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

### Renegotiation

Loans are identified as renegotiated and classified as credit- impaired when we modify the contractual payment terms due to significant credit distress of the borrower. Renegotiated loans remain classified as credit-impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows and retain the designation of renegotiated until maturity or derecognition.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement is made on substantially different terms or if the terms of an existing agreement are modified such that the renegotiated loan is a substantially different financial instrument. Any new loans that arise following derecognition events in these circumstances are considered to be purchased or originated credit-impaired (POCI) and will continue to be disclosed as renegotiated loans.

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

## Loan modifications that are not credit-impaired

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

## Significant increase in credit risk (stage 2)

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

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

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

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

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

Further information about the 23-grade scale used for CRR can be found on page 58.

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

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

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

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

## Purchased or originated credit-impaired

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

### Movement between stages

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

### Measurement of ECL

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

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

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

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

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

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

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

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

### Period over which ECL is measured

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

### Forward-looking economic inputs

The group will in general apply three forward-looking global economic scenarios determined with reference to external forecast distributions representative of our view of forecast economic conditions, the Consensus Economic Scenario approach. This approach is

considered sufficient to calculate unbiased expected loss in most economic environments. They represent a 'most likely outcome' (the Central scenario) and two, less likely, 'Outer' scenarios, referred to as the Upside and Downside scenarios. The Central scenario is used

by the annual operating planning process and, with regulatory modifications, will also be used in enterprise-wide stress tests. The Upside and Downside are constructed following a standard process supported by a scenario narrative reflecting the Group's current top and emerging risks and by consulting external and internal subject matter experts. The relationship between the Outer scenarios and Central scenario will generally be fixed with the Central scenario being assigned a weighting of 80% and the Upside and Downside scenarios 10% each, with the difference between the Central and Outer scenarios in terms of economic severity being informed by the spread of external forecast distributions among professional industry forecasts. The Outer scenarios are economically plausible, internally

consistent states of the world and will not necessarily be as severe as scenarios used in stress testing. The period of forecast is five years, after which the forecasts will revert to a view based on average past experience. The spread between the central and outer scenarios is grounded on consensus distributions of projected gross domestic product of UAE. The economic factors include, but are not limited to, gross domestic product, unemployment, interest rates, inflation and commercial property prices across all the countries in which the group operates.

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

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

### Critical accounting estimates and judgements

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

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

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

### (j) Employee compensation and benefits

#### Share-based payments

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

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

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

#### Post-employment benefit plans

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

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

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

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

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

### (k) Tax

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

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

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled.

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

### Critical accounting estimates and judgements

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

## (l) Debt securities in issue

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

## (m) Provisions, contingent liabilities and guarantees

### Provisions

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

### Critical accounting estimates and judgements

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

### Contingent liabilities, contractual commitments and guarantees

*Contingent liabilities*

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

*Financial guarantee contracts*

Liabilities under financial guarantee contracts which are not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or present value of the fee receivable.

## (n) Acceptances and endorsements

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

## (o) Accounting policies applied to financial instruments prior to 1 January 2018

### Financial instruments measured at amortised cost

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

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

### Impairment of loans and advances

Losses for impaired loans are recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Losses which may arise from future events are not recognised.

*Individually assessed loans and advances*

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

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

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

Impairment losses are calculated by discounting the expected future cash flows of a loan, which include expected future receipts of contractual interest, at the loan's original effective interest rate or an approximation thereof, and comparing the resultant present value with the loan's current carrying amount.

*Collectively assessed loans and advances*

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

*Incurred but not yet identified impairment*

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for a collective impairment assessment. This assessment captures impairment losses that HSBC has incurred as a result of events occurring before the balance sheet date that HSBC is not able to identify on an individual loan basis, and that can be reliably estimated. When information becomes available that identifies losses on individual loans within a group, those loans are removed from the group and assessed individually.

*Homogeneous groups of loans and advances*

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

- When appropriate empirical information is available, HSBC utilises roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of the loans that will eventually be written off as a result of events occurring before the balance sheet date. Individual loans are grouped using ranges of past due days, and statistical estimates are made of the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics, such as industry sector, loan grade or product. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring, for example because of a missed payment, and its confirmation through write-off (known as the loss identification period). Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, models also take into account behavioural and account management trends as revealed in, for example bankruptcy and rescheduling statistics.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, HSBC adopts a basic formulaic approach based on historical loss rate experience, or a discounted cash flow model. Where a basic formulaic approach is undertaken, the period between a loss event occurring and its identification is estimated by local management, and is typically between six and 12 months.

*Write-off of loans and advances*

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

*Reversals of impairment*

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

*Assets acquired in exchange for loans*

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

*Renegotiated loans*

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

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

*Non-trading reverse repurchase, repurchase and similar agreements*

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

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

### Financial instruments measured at fair value

*Available-for-sale financial assets*

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

*Impairment of available-for-sale financial assets*

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

*Available-for-sale debt securities*

In assessing objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in the recovery of future cash flows. A subsequent decline in the fair value of the instrument is recognised in the income statement when there is objective evidence of impairment as a result of decreases in the estimated future cash flows. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, or the instrument is no longer impaired, the impairment loss is reversed through the income statement.

*Available-for-sale equity securities*

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

All subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised in other comprehensive income. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement to the extent that further cumulative impairment losses have been incurred. Impairment losses recognised on the equity security are not reversed through the income statement.

*Financial instruments designated at fair value*

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated irrevocably at inception:

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

*Long-term debt issues*

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

Financial assets and financial liabilities under unit-linked and non-linked investment contracts

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

| | Footnotes | 2018<br>US$000 | 2017<br>US$000 |
|---|---|---|---|
| Net income/(expense) arising on: | | | |
| – other changes in fair value | | **1,558** | 4,988 |
| **Year ended 31 Dec** | | **1,558** | 4,988 |

## 4 Operating profit

Operating profit is stated after the following items:

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| **Income** | | |
| Interest recognised on impaired financial assets | **11,162** | 11,353 |
| Interest recognised on financial assets measured at amortised cost | **1,050,036** | N/A |
| Interest recognised on financial assets measured at FVOCI | **134,480** | N/A |
| Fees earned on financial assets that are not at fair value through profit or loss (other than amounts included in determining the effective interest rate) | **372,490** | 426,002 |
| Fees earned on trust and other fiduciary activities | **17,774** | 21,355 |
| **Expense** | | |
| Interest on financial instruments, excluding interest on financial liabilities held for trading or designated or otherwise mandatorily measured at fair value | **(140,539)** | (144,471) |
| Fees payable on financial liabilities that are not at fair value through profit or loss (other than amounts included in determining the effective interest rate) | **(79,383)** | (67,633) |
| Fees payable relating to trust and other fiduciary activities | **(384)** | — |
| Payments under lease sublease agreements | **(42,132)** | (24,955) |
| Restructuring provisions | **(5,068)** | (6,749) |
| **Gains/(losses)** | | |
| Impairment of available-for-sale equity securities | **N/A** | (2,660) |
| Gains recognised on assets held for sale | **3,079** | 55,438 |
| Losses on disposal or settlement of loans and advances | **—** | (145) |
| Gains on disposal of property, plant and equipment, intangible assets and non-financial investments | **(56)** | 16,805 |
| Change in expected credit loss charges and other credit impairment charges | **(127,620)** | N/A |
| – loans and advances to banks and customers | **(143,268)** | N/A |
| – loans commitments and guarantees | **18,873** | N/A |
| – other financial assets | **(3,389)** | N/A |
| – debt instruments measured at fair value though other comprehensive income | **164** | N/A |
| Loan impairment charges and other credit risk provisions | **N/A** | (149,912) |
| – net impairment charge on loans and advances | **N/A** | (141,228) |
| – other credit risk provisions | **N/A** | (8,684) |

## 5 Employee compensation and benefits

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Wages and salaries | **511,783** | 490,572 |
| Social security costs | **6,085** | 5,059 |
| Post-employment benefits | **30,922** | 26,630 |
| **Year ended 31 Dec** | **548,790** | 522,261 |

### Average number of persons employed by the group during the year

| | 2018 | 2017 |
|---|---|---|
| Retail Banking and Wealth Management | **1,279** | 1,266 |
| Commercial Banking | **695** | 672 |
| Global Banking and Markets | **429** | 427 |
| Global Private Banking | **8** | 9 |
| Corporate Centre | **1,373** | 1,432 |
| **Total** | **3,784** | 3,806 |

Year in which income statement is expected to reflect deferred bonuses

| | Current year bonus pool[1] US$000 | Prior year bonus pools US$000 | Total US$000 |
|---|---|---|---|
| **2018** | | | |
| Charge recognised in 2018 | **8,257** | **9,682** | **17,939** |
| – deferred share awards | **2,217** | **4,387** | **6,604** |
| – deferred cash awards | **6,040** | **5,295** | **11,335** |
| Charge expected to be recognised in 2019 or later | **5,658** | **4,201** | **9,859** |
| – deferred share awards | **3,895** | **2,783** | **6,678** |
| – deferred cash awards | **1,763** | **1,418** | **3,181** |
| 2017 | | | |
| Charge recognised in 2017 | 4,767 | 5,687 | 10,454 |
| – deferred share awards | 2,268 | 4,330 | 6,598 |
| – deferred cash awards | 2,499 | 1,357 | 3,856 |
| Charge expected to be recognised in 2018 or later | 6,657 | 4,921 | 11,578 |
| – deferred share awards | 4,204 | 3,481 | 7,685 |
| – deferred cash awards | 2,453 | 1,440 | 3,893 |

1 *Current year bonus pool relates to the bonus pool declared for the reporting period (2018 for the current year, 2017 for the 2017 comparatives).*

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

## Share-based payments

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

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Restricted share awards | **10,954** | 9,818 |
| Savings-related and other share award option plans | **—** | 18 |
| **Year ended 31 Dec** | **10,954** | 9,836 |

HSBC share awards

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

Movement on HSBC share awards

| | 2018 Number US$000 | 2017 Number (US$000 |
|---|---|---|
| **Restricted share awards outstanding at 1 Jan** | **3,588** | 4,041 |
| Additions during the year | **1,034** | 1,915 |
| Released and forfeited in the year | **(3,018)** | (2,368) |
| **Restricted share awards outstanding at 31 Dec** | **1,604** | 3,588 |
| Weighted average fair value of awards granted (£) | **8.81** | 7.26 |

HSBC share option plans

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

### Calculation of fair values

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

### Movement on HSBC share option plans

| | Savings-related share option plans | |
|---|---|---|
| | **Number** | **WAEP[1]** |
| | **US$000** | **£** |
| **Outstanding at 1 Jan 2018** | **74** | **7.03** |
| Granted during the year | **33** | **7.07** |
| Exercised during the year | **(26)** | **7.15** |
| Transferred during the year | **17** | **9.85** |
| Forfeited, expired and cancelled during the year | **(6)** | **7.61** |
| **Outstanding at 31 Dec 2018** | **92** | **6.71** |
| Weighted average remaining contractual life (years) | **1.79** | |
| | | |
| Outstanding at 1 Jan 2017 | 131 | 7.21 |
| Granted during the year | 11 | 7.91 |
| Exercised during the year | (57) | 7.52 |
| Transferred during the year | 1 | 4.79 |
| Forfeited, expired and cancelled during the year | (12) | 7.46 |
| Outstanding at 31 Dec 2017 | 74 | 7.03 |
| Weighted average remaining contractual life (years) | 1.83 | |

1 *Weighted average exercise price.*

## Post-employment benefit plans

### Income statement charge

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| Defined benefit pension plans | **26,247** | 24,049 |
| Defined contribution pension plans | **4,675** | 2,512 |
| Defined benefit and contribution healthcare plans | **—** | 69 |
| **Year ended 31 Dec** | **30,922** | 26,630 |

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

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| Net employee benefit liabilities (Note 23) | **(168,261)** | (175,445) |

## Defined benefit pension plans

Net asset/(liability) under defined benefit pension plans

| | Fair value of plan assets | Present value of defined benefit obligations | Net defined benefit liability |
|---|---|---|---|
| | US$000 | US$000 | US$000 |
| **At 1 Jan 2018** | **–** | **(175,445)** | **(175,445)** |
| Service cost | **–** | **(24,926)** | **(24,926)** |
| – Current service cost | **–** | **(24,926)** | **(24,926)** |
| Net interest cost on the net defined benefit liability | **–** | **(3,678)** | **(3,678)** |
| Re-measurement effects recognised in other comprehensive income | **–** | **23,859** | **23,859** |
| – actuarial gains | **–** | **23,859** | **23,859** |
| Exchange differences and other movements | **–** | **(1,758)** | **(1,758)** |
| Benefits paid | **–** | **13,687** | **13,687** |
| **At 31 Dec 2018** | **–** | **(168,261)** | **(168,261)** |
| Present value of defined benefit obligation relating to: | **–** | **(168,261)** | **(168,261)** |
| – actives | **–** | **(165,348)** | **–** |
| – deferreds | **–** | **(2,913)** | **–** |
| At 1 Jan 2017 | – | (144,520) | (144,520) |
| Service cost | – | (21,574) | (21,574) |
| – Current service cost | – | (21,574) | (21,574) |
| Net interest cost on the net defined benefit liability | – | (2,475) | (2,475) |
| Re-measurement effects recognised in other comprehensive income | – | (16,553) | (16,553) |
| – actuarial losses | | (16,553) | (16,553) |
| Exchange differences and other movements | – | (1,145) | (1,145) |
| Benefits paid | – | 10,822 | 10,822 |
| At 31 Dec 2017 | – | (175,445) | (175,445) |
| Present value of defined benefit obligation relating to: | | (175,445) | |
| – actives | – | (163,134) | – |
| – deferreds | – | (12,311) | – |

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

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

Key actuarial assumptions for the principal plan

| | Discount rate | Rate of pay increase | Combined rate of resignation and employment termination |
|---|---|---|---|
| | % | % | % |
| **United Arab Emirates** | | | |
| **At 31 Dec 2018** | **3.13** | **5.10** | **8.00** |
| At 31 Dec 2017 | 2.20 | 6.40 | 9.30 |

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

The effect of changes in key assumptions on the principal plan

| | United Arab Emirates | |
|---|---|---|
| | **2018** | 2017 |
| | **US$000** | US$000 |
| **Discount rate** | | |
| Change in scheme obligation at year end from a 25bps increase | **(2,330)** | (3,250) |
| Change in scheme obligation at year end from a 25bps decrease | **3,700** | 3,367 |
| Change in following year scheme cost from a 25bps increase | **(60)** | (170) |
| Change in following year scheme cost from a 25bps decrease | **224** | 176 |
| **Rate of pay increase** | | |
| Change in scheme obligation at year end from a 25bps increase | **3,797** | 3,393 |
| Change in scheme obligation at year end from a 25bps decrease | **(2,438)** | (3,293) |
| Change in following year scheme cost from a 25bps increase | **685** | 645 |
| Change in following year scheme cost from a 25bps decrease | **(506)** | (626) |

## 6 Auditors' remuneration

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Audit fees payable to PwC | **1,179** | 1,384 |
| Other audit fees payable | **31** | 34 |
| **Year ended 31 Dec** | **1,210** | 1,418 |

### Fees payable by the group to PwC

| | Footnotes | 2018 US$000 | 2017 US$000 |
|---|---|---|---|
| Fees for HSBC Bank Middle East Limited statutory audit | 1 | **1,179** | 1,384 |
| – relating to current year | | **1,168** | 1,329 |
| – relating to prior year | | **11** | 55 |
| Fees for other services provided to the group | | **1,211** | 1,416 |
| – audit-related assurance services | 2 | **648** | 705 |
| – taxation-related services | | **280** | 323 |
| – other non-audit services | | **283** | 388 |
| **Year ended 31 Dec** | | **2,390** | 2,800 |

*1 Fees payable to PwC for the statutory audit of the consolidated financial statements of the group.*
*2 Including services for assurance and other services that relate to statutory and regulatory filings, including comfort letters and interim reviews.*

No fees were payable by the group to PwC as principal auditor for the following types of services: internal audit services and services related to litigation, recruitment and remuneration.

## 7 Tax

### Tax expense

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Current tax | **90,301** | 87,864 |
| – for this year | **88,211** | 94,798 |
| – adjustments in respect of prior years | **2,090** | (6,934) |
| Deferred tax | **11,568** | 4,140 |
| – origination and reversal of temporary differences | **11,568** | 4,140 |
| **Year ended 31 Dec** | **101,869** | 92,004 |

The group provides for taxation at the appropriate rates in the countries in which it operates.

### Tax reconciliation

The tax charged to the income statement differs from the tax charge that would apply if all profits had been taxed at the corporate tax rate applicable in UAE:

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | **US$000** | **%** | US$000 | % |
| Profit before tax | **643,019** | | 637,357 | |
| **Tax expense** | | | | |
| Taxation at UAE corporate tax rate of 20% (2017: 20%) | **128,604** | **20.0** | 127,471 | 20.0 |
| Effect of differently taxed overseas profits | **(12,992)** | **(2.0)** | (17,368) | (2.7) |
| Adjustments in respect of prior period liabilities | **1,972** | **0.3** | (7,200) | (1.1) |
| Non-taxable income and gains | **(22,276)** | **(3.5)** | (22,379) | (3.5) |
| Permanent disallowables | **4,654** | **0.7** | 188 | – |
| Local taxes and overseas withholding taxes | **1,907** | **0.3** | 11,797 | 1.9 |
| Other items | **–** | **–** | (505) | (0.1) |
| **Overall tax expense** | **101,869** | **15.8** | 92,004 | 14.5 |

Accounting for taxes involves some estimation because the tax law is uncertain and the application requires a degree of judgement, which authorities may dispute. Liabilities are recognised based on best estimates of the probable outcome, taking into account external advice where appropriate. We do not expect significant liabilities to arise in excess of the amounts provided. The group only recognises current and deferred tax assets where recovery is probable.

Movement of deferred tax assets and liabilities

| | Retirement benefits | Loan impairment allowances | Revaluation of property | Other | Total |
|---|---|---|---|---|---|
| | US$000 | US$000 | US$000 | US$000 | US$000 |
| Assets | **12,585** | **185,871** | **—** | **7,401** | **205,857** |
| Liabilities | **—** | **—** | **—** | **—** | **—** |
| **At 1 Jan 2018** | **12,585** | **185,871** | **—** | **7,401** | **205,857** |
| IFRS 9 transitional adjustment | **—** | **10,683** | **—** | **—** | **10,683** |
| Income statement | **(8)** | **(10,948)** | **—** | **(612)** | **(11,568)** |
| Other comprehensive income | **—** | **—** | **—** | **—** | **—** |
| Foreign exchange and other adjustments | **572** | **(568)** | **—** | **6** | **10** |
| **At 31 Dec 2018** | **13,149** | **185,038** | **—** | **6,795** | **204,982** |
| Assets | **13,149** | **185,038** | **—** | **6,795** | **204,982** |
| Liabilities | **—** | **—** | **—** | **—** | **—** |
| | | | | | |
| Assets | 11,194 | 190,058 | — | 7,859 | 209,111 |
| Liabilities | — | — | (523) | — | (523) |
| At 1 Jan 2017 | 11,194 | 190,058 | (523) | 7,859 | 208,588 |
| Income statement | — | (4,165) | 523 | (498) | (4,140) |
| Other comprehensive income | 1,391 | — | — | — | 1,391 |
| Foreign exchange and other adjustments | — | (22) | — | 40 | 18 |
| At 31 Dec 2017 | 12,585 | 185,871 | — | 7,401 | 205,857 |
| Assets | 12,585 | 185,871 | — | 7,401 | 205,857 |
| Liabilities | — | — | — | — | — |

### Unrecognised deferred tax

The amount of temporary differences, unused tax losses and tax credits for which no deferred tax asset is recognised in the balance sheet was nil (2017: nil).

## 8 Dividends

Dividends to shareholders of the parent company

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | Per share | Total | Per share | Total |
| | US$ | US$000 | US$ | US$000 |
| **Dividends paid on ordinary shares** | | | | |
| In respect of previous year: | | | | |
| – fourth interim dividend | **0.1504** | **140,000** | 0.0269 | 25,000 |
| In respect of current year: | | | | |
| – first interim dividend | **0.0537** | **50,000** | 0.1482 | 138,000 |
| – second interim dividend | **—** | **—** | 0.1729 | 161,000 |
| – third interim dividend | **—** | **—** | 0.1138 | 106,000 |
| **Total** | **0.2041** | **190,000** | 0.4618 | 430,000 |

On 12 February 2019, the Directors declared a second interim dividend in respect of the financial year ended 31 December 2018 of US$ 0.1074 per ordinary share, a distribution of US$100 million.

## 9 Segment analysis

### Profit/(loss) for the period

| Full year | Retail Banking and Wealth Management US$000 | Commercial Banking US$000 | Global Banking and Markets US$000 | Global Private Banking US$000 | Corporate Centre US$000 | Total US$000 |
|---|---|---|---|---|---|---|
| | 2018 | | | | | |
| Net interest income | **396,477** | **232,830** | **319,766** | **—** | **36,890** | **985,963** |
| Net fee income/(expense) | **100,289** | **121,567** | **189,145** | **—** | **(3,701)** | **407,300** |
| Net income from financial instruments held for trading or managed on a fair value basis | **38,388** | **30,102** | **114,586** | **—** | **24,720** | **207,796** |
| Other income | **9,307** | **13,370** | **19,302** | **—** | **38,873** | **80,852** |
| Net operating income before change in expected credit losses and other credit impairment charges | **544,461** | **397,869** | **642,799** | **—** | **96,782** | **1,681,911** |
| Change in expected credit losses and other credit impairment charges | **(63,543)** | **(83,504)** | **18,967** | **—** | **460** | **(127,620)** |
| **Net operating income** | **480,918** | **314,365** | **661,766** | **—** | **97,242** | **1,554,291** |
| Total operating expenses | **(349,760)** | **(231,417)** | **(248,402)** | **—** | **(82,168)** | **(911,747)** |
| **Operating profit** | **131,158** | **82,948** | **413,364** | **—** | **15,074** | **642,544** |
| Share of profit in associates | **—** | **—** | **—** | **—** | **475** | **475** |
| **Profit before tax** | **131,158** | **82,948** | **413,364** | **—** | **15,549** | **643,019** |
| **By geographical region** | | | | | | |
| U.A.E. | **112,476** | **57,712** | **277,165** | **—** | **(438)** | **446,915** |
| Qatar | **6,962** | **4,832** | **69,568** | **—** | **4,301** | **85,663** |
| Rest of Middle East | **11,720** | **20,404** | **66,631** | **—** | **11,686** | **110,441** |
| **Profit before tax** | **131,158** | **82,948** | **413,364** | **—** | **15,549** | **643,019** |
| | 2017 | | | | | |
| Net interest income | 382,556 | 213,829 | 220,537 | — | 89,570 | 906,492 |
| Net fee income/(expense) | 105,936 | 132,551 | 203,472 | — | (6,914) | 435,045 |
| Net trading income/(expense) | 38,026 | 29,275 | 159,673 | — | (10,726) | 216,248 |
| Other income | 16,811 | 15,391 | 16,552 | 163 | 81,248 | 130,165 |
| Net operating income before loan impairment charges and other credit risk | 543,329 | 391,046 | 600,234 | 163 | 153,178 | 1,687,950 |
| Loan impairment charges and other credit risk provisions | (74,539) | (57,708) | (17,665) | — | — | (149,912) |
| Net operating income | 468,790 | 333,338 | 582,569 | 163 | 153,178 | 1,538,038 |
| Total operating expenses | (334,980) | (232,023) | (246,973) | (163) | (86,832) | (900,971) |
| Operating profit | 133,810 | 101,315 | 335,596 | — | 66,346 | 637,067 |
| Share of profit in associates | — | — | — | — | 290 | 290 |
| Profit before tax | 133,810 | 101,315 | 335,596 | — | 66,636 | 637,357 |
| By geographical region | | | | | | |
| U.A.E. | 110,156 | 52,702 | 256,909 | — | 45,468 | 465,235 |
| Qatar | 12,743 | 24,178 | 68,020 | — | 3,380 | 108,321 |
| Rest of Middle East | 10,911 | 24,435 | 10,667 | — | 17,788 | 63,801 |
| Profit before tax | 133,810 | 101,315 | 335,596 | — | 66,636 | 637,357 |

### Balance sheet information

| | Retail Banking and Wealth Management US$000 | Commercial Banking US$000 | Global Banking and Markets US$000 | Global Private Banking US$000 | Corporate Centre US$000 | Total US$000 |
|---|---|---|---|---|---|---|
| | 2018 | | | | | |
| Loans and advances to customers (net) | **3,674,797** | **6,412,781** | **9,985,797** | **—** | **—** | **20,073,375** |
| Interest in associates | **—** | **—** | **—** | **—** | **2,423** | **2,423** |
| **Total assets** | **3,695,109** | **6,800,324** | **13,624,166** | **—** | **11,409,452** | **35,529,051** |
| Customer accounts | **10,520,824** | **4,147,079** | **7,105,591** | **—** | **50,013** | **21,823,507** |
| **Total liabilities** | **10,683,194** | **5,321,362** | **10,775,700** | **—** | **4,199,695** | **30,979,951** |
| | 2017 | | | | | |
| Loans and advances to customers (net) | 3,788,578 | 6,033,990 | 8,492,130 | — | 2,082 | 18,316,780 |
| Interest in associates | — | — | — | — | 1,948 | 1,948 |
| **Total assets** | 3,800,405 | 6,369,620 | 12,801,850 | — | 12,699,034 | 35,670,909 |
| Customer accounts | 10,647,785 | 4,562,150 | 6,846,188 | — | 527,526 | 22,583,649 |
| **Total liabilities** | 10,838,029 | 5,736,970 | 10,744,100 | — | 4,045,975 | 31,365,074 |

## Other financial information

### Net operating income by global business

| | Footnotes | Retail Banking and Wealth Management | Commercial Banking | Global Banking and Markets | Global Private Banking | Corporate Centre | Total |
|---|---|---|---|---|---|---|---|
| | | **2018** | | | | | |
| | | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** | **US$000** |
| Net operating income | 1 | **544,461** | **397,869** | **642,799** | **–** | **96,782** | **1,681,911** |
| – external | | **382,978** | **465,531** | **698,808** | **–** | **134,594** | **1,681,911** |
| – internal | | **161,483** | **(67,662)** | **(56,009)** | **–** | **(37,812)** | **–** |
| | | 2017 | | | | | |
| Net operating income | 1 | 543,329 | 391,046 | 600,234 | 163 | 153,178 | 1,687,950 |
| – external | | 439,999 | 434,724 | 650,102 | – | 163,125 | 1,687,950 |
| – internal | | 103,330 | (43,678) | (49,868) | 163 | (9,947) | – |

1 *Net operating income before loan impairment charges and other credit risk provisions, also referred to as revenue.*

### Information by country

| | **2018** External net operating income[1] | **2018** Non-current assets[2] | 2017 External net operating income[1] | 2017 Non-current assets[2] |
|---|---|---|---|---|
| | **US$000** | **US$000** | US$000 | US$000 |
| U.A.E. | **1,294,281** | **316,735** | 1,303,304 | 44,405 |
| Qatar | **191,241** | **5,386** | 197,261 | 4,435 |
| Rest of Middle East | **196,389** | **10,769** | 187,385 | 11,850 |
| **Total** | **1,681,911** | **332,890** | 1,687,950 | 60,690 |

1 *External net operating income is attributed to countries on the basis of the location of the branch responsible for reporting the results or advancing the funds.*
2 *Non current assets consist of property, plant and equipment, other intangible assets and certain other assets expected to be recovered more than 12 months after the reporting period.*

### Performance ratios

| | Retail Banking and Wealth Management | Commercial Banking | Global Banking and Markets | Global Private Banking | Corporate Centre | Total |
|---|---|---|---|---|---|---|
| | **2018** | | | | | |
| | % | % | % | % | % | % |
| **Year ended 31 December 2018** | | | | | | |
| Share of the group's profit before tax | **20.4** | **12.9** | **64.3** | **–** | **2.4** | **100.0** |
| Cost efficiency ratio | **64.2** | **58.2** | **38.6** | **–** | **84.9** | **54.2** |
| | 2017 | | | | | |
| Year ended 31 December 2017 | | | | | | |
| Share of the group's profit before tax | 21.0 | 15.9 | 52.6 | – | 10.5 | 100.0 |
| Cost efficiency ratio | 61.7 | 59.3 | 41.1 | 100.0 | 56.7 | 53.4 |

## 10 Trading assets

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| Trading assets: | | |
| – not subject to repledge or resale by counterparties | **246,156** | 440,624 |
| **At 31 Dec** | **246,156** | 440,624 |
| Debt securities | **194,711** | 280,747 |
| Treasury and other eligible bills | **51,445** | 46,294 |
| **Trading securities** | **246,156** | 327,041 |
| Loans and advances to banks | **–** | 53,231 |
| Loans and advances to customers | **–** | 60,352 |
| **At 31 Dec** | **246,156** | 440,624 |

## 11 Fair values of financial instruments carried at fair value

### Control framework

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

Where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is used. For inactive markets, the group sources alternative market information, with greater weight given to

information that is considered to be more relevant and reliable. Examples of the factors considered are price observability, instrument comparability, consistency of data sources, underlying data accuracy and timing of prices.

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

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

## Financial liabilities measured at fair value

In certain circumstances, the group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, where available. An example of this is where own debt in issue is hedged with interest rate derivatives. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liabilities. The change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a Libor-based discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

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

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

## Fair value hierarchy

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

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

Financial instruments carried at fair value and bases of valuation

| | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** | Level 1 | Level 2 | Level 3 | Total |
| | **US$000** | **US$000** | **US$000** | **US$000** | US$000 | US$000 | US$000 | US$000 |
| **Recurring fair value measurements at 31 Dec** | | | | | | | | |
| **Assets** | | | | | | | | |
| Trading assets | **–** | **166,201** | **79,955** | **246,156** | – | 440,624 | – | 440,624 |
| Financial assets designated and otherwise mandatorily measured at fair value through profit or loss | **–** | **–** | **47,839** | **47,839** | N/A | N/A | N/A | N/A |
| Derivatives | **–** | **953,222** | **–** | **953,222** | – | 960,097 | 3,005 | 963,102 |
| Financial investments | **2,099,446** | **3,378,498** | **256,832** | **5,734,776** | – | 6,628,271 | 118,233 | 6,746,504 |
| **Liabilities** | | | | | | | | |
| Trading liabilities | **–** | **59,023** | **–** | **59,023** | – | 1,309,860 | – | 1,309,860 |
| Financial liabilities designated at fair value | **–** | **2,017,966** | **–** | **2,017,966** | – | 739,425 | – | 739,425 |
| Derivatives | **–** | **951,976** | **–** | **951,976** | – | 949,327 | 3,005 | 952,332 |

The balance as at 31 December 2018 under financial assets designated at fair value through profit or loss is US$ 47.8 million and financial assets mandatorily measured at fair value through profit or loss is US$ Nil.

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

During 2018 there was a transfer of US$2,099 million from Level 2 to Level 1 Financial Investments. There were no corresponding transfers in 2017. The transfers from Level 2 to Level 3 during the year are shown in 'Movement in Level 3 financial instruments' on page 35.

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

## Fair value adjustments

Fair value adjustments are adopted when the group considers that there are additional factors that would be considered by a market participant which are not incorporated within the valuation model.

Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required.

### Bid-offer

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

### Uncertainty

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

### Credit and debit valuation adjustment

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

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

The group calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each group legal entity, and within each entity for each counterparty to which the entity has exposure.

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

### Funding fair value adjustment

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

## Model limitation

Models used for portfolio valuation purposes may be based upon a simplified set of assumptions that do not capture all current and future material market characteristics. In these circumstances, model limitation adjustments are adopted.

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

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

## Fair value valuation bases

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

| | Assets | | | | | Liabilities | |
|---|---|---|---|---|---|---|---|
| | Financial Investments | Trading Assets | Designated and otherwise mandatorily measured at fair value through profit or loss | Derivatives | Total | Derivatives | Total |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Private equity including strategic investments | **39,203** | **–** | **47,839** | **–** | **87,042** | **–** | **–** |
| Other derivatives | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| Other portfolios | **217,629** | **79,955** | **–** | **–** | **297,584** | **–** | **–** |
| **At 31 Dec 2018** | **256,832** | **79,955** | **47,839** | **–** | **384,626** | **–** | **–** |
| | | | | | | | |
| Private equity including strategic investments | 118,233 | – | – | – | 118,233 | – | – |
| Other derivatives | – | – | – | 3,005 | 3,005 | 3,005 | 3,005 |
| Other portfolios | – | – | – | – | – | – | – |
| At 31 Dec 2017 | 118,233 | – | – | 3,005 | 121,238 | 3,005 | 3,005 |

### Private equity including strategic investments

The investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors; by reference to market valuations for similar entities quoted in an active market; or the price at which similar companies have changed ownership.

### Derivatives

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

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

### Movement in Level 3 financial instruments

| | Assets | | | | Liabilities |
|---|---|---|---|---|---|
| | Financial Investments | Trading Assets | Designated and otherwise mandatorily measured at fair value through profit or loss | Derivatives | Derivatives |
| | US$000 | US$000 | US$000 | US$000 | US$000 |
| **At 1 Jan 2018** | **60,094** | **—** | **58,139** | **3,005** | **3,005** |
| Total losses recognised in profit or loss | — | — | (10,300) | — | — |
| – net income from financial instruments held for trading or managed on a fair value basis | — | — | — | — | — |
| – changes in fair value of other financial instruments mandatorily measured at fair value through profit or loss | — | — | (10,300) | — | — |
| Total losses recognised in other comprehensive income | (20,819) | — | — | — | — |
| – financial investments: fair value losses | (20,819) | — | — | — | — |
| – Exchange differences | — | — | — | — | — |
| Sales | (66) | — | — | — | — |
| Settlements | — | — | — | (3,005) | (3,005) |
| Transfers out | — | — | — | — | — |
| Transfers in | 217,623 | 79,955 | — | — | — |
| **At 31 Dec 2018** | **256,832** | **79,955** | **47,839** | **—** | **—** |
| Unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held at 31 Dec 2018 | — | — | (10,300) | — | — |
| – net income from financial instruments held for trading or managed on a fair value basis | — | — | — | — | — |
| – changes in fair value of other financial instruments mandatorily measured at fair value through profit or loss | — | — | (10,300) | — | — |

| | Assets | | | | Liabilities |
|---|---|---|---|---|---|
| | Available for sale | Held for trading | Designated at fair value | Derivatives | Derivatives |
| | US$000 | $000 | US$000 | US$000 | US$000 |
| At 1 Jan 2017 | 70,480 | — | — | 7,230 | 7,230 |
| Total gains/(losses) recognised in profit or loss | (2,870) | — | — | 59,577 | 59,577 |
| – trading income excluding net interest income | — | — | — | 59,577 | 59,577 |
| – gains less losses from financial investments | (2,870) | — | — | — | — |
| Total losses recognised in other comprehensive income | (2,119) | — | — | — | — |
| – available-for-sale investments: fair value losses | (2,160) | — | — | — | — |
| – exchange differences | 41 | — | — | — | — |
| Purchases | 61,346 | — | — | — | — |
| Sales | (8,604) | — | — | — | — |
| Transfers out | — | — | — | (63,802) | (63,802) |
| Transfers in | — | — | — | — | — |
| At 31 Dec 2017 | 118,233 | — | — | 3,005 | 3,005 |
| Unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held at 31 Dec 2017 | (2,652) | — | — | 3,005 | (3,005) |
| – trading income/(expense) excluding net interest income | — | — | — | 3,005 | (3,005) |
| – gains less losses from financial investments | (2,652) | — | — | — | — |

## Effect of changes in significant unobservable assumptions to reasonably possible alternatives

### Sensitivity of Level 3 fair values to reasonably possible alternative assumptions

| | | 31 Dec 2018 | | | | 31 Dec 2017 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Reflected in profit or loss | | Reflected in OCI | | Reflected in profit or loss | | Reflected in OCI | |
| | | Favourable changes | Un-favourable changes | Favourable changes | Un-favourable changes | Favourable changes | Un-favourable changes | Favourable changes | Un-favourable changes |
| | *Footnotes* | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Derivatives, trading assets and trading liabilities | *1* | 9 | (1,809) | — | — | 301 | (301) | — | — |
| Financial assets designated and otherwise mandatorily measured at fair value through profit or loss | | 4,784 | (2,392) | — | — | N/A | N/A | N/A | N/A |
| Financial investments | | — | — | 5,292 | (3,141) | 2,443 | (1,222) | 9,380 | (4,690) |
| **Total** | | **4,793** | **(4,201)** | **5,292** | **(3,141)** | 2,744 | (1,523) | 9,380 | (4,690) |

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

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

| | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | Reflected in profit or loss | | Reflected in OCI | | Reflected in profit or loss | | Reflected in OCI | |
| | Favourable changes | Un-favourable changes | Favourable changes | Un-favourable changes | Favourable changes | Un-favourable changes | Favourable changes | Un-favourable changes |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Private equity including strategic investments | 4,784 | (2,392) | 5,292 | (1,961) | 2,443 | (1,222) | 9,380 | (4,690) |
| Other derivatives | 9 | (9) | – | – | 301 | (301) | – | – |
| Other portfolios | – | (1,800) | – | (1,180) | – | – | – | – |
| **At 31 Dec** | **4,793** | **(4,201)** | **5,292** | **(3,141)** | 2,744 | (1,523) | 9,380 | (4,690) |

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters using statistical techniques. The statistical techniques aim to apply a 95% confidence interval. When parameters are not amenable to statistical analysis, the quantification of uncertainty is judgemental, but is also guided by the 95% confidence interval.

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

## Key unobservable inputs to Level 3 financial instruments

**Quantitative information about significant unobservable inputs in Level 3 valuations**

| | Fair value | | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Assets | Liabilities | Full range of inputs | | Core range of inputs[1] | | Full range of inputs | | Core range of inputs[1] | |
| | US$000 | US$000 | Lower | Higher | Lower | Higher | Lower | Higher | Lower | Higher |
| Private equity including strategic investments | 87,048 | – | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Interest rate derivatives | – | – | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| FX derivatives | – | – | N/A | N/A | N/A | N/A | 0.4% | 5% | 0.4% | 5% |
| EM bonds | 297,578 | – | 100% | 100% | 100% | 100% | N/A | N/A | N/A | N/A |
| **At 31 Dec 2018** | **384,626** | – | | | | | | | | |

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

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

### Private equity including strategic investments

Given the bespoke nature of the analysis in respect of each holding, it is not practical to quote a range of key unobservable inputs.

### Prepayment rates

Prepayment rates are a measure of the anticipated future speed at which a loan portfolio will be repaid in advance of the due date. They vary according to the nature of the loan portfolio and expectations of future market conditions, and may be estimated using a variety of evidence, such as prepayment rates implied from proxy observable security prices, current or historical prepayment rates and macroeconomic modelling.

### Market proxy

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

### Volatility

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

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

### Correlation

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

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

### Credit spread

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

### Inter-relationships between key unobservable inputs

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

## 12 Fair values of financial instruments not carried at fair value

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

| | | Fair value | | | |
|---|---|---|---|---|---|
| | Carrying amount | Quoted market price Level 1 | Observable inputs Level 2 | Significant unobservable inputs Level 3 | Total |
| | US$000 | US$000 | US$000 | US$000 | US$000 |
| **At 31 Dec 2018** | | | | | |
| Assets | | | | | |
| Loans and advances to banks | **5,057,308** | **—** | **5,045,941** | **—** | **5,045,941** |
| Loans and advances to customers | **20,073,375** | **—** | **—** | **19,726,291** | **19,726,291** |
| Reverse repurchase agreements – non-trading | **755,076** | **—** | **755,076** | **—** | **755,076** |
| **Liabilities** | | | | | |
| Deposits by banks | **1,582,477** | **—** | **1,582,218** | **—** | **1,582,218** |
| Customer accounts | **21,823,507** | **—** | **21,912,519** | **—** | **21,912,519** |
| Repurchase agreements – non-trading | **2,999** | **—** | **2,999** | **—** | **2,999** |
| Debt securities in issue | **2,490,371** | **—** | **2,459,605** | **—** | **2,459,605** |
| At 31 Dec 2017 | | | | | |
| Assets | | | | | |
| Loans and advances to banks | 6,203,202 | — | 6,194,592 | — | 6,194,592 |
| Loans and advances to customers | 18,316,780 | — | — | 18,155,119 | 18,155,119 |
| Reverse repurchase agreements – non-trading | 1,387,254 | — | 1,387,254 | — | 1,387,254 |
| Liabilities | | | | | |
| Deposits by banks | 1,798,474 | — | 1,797,266 | — | 1,797,266 |
| Customer accounts | 22,583,649 | — | 22,793,255 | — | 22,793,255 |
| Debt securities in issue | 2,092,390 | — | 2,028,795 | — | 2,028,795 |

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

### Valuation

The fair value measurement is the group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available.

#### Loans and advances to banks and customers

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

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

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

#### Financial investments

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

#### Deposits by banks and customer accounts

Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is approximated by its carrying value.

#### Debt securities in issue and subordinated liabilities

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

### Repurchase and reverse repurchase agreements – non-trading

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

### Debt securities

Subject to available quotes, the group uses composite market data to price debt securities at FVOCI. This is applicable to High Quality Liquid Assets (HQLA) portfolio. For local currency bonds, where such market data is not available, verified internal valuation models are used for valuations. These are normally Local Government and Central bank securities issued in their local currencies and uses market data published by the issuing entities.

## 13 Derivatives

Notional contract amounts and fair values of derivatives by product contract type held by the group

| | Notional contract amount | | Fair value – Assets | | | Fair value – Liabilities | | |
|---|---|---|---|---|---|---|---|---|
| | Trading | Hedging | Trading | Hedging | Total | Trading | Hedging | Total |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Foreign exchange | **80,982,182** | **1,922,755** | **413,613** | **23,240** | **436,853** | **448,502** | **59** | **448,561** |
| Interest rate | **52,054,524** | **5,749,262** | **436,043** | **43,973** | **480,016** | **445,607** | **21,899** | **467,506** |
| Equities | **3,740** | **—** | **442** | **—** | **442** | **442** | **—** | **442** |
| Credit | **96,339** | **—** | **807** | **—** | **807** | **326** | **—** | **326** |
| Commodity and other | **686,791** | **—** | **35,104** | **—** | **35,104** | **35,141** | **—** | **35,141** |
| **At 31 Dec 2018** | **133,823,576** | **7,672,017** | **886,009** | **67,213** | **953,222** | **930,018** | **21,958** | **951,976** |
| | | | | | | | | |
| Foreign exchange | 66,715,598 | 1,346,629 | 484,842 | 4,424 | 489,266 | 498,264 | 24 | 498,288 |
| Interest rate | 46,525,580 | 4,354,726 | 415,242 | 22,697 | 437,939 | 410,801 | 7,555 | 418,356 |
| Equities | 52,036 | — | 685 | — | 685 | 685 | — | 685 |
| Credit | 217,634 | — | 857 | — | 857 | 234 | — | 234 |
| Commodity and other | 1,168,608 | — | 34,355 | — | 34,355 | 34,769 | — | 34,769 |
| At 31 Dec 2017 | 114,679,456 | 5,701,355 | 935,981 | 27,121 | 963,102 | 944,753 | 7,579 | 952,332 |

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

## Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio risks arising from client business and to manage and hedge the group's own risks.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels. When entering into derivative transactions, the group employs the same credit risk management framework to assess and approve potential credit exposures that it uses for traditional lending.

## Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities include market-making and risk management. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume. Risk management activity is undertaken to manage the risk arising from client transactions, with the principal purpose of retaining client margin. Other derivatives classified as held for trading include non-qualifying hedging derivatives.

### Derivatives valued using models with unobservable inputs

The difference between the fair value at initial recognition (the transaction price) and the value that would have been derived had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is nil (2017: nil).

## Hedge accounting derivatives

### Fair value hedges

The group enters into to fixed-for-floating-interest-rate swaps to manage the exposure to changes in fair value due to movements in market interest rates on certain fixed rate financial instruments which are not measured at fair value through profit or loss, including debt securities held and issued.

Hedging instrument by hedged risk

| | Hedging Instrument | | | | |
|---|---|---|---|---|---|
| | | Carrying amount | | | |
| | Notional amount[1] | Assets | Liabilities | Balance sheet presentation | Change in fair value[2] |
| Hedged Risk | US$000 | US$000 | US$000 | | US$000 |
| Interest rate | **1,680,150** | **11,688** | **9,029** | **Derivatives** | **(5,835)** |
| **At 31 Dec 2018** | **1,680,150** | **11,688** | **9,029** | | **(5,835)** |

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

## Hedged item by hedged risk

| | Hedged Item | | | | | | In-effectiveness | |
|---|---|---|---|---|---|---|---|---|
| | Carrying amount | | Accumulated fair value hedge adjustments included in carrying amount | | | Change in fair value[1] | Recognised in profit and loss | |
| | Assets | Liabilities | Assets | Liabilities | Balance sheet presentation | | | Profit and loss presentation |
| Hedged Risk | $000 | $000 | $000 | $000 | | $000 | $000 | |
| Interest rate | **1,202,221** | **–** | **(11,716)** | **–** | **FVOCI** | **5,345** | | |
| Interest rate | **–** | **–** | **–** | **–** | **L&A to Bank** | **(267)** | | **Net income from financial instruments held for trading or managed on a fair value basis** |
| Interest rate | **–** | **–** | **–** | **–** | **L&A to Cust** | **404** | **(33)** | |
| Interest rate | **–** | **119,169** | **–** | **2,506** | **Debt issued** | **936** | | |
| Interest rate | **–** | **259,910** | **–** | **–** | **Depo by Bank** | **(616)** | | |
| **At 31 Dec 2018** | **1,202,221** | **379,079** | **(11,716)** | **2,506** | | **5,802** | **(33)** | |

*1 Used in effectiveness assessment; comprising amount attributable to the designated hedged risk that can be a risk component.*
*The hedged item is either the benchmark interest rate risk portion within the fixed rate of the hedged item or the full fixed rate and it is hedged for changes in fair value due to changes in the benchmark interest rate risk.*

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

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

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

### Cash flow hedges

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

The group applies macro cash flow hedging for interest-rate risk exposures on portfolios of replenishing current and forecasted issuances of non-trading assets and liabilities that bear interest at variable rates, including rolling such instruments. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate cash flows representing both principal balances and interest cash flows across all portfolios are used to determine the effectiveness and ineffectiveness. Macro cash flow hedges are considered to be dynamic hedges.

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

## Hedging instrument by hedged risk

| | Hedging Instrument | | | | | Hedged Item | Ineffectiveness | |
|---|---|---|---|---|---|---|---|---|
| | | Carrying amount | | | Change in fair value[2] | Change in fair value[3] | Recognised in profit and loss | |
| | Notional amount[1] | Assets | Liabilities | Balance sheet presentation | | | | Profit and loss presentation |
| Hedged Risk | $000 | $000 | $000 | | $000 | $000 | $000 | |
| Foreign currency | **1,922,755** | **23,240** | **59** | **Derivatives** | **(1,041)** | **–** | **(5)** | **Net income from financial instruments held for trading or managed on a fair value basis** |
| Interest rate | **4,069,112** | **32,285** | **12,870** | **Derivatives** | **(12,340)** | **(13,208)** | **178** | |
| **At 31 Dec 2018** | **5,991,867** | **55,525** | **12,929** | | **(13,381)** | **(13,208)** | **173** | |

*1. The notional contract amounts of derivatives designated in qualifying hedge accounting relationships indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.*
*2. Used in effectiveness testing; comprising the full fair value change of the hedging instrument not excluding any component.*
*3. Used in effectiveness assessment; comprising amount attributable to the designated hedged risk that can be a risk component.*

# 14 Financial investments

## Carrying amount of financial investments

| | Footnotes | 2018 | 2017 |
|---|---|---|---|
| | | US$000 | US$000 |
| **Financial investment measured at fair value through other comprehensive income** | | | |
| Treasury and other eligible bills | | **1,495,474** | 1,326,312 |
| Debt securities | | **4,200,099** | 5,301,959 |
| Equity securities[1] | 1 | **39,203** | 118,233 |
| **At 31 Dec** | | **5,734,776** | 6,746,504 |

*1 The dividends recognised on these investments during the year were US$ 0.757 million (2017: US$ Nil).*

## 15 Assets charged as security for liabilities, and collateral accepted as security for assets

### Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is US$917 million (2017: US$1,410 million). The fair value of any such collateral sold or repledged is nil (2017: nil). The group is obliged to return these assets. These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.

The fair value of assets pledged as collateral but that do not qualify for derecognition is US$3 million (2017: nil).

## 16 Interests in associates and joint arrangement

### Associates of the group

| | At 31 Dec 2018 | | | |
|---|---|---|---|---|
| | **Country of incorporation** | **Principal activity** | **The group's interest in equity capital** | **Issued equity capital** |
| MENA Infrastructure Fund (GP) Limited | **Dubai, UAE** | **Private Equity fund management** | **33.33%** | **US$0.99 million fully paid** |

The above associate is not considered significant to the group and is unlisted.

#### Summarised financial information in respect of associates not individually significant

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| Carrying value | **2,423** | 1,948 |
| The group's share of | | |
| – assets | **2,629** | 2,180 |
| – liabilities | **206** | 232 |
| – profit or loss from continuing operations | **475** | 290 |
| – total comprehensive income | **475** | 290 |

#### Movements in interests in associates

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| At 1 Jan | **1,948** | 1,658 |
| Disposals | **—** | — |
| Share of results | **475** | 290 |
| Dividends | **—** | — |
| Other movements and foreign exchange | **—** | — |
| Reclassification from associate to joint operation | **—** | — |
| **At 31 Dec** | **2,423** | 1,948 |

### Joint arrangement of the group

| | At 31 Dec 2018 | | | |
|---|---|---|---|---|
| | **Country of incorporation** | **Principal activity** | **The group's interest in equity capital** | **Issued equity capital** |
| HSBC Middle East Leasing Partnership - (Joint operation) | **Dubai, UAE** | **Leasing** | **15.00%** | **US$621 million fully paid** |

## 17 Investments in subsidiaries

#### Subsidiary undertakings of the bank

| | At 31 Dec 2018 | |
|---|---|---|
| | **Country of incorporation or registration** | **Bank's interest in equity capital** |
| HSBC Financial Services (Middle East) Limited (in liquidation) | **Dubai, UAE** | **100%** |
| HSBC Middle East Finance Company Limited | **Dubai, UAE** | **80%** |
| HSBC Middle East Securities LLC | **Dubai, UAE** | **100%** |
| HSBC Insurance Services (Lebanon) S.A.L. (in liquidation) | **Lebanon** | **100%** |
| HSBC Bank Middle East Representative Office Morocco S.A.R.L. | **Morocco** | **100%** |

*All the above prepare their financial statements up to 31 December and the countries of operation are the same as the countries of incorporation.*

The subsidiary undertakings are unlisted, directly owned and are included in the consolidated financial statements of the group.

In order to comply with local legal requirements, the ownership of the investment in HSBC Middle East Securities LLC is held 49.00% in the name of the bank and 51.00% in the personal name of Mr. Abdul Wahid Al Ulama, as nominee. Under a Memorandum of Understanding, the nominee has transferred his legal and/or beneficial interest in HSBC Middle East Securities LLC to the bank. The total book value of the assets of HSBC Middle East Securities LLC amount to US$3.5 million (2017: US$3.2 million).

## 18 Prepayments, accrued income and other assets

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| Prepayments and accrued income | **185,504** | 82,271 |
| Endorsements and acceptances | **505,981** | 461,318 |
| Other accounts | **179,579** | 66,065 |
| Property, plant and equipment* | **299,003** | 48,240 |
| **At 31 Dec** | **1,170,067** | 657,894 |

*Increase in property, plant and equipment is mainly from the acquisition of HSBC Tower US$ 252million in 2018.

## 19 Assets held for sale and liabilities of disposal groups held for sale and intangible assets

### Disposal groups - Lebanon

On 16 November 2016, the bank entered into an agreement with BLOM BANK S.A.L. to sell the banking operations in Lebanon and on 16 June 2017 completed the disposal.

### Intangible Assets

Included within intangible assets is internally generated software with a net carrying value of US$29 million (2017: US$5 million).

During the year, capitalisation of internally generated software was US$27 million (2017: US$6 million) and amortisation was US$4 million (2017: US$3 million).

## 20 Trading liabilities

The sale of borrowed securities is classified as trading liabilities.

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| Deposits by banks | **–** | 6,457 |
| Customer accounts | **9,964** | 1,743 |
| Other debt securities in issue (Note 22) | **–** | 1,267,800 |
| Other liabilities – net short positions in securities | **49,059** | 33,860 |
| **At 31 Dec** | **59,023** | 1,309,860 |

## 21 Financial liabilities designated at fair value

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| Deposits by bank and customer accounts | **259,853** | – |
| Debt securities in issue (Note 22) | **1,758,113** | 739,425 |
| Total | **2,017,966** | 739,425 |

At 31 December 2018, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of US$ 18.8 million (2017: US$2.8 million loss).

## 22 Debt securities in issue

| | **2018** | | 2017 | |
|---|---|---|---|---|
| | **Carrying amount** | **Fair value** | Carrying amount | Fair value |
| | **US$000** | **US$000** | US$000 | US$000 |
| Medium-term notes | **3,298,484** | **3,298,303** | 3,149,615 | 3,150,286 |
| Non-equity preference shares | **950,000** | **919,415** | 950,000 | 885,734 |
| Total debt securities in issue | **4,248,484** | **4,217,718** | 4,099,615 | 4,036,020 |
| Included within: | | | | |
| – trading liabilities (Note 20) | **–** | **–** | (1,267,800) | (1,267,800) |
| – financial liabilities designated at fair value (Note 21) | **(1,758,113)** | **(1,758,113)** | (739,425) | (739,425) |
| **At 31 Dec** | **2,490,371** | **2,459,605** | 2,092,390 | 2,028,795 |

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

## Non-equity preference share capital

### Authorised

The authorised non-equity preference share capital of the bank at 31 December 2018 and 31 December 2017 was 1,125,000 dated preference shares of US$1.00 each and 225,000 undated preference shares of US$1.00 each.

### Issued

#### Undated preference shares

| Issue number | Issue date | Undated preference shares | Preference dividends | Redeemable at the option of the bank on any date after |
|---|---|---|---|---|
| | | Number | % | Date |
| 1 | 29 October 1997 | 50,000 | 12 month US dollar LIBOR + 0.35 | 30 October 2002 |
| 2 | 1 April 1998 | 25,000 | 12 month US dollar LIBOR + 0.70 | 2 April 2003 |
| 6 | 14 March 2006 | 150,000 | 12 month US dollar LIBOR + 0.65 | 15 March 2011 |

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

#### Dated preference shares

| Issue number | Issue date | Dated preference shares | Preference dividends | Redeemable at the option of the bank on any date after |
|---|---|---|---|---|
| | | Number | % | Date |
| 11 | 16 December 2014 | 250,000 | 3 month US dollar LIBOR + 2.40 | 16 December 2019 |
| 11 | 16 December 2014 | 250,000 | 3 month US dollar LIBOR + 2.70 | 16 December 2024 |
| 12 | 30 December 2014 | 225,000 | 3 month US dollar LIBOR + 2.70 | 30 December 2024 |

1 *The dated preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*
2 *Preference dividends are payable quarterly on the issue price of each dated share.*
3 *Redemption of the dated preference shares, other than at the option of the bank, will be subject to the approval of the ordinary shareholders of the bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the Bank without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*
4 *In the event of a winding up, the preference shareholders would receive, in priority to the ordinary shareholders of the bank, repayment of US$1,000 per share, plus an amount equal to any accrued but unpaid dividends. With the exception of the above, the preference shares do not carry any right to participate in the surplus of assets on a winding up.*

## 23 Accruals, deferred income and other liabilities

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| Accruals and deferred income | **222,860** | 194,893 |
| Share-based payments liability to HSBC Holdings plc | **14,216** | 16,981 |
| Endorsements and acceptances | **506,465** | 461,318 |
| Employee benefit liabilities (Note 5) | **168,261** | 175,445 |
| Other liabilities | **703,378** | 771,056 |
| **At 31 Dec** | **1,615,180** | 1,619,693 |

## 24 Provisions

| | Restructuring costs | Contractual commitments | Legal proceedings and regulatory matters | Customer remediation | Other provisions | Total |
|---|---|---|---|---|---|---|
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **At 1 Jan 2018** | **6,762** | **15,631** | **27,352** | **238** | **21,625** | **71,608** |
| Impact on transition to IFRS 9 | **—** | **36,418** | **—** | **—** | **—** | **36,418** |
| Additions | **5,068** | **—** | **8,288** | **—** | **1,214** | **14,570** |
| Amounts utilised | **(4,468)** | **—** | **(18,296)** | **(187)** | **(5,196)** | **(28,147)** |
| Unused amounts reversed | **(3,174)** | **—** | **(2,332)** | **(29)** | **(898)** | **(6,433)** |
| Net Change in expected credit loss provision | **—** | **(18,873)** | **—** | **—** | **—** | **(18,873)** |
| Exchange and other movements | **—** | **(138)** | **94** | **—** | **(2,948)** | **(2,992)** |
| **At 31 Dec 2018** | **4,188** | **33,038** | **15,106** | **22** | **13,797** | **66,151** |
| | | | | | | |
| At 1 Jan 2017 | 5,032 | 8,391 | 7,420 | 3,150 | 19,796 | 43,789 |
| Additions | 6,749 | 8,193 | 21,715 | 375 | 11,109 | 48,141 |
| Amounts utilised | (3,623) | — | (849) | (690) | (8,888) | (14,050) |
| Unused amounts reversed | (1,398) | — | (1,580) | (2,597) | (89) | (5,664) |
| Exchange and other movements | 2 | (953) | 646 | — | (303) | (608) |
| At 31 Dec 2017 | 6,762 | 15,631 | 27,352 | 238 | 21,625 | 71,608 |

## 25 Maturity analysis of assets, liabilities and off-balance sheet commitments

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

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

### Maturity analysis of assets and liabilities

| | **At 31 Dec 2018** | | | At 31 Dec 2017 | | |
|---|---|---|---|---|---|---|
| | **Due within 1 year** | **Due after 1 year** | **Total** | Due within 1 year | Due after 1 year | Total |
| | **US$000** | **US$000** | **US$000** | US$000 | US$000 | US$000 |
| **Financial assets** | | | | | | |
| Loans and advances to banks | **4,464,847** | **592,461** | **5,057,308** | 6,047,593 | 155,609 | 6,203,202 |
| Loans and advances to customers | **10,367,959** | **9,705,416** | **20,073,375** | 9,956,254 | 8,360,526 | 18,316,780 |
| Reverse repurchase agreements – non-trading | **475,555** | **279,521** | **755,076** | 1,387,254 | — | 1,387,254 |
| Financial investments | **3,257,430** | **2,477,346** | **5,734,776** | 4,444,066 | 2,302,438 | 6,746,504 |
| Other financial assets | **850,443** | **3,759** | **854,202** | 525,120 | 2,227 | 527,347 |
| | **19,416,234** | **13,058,503** | **32,474,737** | 22,360,287 | 10,820,800 | 33,181,087 |
| **Financial liabilities** | | | | | | |
| Deposits by banks | **882,629** | **699,848** | **1,582,477** | 1,638,836 | 159,638 | 1,798,474 |
| Customer accounts | **21,755,312** | **68,195** | **21,823,507** | 22,561,753 | 21,896 | 22,583,649 |
| Financial liabilities designated at fair value | **1,073,802** | **944,164** | **2,017,966** | — | 739,425 | 739,425 |
| Debt securities in issue | **955,723** | **1,534,648** | **2,490,371** | 594,783 | 1,497,607 | 2,092,390 |
| Other financial liabilities | **1,325,857** | **2,416** | **1,328,273** | 1,205,108 | 27,153 | 1,232,261 |
| | **25,993,323** | **3,249,271** | **29,242,594** | 26,000,480 | 2,445,719 | 28,446,199 |

Cash flows payable by the group under financial liabilities by remaining contractual maturities

| | On demand | Due within 3 months | Due between 3 and 12 months | Due between 1 and 5 years | Due after 5 years |
|---|---|---|---|---|---|
| | US$000 | US$000 | US$000 | US$000 | US$000 |
| Deposits by banks | **236,197** | **1,122,269** | **203,919** | **767,452** | **–** |
| Customer accounts | **18,239,733** | **1,839,448** | **1,710,561** | **69,211** | **–** |
| Trading liabilities | **59,023** | **–** | **–** | **–** | **–** |
| Financial liabilities designated at fair value | **–** | **46,133** | **1,046,993** | **732,209** | **243,307** |
| Derivatives | **930,009** | **2,722** | **4,907** | **14,329** | **–** |
| Debt securities in issue | **225,000** | **324,054** | **463,917** | **1,073,248** | **475,000** |
| Other financial liabilities | **398,444** | **1,129,190** | **106,151** | **3,759** | **–** |
| | **20,088,406** | **4,463,816** | **3,536,448** | **2,660,208** | **718,307** |
| Loan and other credit-related commitments | **15,896,909** | **8,330** | **1,181** | **–** | **–** |
| Financial guarantees and similar contracts | **6,369,554** | **–** | **–** | **–** | **–** |
| **At 31 Dec 2018** | **42,354,869** | **4,472,146** | **3,537,629** | **2,660,208** | **718,307** |
| | | | | | |
| Deposits by banks | 1,365,333 | 128,275 | 148,739 | 166,599 | – |
| Customer accounts | 19,600,841 | 1,717,815 | 1,247,771 | 22,252 | – |
| Trading liabilities | 1,309,860 | – | – | – | – |
| Financial liabilities designated at fair value | – | 6,298 | 30,447 | 764,184 | – |
| Derivatives | 944,753 | 236 | 845 | 6,498 | – |
| Debt securities in issue | 225,000 | 349,935 | 20,365 | 774,672 | 725,000 |
| Other financial liabilities | 902,077 | 406,058 | 128,081 | 27,148 | – |
| | 24,347,864 | 2,608,617 | 1,576,248 | 1,761,353 | 725,000 |
| Loan and other credit-related commitments | 3,135,419 | 5,037,874 | 6,318,227 | 1,397,841 | 1,042,070 |
| Financial guarantees and similar contracts | 6,816,340 | – | – | – | – |
| At 31 Dec 2017 | 34,299,623 | 7,646,491 | 7,894,475 | 3,159,194 | 1,767,070 |

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

Further discussion of the group's liquidity and funding management can be found in Note 31 'Risk management'.

## 26 Offsetting of financial assets and financial liabilities

The 'Amounts not set off in the balance sheet' include transactions where:

- the counterparty has an offsetting exposure with the group and a master netting or similar arrangement is in place with a right to set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- in the case of derivatives and reverse repurchase/repurchase, stock borrowing/lending and similar agreements, cash and non-cash collateral has been received/pledged.

For risk management purposes, the net amounts of loans and advances to customers are subject to limits, which are monitored and the relevant customer agreements are subject to review and updated, as necessary, to ensure that the legal right to set off remains appropriate.

| | Amounts subject to enforceable netting arrangements | | | | |
|---|---|---|---|---|---|
| | | | | Amounts not set off in the balance sheet | |
| | Gross amounts | Amounts offset | Net amounts in the balance sheet | Cash collateral | Net amount |
| | US$000 | US$000 | US$000 | US$000 | US$000 |
| **Financial assets** | | | | | |
| Derivatives (Note 13) | **953,222** | **–** | **953,222** | **–** | **953,222** |
| Reverse repos, securities borrowing and similar agreements classified as: | **755,076** | **–** | **755,076** | **–** | **755,076** |
| – loans and advances to banks and customers at amortised cost | **755,076** | **–** | **755,076** | **–** | **755,076** |
| Loans and advances to customers excluding reverse repos at amortised cost | **536,026** | **–** | **536,026** | **(161,515)** | **374,511** |
| **At 31 Dec 2018** | **2,244,324** | **–** | **2,244,324** | **(161,515)** | **2,082,809** |
| Derivatives (Note 13) | 963,102 | – | 963,102 | – | 963,102 |
| Reverse repos, securities borrowing and similar agreements classified as: | 1,387,254 | – | 1,387,254 | – | 1,387,254 |
| – loans and advances to banks and customers at amortised cost | 1,387,254 | – | 1,387,254 | – | 1,387,254 |
| Loans and advances to customers excluding reverse repos at amortised cost | 581,219 | – | 581,219 | (103,251) | 477,968 |
| At 31 Dec 2017 | 2,931,575 | – | 2,931,575 | (103,251) | 2,828,324 |
| **Financial liabilities** | | | | | |
| Derivatives (Note 13) | **951,976** | **–** | **951,976** | **–** | **951,976** |
| **At 31 Dec 2018** | **951,976** | **–** | **951,976** | **–** | **951,976** |
| Derivatives (Note 13) | 952,332 | – | 952,332 | – | 952,332 |
| At 31 Dec 2017 | 952,332 | – | 952,332 | – | 952,332 |

## 27 Foreign exchange exposure

### Structural foreign exchange exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiaries, branches and associates with non-US dollar functional currencies. Gains or losses on structural foreign exchange exposures are recognised in other comprehensive income.

The main operating currencies of the group are UAE dirham and other Gulf currencies that are linked to the US dollar.

The group's management of structural foreign currency exposures is discussed in Note 30 'Risk management'.

#### Net structural foreign currency exposures

Currency of structural exposure

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| Algerian dinar | **147,528** | 151,586 |
| Bahraini dinar | **78,546** | 79,160 |
| Kuwaiti dinar | **209,635** | 198,260 |
| Lebanese pound | **318** | 345 |
| Moroccan dirham | **156** | 117 |
| Qatari riyal | **339,403** | 374,482 |
| UAE dirham | **2,184,991** | 2,054,022 |
| **Total** | **2,960,577** | 2,857,972 |

## 28 Called up share capital and share premium

### Authorised

The authorised ordinary share capital of the Bank at 31 December 2018 was 1,500,000,000 (2017: 1,500,000,000) ordinary shares[1] of US$1.00 each.

### Called up share capital and share premium

Issued and fully paid

| | | 2018 | | 2017 | |
|---|---|---|---|---|---|
| | *Footnotes* | Number | US$000 | Number | US$000 |
| **At 1 Jan** | | **931,055,001** | **931,055** | 931,055,000 | 931,055 |
| Shares issued | *2* | **–** | **–** | 1 | – |
| **At 31 Dec** | *1* | **931,055,001** | **931,055** | 931,055,001 | 931,055 |

### Share premium

| | Footnotes | 2018 US$000 | 2017 US$000 |
|---|---|---|---|
| **At 31 Dec** | 2 | **61,346** | 61,346 |

### Total called up share capital and share premium

| | Footnotes | 2018 US$000 | 2017 US$000 |
|---|---|---|---|
| **At 31 Dec** | 2 | **992,401** | 992,401 |

*1 All ordinary shares in issue confer identical rights, including in respect of capital, dividends and voting.*
*2 On 29 June 2017 (the 'transaction date'), the bank acquired 10.01% stake in HSBC Bank A.S. in Turkey from HSBC Bank plc. The acquisition was settled through the issuance of one ordinary share, which was allotted to its sole shareholder, HSBC Middle East Holdings BV, with a nominal value of US$1.00, at a premium of US$61.3 million recognised as share premium account as at the transaction date.*

## 29 Notes on the statement of cash flows

### Non-cash items included in profit before tax

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Depreciation, amortisation and impairment | **20,153** | 19,027 |
| Share-based payment expense | **11,031** | 9,836 |
| Change in expected credit losses and other credit impairment charges | **145,398** | N/A |
| Loan impairment losses gross of recoveries and other credit risk provisions | **N/A** | 149,912 |
| Provisions including pensions | **36,732** | 42,477 |
| Impairment of financial investments | **N/A** | 2,660 |
| Other non-cash items included in profit before tax | **28,108** | 26,744 |
| | **241,422** | 250,656 |

### Change in operating assets

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Change in other assets | **(229,983)** | 863,639 |
| Change in net trading securities and net derivatives | **(2,770,995)** | (545,480) |
| Change in loans and advances to banks and customers | **(1,683,279)** | 1,178,527 |
| Change in reverse repurchase agreements – non-trading | **666,044** | (336,411) |
| Change in mandatory deposits at central banks | **20,599** | 300,003 |
| Change in financial assets designated at fair value | **(47,839)** | — |
| | **(4,045,453)** | 1,460,278 |

### Change in operating liabilities

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Change in other liabilities | **(14,051)** | (832,197) |
| Change in deposits by banks and customer accounts | **(976,138)** | (1,453,458) |
| Change in debt securities in issue | **397,981** | (553,093) |
| Change in financial liabilities designated at fair value | **1,278,541** | 337,833 |
| Change in provisions | **—** | (14,050) |
| Change in repurchase agreements – non-trading | **2,999** | — |
| | **689,332** | (2,514,965) |

### Cash and cash equivalents

| | 2018 US$000 | 2017 US$000 |
|---|---|---|
| Cash and balances at central banks | **1,170,359** | 671,440 |
| Items in the course of collection from other banks | **81,984** | 64,419 |
| Loans and advances to banks of one month or less | **2,538,093** | 3,345,397 |
| Reverse repurchase agreement with banks of one month or less | **33,866** | 43,921 |
| Treasury bills, other bills and certificates of deposit less than three months | **38,261** | 1,762,411 |
| Less: items in the course of transmission to other banks | **(263,907)** | (87,502) |
| Less: mandatory deposits at central banks * | **(1,918,699)** | (1,939,298) |
| **Total cash and cash equivalents** | **1,679,957** | 3,860,788 |

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

Total interest paid by the group during the year was US$110 million (2017: US$129 million). Total interest received by the group during the year was US$938 million (2017: US$1,067 million). Total dividends received by the group during the year were US$6.6million (2017: US$4 million).

## 30 Effect of reclassification upon adoption of IFRS 9

Reconciliation of consolidated balance sheet at 31 December 2017 and 1 January 2018

| | Footnotes | IAS 39 measurement category | IFRS 9 measurement category | IAS 39 carrying amount at 31 Dec 2017 | Other changes in classification | IFRS 9 reclassification to: Fair value through profit and loss | IFRS 9 reclassification to: Fair value through other comprehensive income | IFRS 9 reclassification to: Amortised cost | Carrying amount post reclassification | IFRS 9 re-measurement including expected credit losses[2] | IFRS 9 carrying amount at 1 Jan 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **Assets** | | | | | | | | | | | |
| Cash and balances at central banks | | Amortised cost | **Amortised cost** | **671,440** | **—** | **—** | **—** | **—** | **671,440** | **(163)** | **671,277** |
| Items in the course of collection from other banks | | Amortised cost | **Amortised cost** | **64,419** | **—** | **—** | **—** | **—** | **64,419** | **—** | **64,419** |
| Trading assets | 1 | FVPL | **FVPL** | **440,624** | **(203)** | **—** | **—** | **—** | **440,421** | **—** | **440,421** |
| Financial assets designated and otherwise mandatorily measured at fair value through profit or loss | 2 | FVPL | **FVPL** | **—** | **—** | **58,140** | **—** | **—** | **58,140** | **—** | **58,140** |
| Derivatives | | FVPL | **FVPL** | **963,102** | **—** | **—** | **—** | **—** | **963,102** | **—** | **963,102** |
| Loans and advances to banks | | Amortised cost | **Amortised cost** | **6,203,202** | **—** | **—** | **—** | **—** | **6,203,202** | **(826)** | **6,202,376** |
| Loans and advances to customers | | Amortised cost | **Amortised cost** | **18,316,780** | **—** | **—** | **—** | **—** | **18,316,780** | **(78,142)** | **18,238,638** |
| Reverse repurchase agreements – non-trading | | Amortised cost | **Amortised cost** | **1,387,254** | **—** | **—** | **—** | **—** | **1,387,254** | **—** | **1,387,254** |
| Financial investments | 2,3 | FVOCI (Available for sale – equity instruments) | **FVOCI** | **6,746,504** | **—** | **(58,140)** | **—** | **—** | **6,688,364** | **—** | **6,688,364** |
| Prepayments, accrued income and other assets | 1 | Amortised cost | **Amortised cost** | **657,894** | **203** | **—** | **—** | **—** | **658,097** | **(509)** | **657,588** |
| Current tax assets | | N/A | **N/A** | **1,383** | **—** | **—** | **—** | **—** | **1,383** | **—** | **1,383** |
| Interests in associates and joint ventures | | N/A | **N/A** | **1,948** | **—** | **—** | **—** | **—** | **1,948** | **—** | **1,948** |
| Intangible assets | | N/A | **N/A** | **10,502** | **—** | **—** | **—** | **—** | **10,502** | **—** | **10,502** |
| Deferred tax assets | | N/A | **N/A** | **205,857** | **—** | **—** | **—** | **—** | **205,857** | **10,683** | **216,540** |
| **Total assets** | | | | **35,670,909** | **—** | **—** | **—** | **—** | **35,670,909** | **(68,957)** | **35,601,952** |

## Footnotes to Effect of reclassification upon adoption of IFRS 9

1 *Settlement accounts of US$0.2 million have been reclassified from 'Trading assets' to 'Prepayments, accrued income and other assets' as a result of the assessment of business model in accordance with IFRS 9. Settlement accounts previously presented as 'Trading liabilities' of US$1.7 million have been represented in 'Accruals, deferred income and other liabilities'. This change in presentation for financial liabilities is considered to provide more relevant information, given the change in presentation for the financial assets. These changes in presentation for financial assets and liabilities have had no effect on measurement of these items and therefore on 'Retained earnings'.*

2 *US$58.1 million of available for sale non-traded equity instruments have been reclassified as 'Financial assets designated and otherwise mandatorily measured at fair value through profit or loss' in accordance with IFRS 9.*

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

Reconciliation for consolidated balance sheet at 31 December 2017 and 1 January 2018 (continued)

| | Footnotes | IAS 39 measure-ment category | IFRS 9 measure-ment category | IAS 39 carrying amount at 31 Dec 2017 | Other changes in classif-ication | IFRS 9 reclassification to: Fair value through profit and loss | IFRS 9 reclassification to: Fair value through other compre-hensive income | IFRS 9 reclassification to: Amortised cost | Carrying amount post reclassi-fication | IFRS 9 remeasure-ment including expected credit losses[2] | IFRS 9 carrying amount at 1 Jan 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **Liabilities** | | | | | | | | | | | |
| Deposits by banks | | Amortised cost | Amortised cost | 1,798,474 | – | – | – | – | 1,798,474 | – | 1,798,474 |
| Customer accounts | | Amortised cost | Amortised cost | 22,583,649 | – | – | – | – | 22,583,649 | – | 22,583,649 |
| Items in the course of transmission to other banks | | Amortised cost | Amortised cost | 87,502 | – | – | – | – | 87,502 | – | 87,502 |
| Trading liabilities | 4,5 | FVPL | FVPL | 1,309,860 | (1,269,543) | – | – | – | 40,317 | – | 40,317 |
| Financial liabilities designated at fair value | 5 | FVPL | FVPL | 739,425 | 1,267,800 | – | – | – | 2,007,225 | – | 2,007,225 |
| Derivatives | | FVPL | FVPL | 952,332 | – | – | – | – | 952,332 | – | 952,332 |
| Debt securities in issue | | Amortised cost | Amortised cost | 2,092,390 | – | – | – | – | 2,092,390 | – | 2,092,390 |
| Accruals, deferred income and other liabilities | 4 | Amortised cost | Amortised cost | 1,619,693 | 1,743 | – | – | – | 1,621,436 | – | 1,621,436 |
| Current tax liabilities | | N/A | N/A | 110,141 | – | – | – | – | 110,141 | – | 110,141 |
| Provisions | | N/A | N/A | 71,608 | – | – | – | – | 71,608 | 36,418 | 108,026 |
| **Total liabilities** | | | | 31,365,074 | – | – | – | – | 31,365,074 | 36,418 | 31,401,492 |

| | Footnotes | IAS 39 carrying amount at 31 Dec 2017 | IFRS 9 reclassification | Carrying amount post reclassification | IFRS 9 remeasurement including expected credit losses | Carrying amount at 1 Jan 2018 |
|---|---|---|---|---|---|---|
| | | US$000 | US$000 | US$000 | US$000 | US$000 |
| **Equity** | | | | | | |
| Called up share capital | | 931,055 | – | 931,055 | – | 931,055 |
| Share premium account | | 61,346 | – | 61,346 | – | 61,346 |
| Other reserves | 5 | (132,153) | (14,000) | (146,153) | 1,275 | (144,878) |
| Retained earnings | | 3,441,349 | 14,000 | 3,455,349 | (106,650) | 3,348,699 |
| **Total Shareholders Equity** | | 4,301,597 | – | 4,301,597 | (105,375) | 4,196,222 |
| Non-controlling interests | | 4,238 | – | 4,238 | – | 4,238 |
| **Total equity** | | 4,305,835 | – | 4,305,835 | (105,375) | 4,200,460 |

## Footnotes to Effect of reclassification upon adoption of IFRS 9

4 *Settlement accounts of US$0.2 million have been reclassified from 'Trading assets' to 'Prepayments, accrued income and other assets' as a result of the assessment of business model in accordance with IFRS 9. Settlement accounts previously presented as 'Trading liabilities' of US$1.7 million have been represented in 'Accruals, deferred income and other liabilities'. This change in presentation for financial liabilities is considered to provide more relevant information, given the change in presentation for the financial assets. These changes in presentation for financial assets and liabilities have had no effect on measurement of these items and therefore on 'Retained earnings'.*

5 *We have considered market practices for the presentation of US$1,267.8 million of financial liabilities which contain both deposit and derivative components. We have concluded that a change in accounting policy and presentation from 'Trading liabilities' would be appropriate, since it would better align with the presentation of similar financial instruments by peers and therefore provide more relevant information about the effect of these financial liabilities on our financial position and performance. As a result, rather than being classified as held for trading, we will designate these financial liabilities as at fair value through profit or loss since they are managed and their performance evaluated on a fair value basis. Consequently, changes in fair value of these instruments attributable to changes in own credit risk are recognised in other comprehensive income rather than profit or loss. For the year ended to 31 December 2017, a restatement would have decreased 'Net income from financial instruments held for trading or managed on a fair value basis' by US$15.4 million, with an equivalent net increase in other comprehensive income.*

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

7 *IFRS 9 expected credit losses have decreased net assets by US$105.4 million principally comprising of US$78.1 million reduction in the carrying value of assets classified as 'Loans and advances to customers' and US$36.4 million increase in 'Provisions' relating to expected credit losses on loan commitments and financial guarantee contracts.*

Reconciliation of impairment allowance under IAS 39 and provision under IAS 37 to expected credit losses under IFRS 9

| | | Reclassification to | | | Remeasurement | | |
|---|---|---|---|---|---|---|---|
| | IAS 39 measurement category | Fair value through profit and loss | Fair value through other comprehensive income | Amortised cost | Stage 3 | Stage 1 & Stage 2 | Total |
| | | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **Financial assets at amortised cost** | | | | | | | |
| IAS 39 impairment allowance at 31 Dec 2017 | | | | | | | **1,071,499** |
| Cash and balances at central banks | **Amortised cost (Loans and receivables)** | **–** | **–** | **–** | **–** | **163** | **163** |
| Loans and advances to banks | **Amortised cost (Loans and receivables)** | **–** | **–** | **–** | **–** | **826** | **826** |
| Loans and advances to customers | **Amortised cost (Loans and receivables)** | **–** | **–** | **–** | **67,646** | **10,496** | **78,142** |
| Prepayments, accrued income and other assets | **Amortised cost (Loans and receivables)** | **–** | **–** | **–** | **–** | **509** | **509** |
| **Expected credit loss allowance at 1 Jan 2018** | | | | | | | **1,151,139** |
| **Financial assets at fair value** | | | | | | | |
| IAS 39 impairment allowance at 31 Dec 2017 | | | | | | | **–** |
| Debt instruments at fair value | **N/A** | **N/A** | **1,275** | **N/A** | **N/A** | **N/A** | **1,275** |
| **Expected credit loss allowance at 1 Jan 2018** | | | | | | | **1,275** |
| **Loan commitments and financial guarantee contracts** | | | | | | | |
| IAS 37 provisions at 31 Dec 2017 | | | | | | | **15,631** |
| Provisions (loan commitments and financial guarantees) | **N/A** | **N/A** | **N/A** | **N/A** | **(4,748)** | **41,166** | **36,418** |
| **Expected credit loss provision at 1 Jan 2018** | | | | | | | **52,049** |

## 31 Risk management

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

### Risk governance and ownership

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

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

In their oversight and stewardship of risk management at group level, RMM are supported by a dedicated Risk function headed by the Chief Risk Officer ('CRO'), who is a Chair of the RMM and reports to the Chief Executive Officer ('CEO') and functionally to the Europe CRO in the HSBC Group.

### Risk management tools

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

#### Risk appetite

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

Quantitative and qualitative metrics are organised under 15 categories, namely; returns, costs, capital, risk-weighted assets, liquidity and funding, loan impairments, exposure to the HSBC Group, credit and portfolio concentrations, market risk, operational risk, internal audit,

financial crime compliance, reputational risk, sustainability risk and technology infrastructure. Measurements against the metrics serve to:

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

### Risk map

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

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

### Top and emerging risks

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

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

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

### Stress testing

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

In addition to the HSBC Group-wide risk scenarios, the group conducts regular macroeconomic and event-driven scenario analyses specific to the region. The group is subject to regulatory stress testing in many jurisdictions within the region. These have increased both in frequency and in the granularity of information required by supervisors. Assessment by regulators is on both quantitative and qualitative bases, the latter focusing on portfolio quality, data provision, stress testing capability, forward-looking capital management processes and internal management processes.

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

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

## Risk culture

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

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

## Credit risk

### Credit risk management

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

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

- Controlling exposures to sovereign entities, banks and other financial institutions, as well as debt securities that are not held solely for the purpose of trading.

- Monitoring intra-HSBC Group exposures to ensure they are maintained within regulatory limits.
- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and applying local business knowledge. Transactions with countries deemed to be higher risk are considered case by case.

Within the group, the Credit Risk function is headed by the CRO. Its responsibilities include:

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

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

## Adoption of IFRS9 'Financial Instruments'

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

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

## IFRS 9 process

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

## Modelling

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

These were then enhanced or supplemented to address the IFRS9 requirements, with the appropriate governance and independent review.

## Implementation

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

## Governance

A series of Regional Management Review Forums has been established in key sites/regions in order to review and approve the impairment results. Regional Management Review Forums have representatives from Credit Risk and Finance including the regional Heads of Wholesale Credit and Market Risk and Retail Banking and Wealth Management ('RBWM') Risk, the regional business CFOs, the regional CROs and the regional Chief Accounting Officer are required members of the committee.

## Credit quality of financial instruments

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

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

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

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

## Impairment Assessment

It is the group's policy that each operating company creates allowances for impaired loans promptly and consistently.

For details of impairment policies on loans and advances and financial investments, see Note 2.2(i) on the Financial Statements.

### Write-off of loans and advances

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

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

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

### Refinance risk

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

## Summary of credit risk

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

The IFRS 9 allowance for ECL has decreased from US$ 1,203 million at 1 January 2018 to US$ 1,094 at 31 December 2018.

The IFRS 9 allowance for ECL at 31 December 2018 comprises US$ 1,061 million in respect of assets held at amortised cost, US$ 33 million in respect of loan commitments and financial guarantees.

#### Summary of financial instruments to which the impairment requirements in IFRS 9 are applied

| | **31 Dec 2018** | | At 1 Jan 2018 | |
|---|---|---|---|---|
| | **Gross carrying/ nominal amount** | **Allowance for ECL** | Gross carrying/ nominal amount | Allowance for ECL |
| | **US$000** | **US$000** | US$000 | US$000 |
| Loans and advances to customers at amortised cost | **21,132,610** | **(1,059,235)** | 19,388,279 | (1,149,641) |
| Loans and advances to banks at amortised cost | **5,058,866** | **(1,558)** | 6,203,202 | (826) |
| Other financial assets measured at amortised costs | **2,784,969** | **(632)** | 2,703,479 | (672) |
| – cash and balances at central banks | **1,170,499** | **(140)** | 671,440 | (163) |
| – items in the course of collection from other banks | **81,984** | **—** | 64,419 | — |
| – reverse repurchase agreements – non - trading | **755,084** | **(8)** | 1,387,254 | — |
| – prepayments, accrued income and other assets | **777,402** | **(484)** | 580,366 | (509) |
| **Total gross carrying amount on-balance sheet** | **28,976,445** | **(1,061,425)** | 28,294,960 | (1,151,139) |
| Loans and other credit related commitments | **5,648,633** | **(2,736)** | 6,970,326 | (5,452) |
| Financial guarantee and similar contracts | **14,416,716** | **(30,302)** | 14,361,374 | (46,597) |
| **Total nominal amount off-balance sheet** | **20,065,349** | **(33,038)** | 21,331,700 | (52,049) |

| | **Fair value** | **Memorandum allowance for ECL** | Fair value | Memorandum allowance for ECL |
|---|---|---|---|---|
| | **US$000** | **US$000** | US$000 | US$000 |
| Debt instruments measured at fair value through other comprehensive income (FVOCI) | **5,695,573** | **(1,112)** | 6,628,270 | (1,275) |

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

Stage 1: Unimpaired and without significant increase in credit risk on which a 12-month allowance for ECL is recognised.

Stage 2: A significant increase in credit risk has been experienced since initial recognition on which a lifetime ECL is recognised.

Stage 3: Objective evidence of impairment, and are therefore considered to be in default or otherwise credit-impaired on which a lifetime ECL is recognised.

POCI: Purchased or originated at a deep discount that reflects the incurred credit losses on which a lifetime ECL is recognised.

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

| | Gross carrying/nominal amount | | | | | Allowance for ECL | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Stage 1 | Stage 2 | Stage 3 | POCI | Total | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Loans and advances to customers at amortised cost: | 17,617,241 | 2,177,358 | 1,301,233 | 36,778 | 21,132,610 | (65,826) | (91,814) | (864,817) | (36,778) | (1,059,235) |
| Loans and advances to banks at amortised cost | 5,048,916 | 9,950 | — | — | 5,058,866 | (1,412) | (146) | — | — | (1,558) |
| Other financial assets measured at amortised cost | 2,687,842 | 97,127 | — | — | 2,784,969 | (339) | (293) | — | — | (632) |
| Loan and other credit-related commitments | 5,351,317 | 296,712 | 604 | — | 5,648,633 | (1,912) | (824) | — | — | (2,736) |
| Financial guarantee and similar contracts: | 11,818,716 | 2,494,000 | 104,000 | — | 14,416,716 | (7,426) | (17,159) | (5,717) | — | (30,302) |
| At 31 Dec 2018 | 42,524,032 | 5,075,147 | 1,405,837 | 36,778 | 49,041,794 | (76,915) | (110,236) | (870,534) | (36,778) | (1,094,463) |

(Audited)

| | ECL coverage % | | | | |
|---|---|---|---|---|---|
| | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
| | % | % | % | % | % |
| Loans and advances to customers at amortised cost: | 0.4 | 4.2 | 66.5 | 100.0 | 5.0 |
| Loans and advances to banks at amortised cost | — | 1.5 | — | — | — |
| Other financial assets measured at amortised cost | — | 0.3 | — | — | — |
| Loan and other credit-related commitments | — | 0.3 | — | — | 0.1 |
| Financial guarantee and similar contracts: | 0.1 | 0.7 | 5.5 | — | 0.2 |
| At 31 Dec 2018 | 0.2 | 2.2 | 61.9 | 100.0 | 2.2 |

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

| | Gross carrying/nominal amount | | | | | Allowance for ECL | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Stage 1 | Stage 2 | Stage 3 | POCI | Total | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Loans and advances to customers at amortised cost | 15,001,751 | 2,983,784 | 1,365,966 | 36,778 | 19,388,279 | (65,056) | (109,232) | (938,575) | (36,778) | (1,149,641) |
| Loans and advances to banks at amortised cost | 6,200,649 | 2,553 | — | — | 6,203,202 | (818) | (8) | — | — | (826) |
| Other financial assets measured at amortised cost | 2,567,026 | 132,005 | 4,448 | — | 2,703,479 | (424) | (248) | — | — | (672) |
| Loan and other credit related commitments | 6,719,565 | 248,974 | 1,787 | — | 6,970,326 | (1,148) | (4,304) | — | — | (5,452) |
| Financial guarantee and similar contracts | 11,680,515 | 2,514,603 | 166,256 | — | 14,361,374 | (14,853) | (20,188) | (11,556) | — | (46,597) |
| At 1 Jan 2018 | 42,169,506 | 5,881,919 | 1,538,457 | 36,778 | 49,626,660 | (82,299) | (133,980) | (950,131) | (36,778) | (1,203,188) |

| | ECL coverage % | | | | |
|---|---|---|---|---|---|
| | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
| | % | % | % | % | % |
| Loans and advances to customers at amortised cost | 0.4 | 3.7 | 68.7 | 100.0 | 5.9 |
| Loans and advances to banks at amortised cost | 0.0 | 0.3 | 0.0 | 0.0 | 0.0 |
| Other financial assets measured at amortised cost | 0.0 | 0.2 | 0.0 | 0.0 | 0.0 |
| Loan and other credit related commitments | 0.0 | 1.7 | 0.0 | 0.0 | 0.1 |
| Financial guarantee and similar contracts | 0.1 | 0.8 | 7.0 | 0.0 | 0.3 |
| At 1 Jan 2018 | 0.2 | 2.3 | 61.8 | 100.0 | 2.4 |

# Measurement uncertainty and sensitivity analysis of ECL estimates

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

### Methodology for Developing Forward Looking Economic Scenarios

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

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

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

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

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

### Description of Consensus Economic Scenarios

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

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

### The Consensus Central Scenario

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

- Expected average rates of GDP growth over the 2019-2023 period are lower than average growth rates achieved over the 2013-2017 period for the UAE.
- The average unemployment rate over the projection horizon is expected to remain at or below the averages observed in the 2013-2017 period.
- Inflation is expected to be stable despite steady GDP growth.
- Major central banks are expected to gradually raise their main policy interest rate.
- The West Texas Intermediate oil price is forecast to average US$63p/b over the projection period.

### The Consensus Upside scenario

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

### The Consensus Downside scenario

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

### How economic scenarios are reflected in the wholesale calculation of ECL

HSBC has developed a globally consistent methodology for the application of economic scenarios into the calculation of ECL by incorporating those scenarios into the estimation of the term structure of probability of default ('PD') and loss given default ('LGD'). For

PDs, we consider the correlation of economic guidance to default rates for a particular industry in a country. For LGD calculations we consider the correlation of economic guidance to collateral values and realisation rates for a particular country and industry. PDs and LGDs are estimated for the entire term structure of each instrument.

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

ECL based exposures at 31 December 2018[1]

| | UAE |
|---|---|
| Reported ECL (US$m) | **74** |
| Gross carrying/nominal amount (US$m)[2] | **37,546** |
| Reported ECL Coverage (per cent) | **0.20%** |
| Consensus Upside scenario | **0.18%** |
| Consensus Downside scenario | **0.21%** |
| Consensus Central scenario | **0.20%** |

[1]*Excludes ECL and financial instruments relating to defaulted obligors*
[2]*Includes off-balance sheet financial instruments that are subject to significant measurement uncertainty*

### How economic scenarios are reflected in the retail calculation of ECL

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

ECL based exposures at 31 December 2018

| | UAE |
|---|---|
| Reported ECL (US$m) | **204** |
| Gross carrying amount (US$m) | **3,453** |
| Reported ECL Coverage | **5.90%** |
| Consensus Upside scenario | **5.70%** |
| Consensus Downside scenario | **6.10%** |
| Consensus Central scenario | **5.90%** |

### Economic scenarios sensitivity analysis of ECL estimates

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

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

## Credit exposure

### Maximum exposure to credit risk

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

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

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

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

Maximum exposure to credit risk

| | 2018 | | | 2017 | | |
|---|---|---|---|---|---|---|
| | Maximum exposure | Offset | Net | Maximum exposure | Offset | Net |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Derivatives | 953,222 | – | 953,222 | 963,102 | – | 963,102 |
| Loans and advances to customers held at amortised cost | 20,073,375 | (161,515) | 19,911,860 | 18,316,780 | (101,437) | 18,215,343 |
| Loans and advances to banks held at amortised cost | 5,057,308 | – | 5,057,308 | 6,203,202 | – | 6,203,202 |
| Reverse repurchase agreements – non-trading | 755,076 | – | 755,076 | 1,387,254 | – | 1,387,254 |
| **Total off-balance sheet** | 22,275,974 | – | 22,275,974 | 23,747,771 | | 23,747,771 |
| – financial guarantees and similar contracts | 6,369,554 | – | 6,369,554 | 6,816,340 | – | 6,816,340 |
| – loan and other credit-related commitments | 15,906,420 | – | 15,906,420 | 16,931,431 | – | 16,931,431 |

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

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

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

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

| | Non-credit impaired | | | | Credit impaired | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Stage 1 | | Stage 2 | | Stage 3 | | POCI | | Total | |
| | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **At 1 Jan 2018** | 39,602,480 | (81,875) | 5,749,914 | (133,732) | 1,534,009 | (950,131) | 36,778 | (36,778) | 46,923,181 | (1,202,516) |
| Transfers of financial instruments: | 1,652,446 | (34,074) | (1,897,719) | 105,491 | 245,273 | (71,417) | – | – | – | – |
| – Transfers from Stage 1 to Stage 2 | (5,754,180) | 16,000 | 5,754,180 | (16,000) | – | – | – | – | – | – |
| – Transfers from Stage 2 to Stage 1 | 7,408,735 | (50,080) | (7,408,735) | 50,080 | – | – | – | – | – | – |
| – Transfers to Stage 3 | (2,117) | 6 | (288,543) | 78,705 | 290,660 | (78,711) | – | – | – | – |
| – Transfers from Stage 3 | 8 | – | 45,379 | (7,294) | (45,387) | 7,294 | – | – | – | – |
| Net remeasurement of ECL arising from transfer of stage | – | 27,275 | – | (25,872) | – | (23,980) | – | – | – | (22,577) |
| Net new and further lending / (repayments) | (1,395,244) | 11,989 | 1,119,102 | (57,327) | (118,469) | (77,429) | – | – | (394,611) | (122,767) |
| Assets written off | – | – | – | – | (254,309) | 254,309 | – | – | (254,309) | 254,309 |
| Foreign exchange and others | (23,294) | 30 | 6,723 | 39 | (446) | – | – | – | (17,017) | 69 |
| Others | (198) | 79 | – | 1,458 | (221) | (1,886) | – | – | (419) | (349) |
| **At 31 Dec 2018** | 39,836,190 | (76,576) | 4,978,020 | (109,943) | 1,405,837 | (870,534) | 36,778 | (36,778) | 46,256,825 | (1,093,831) |
| ECL release/(charge) for the period | – | 39,264 | – | (83,199) | – | (101,409) | – | – | – | (145,344) |
| Recoveries | – | – | – | – | – | 22,246 | – | – | – | 22,246 |
| Others | – | 23,347 | – | (27,052) | – | (1,020) | – | – | – | (4,725) |
| **Total ECL Charge for the period** | – | 62,611 | – | (110,251) | – | (80,183) | – | – | – | (127,823) |

| | At 31 Dec 2018 | | Twelve months ended 31 Dec 2018 |
|---|---|---|---|
| | Gross carrying/nominal amount | Allowance for ECL | ECL charge |
| | US$000 | US$000 | US$000 |
| **As above** | 46,256,825 | (1,093,831) | (127,823) |
| Other financial assets measured at amortised cost | 2,029,885 | (624) | 48 |
| Non-trading reverse purchase agreement commitments | 755,084 | (8) | (8) |
| **Summary of financial instruments to which the impairment requirements in IFRS 9 are applied/ Summary consolidated income statement** | 49,041,794 | (1,094,463) | (127,783) |
| Debt instruments measured at FVOCI | 5,695,573 | (1,112) | 163 |
| **Total allowance for ECL/total income statement ECL charge for the period** | N/A | (1,095,575) | (127,620) |

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

| | Non-credit impaired | | | | Credit impaired | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Stage 1 | | Stage 2 | | Stage 3 | | POCI | | Total | |
| | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowanc e for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **At 1 Jan 2018** | **33,671,127** | **(52,701)** | **5,540,702** | **(80,375)** | **1,268,624** | **(787,766)** | **36,778** | **(36,778)** | **40,517,231** | **(957,620)** |
| Transfers of financial instruments: | 1,775,266 | (29,748) | (1,914,417) | 51,642 | 139,151 | (21,894) | – | – | – | – |
| Net remeasurement of ECL arising from transfer of stage | – | 23,334 | – | (20,211) | – | (23,816) | – | – | – | (20,693) |
| Net new and further lending / (repayments) | (1,084,551) | 13,548 | 1,136,339 | (19,103) | (100,794) | (36,661) | – | – | (49,006) | (42,216) |
| Assets written off | – | – | – | – | (152,391) | 152,391 | – | – | (152,391) | 152,391 |
| Foreign exchange and others | (24,759) | 34 | 6,691 | 47 | (186) | 33 | – | – | (18,254) | 114 |
| Others | (198) | 81 | – | 1,460 | (379) | (197) | – | – | (577) | 1,344 |
| **At 31 Dec 2018** | **34,336,885** | **(45,452)** | **4,769,315** | **(66,540)** | **1,154,025** | **(717,910)** | **36,778** | **(36,778)** | **40,297,003** | **(866,680)** |
| ECL release/(charge) for the period | – | 36,882 | – | (39,314) | – | (60,477) | – | – | – | (62,909) |
| Recoveries | – | – | – | – | – | 158 | – | – | – | 158 |
| Others | – | 25,829 | – | (27,052) | – | (1,020) | – | – | – | (2,243) |
| Total ECL Charge for the period | – | 62,711 | – | (66,366) | – | (61,339) | – | – | – | (64,994) |

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

| | Non-credit impaired | | | | Credit impaired | | | |
|---|---|---|---|---|---|---|---|---|
| | Stage 1 | | Stage 2 | | Stage 3 | | Total | |
| | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL | Gross carrying/ nominal amount | Allowance for ECL |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| **At 1 Jan 2018** | **5,931,353** | **(29,174)** | **209,212** | **(53,357)** | **265,385** | **(162,365)** | **6,405,950** | **(244,896)** |
| Transfers of financial instruments: | (122,820) | (4,326) | 16,698 | 53,849 | 106,122 | (49,523) | – | – |
| Net remeasurement of ECL arising from transfer of stage | – | 3,941 | – | (5,661) | – | (164) | – | (1,884) |
| Net new and further lending / (repayments) | (310,693) | (1,559) | (17,237) | (38,224) | (17,675) | (40,768) | (345,605) | (80,551) |
| Assets written off | – | – | – | – | (101,918) | 101,918 | (101,918) | 101,918 |
| Foreign exchange and others | 1,465 | (4) | 32 | (8) | (260) | (33) | 1,237 | (45) |
| Others | – | (2) | – | (2) | 158 | (1,689) | 158 | (1,693) |
| **At 31 Dec 2018** | **5,499,305** | **(31,124)** | **208,705** | **(43,403)** | **251,812** | **(152,624)** | **5,959,822** | **(227,151)** |
| ECL release/(charge) for the period | – | 2,382 | – | (43,885) | – | (40,932) | – | (82,435) |
| Recoveries | – | – | – | – | – | 22,088 | – | 22,088 |
| Others | – | (2,482) | – | – | – | – | – | (2,482) |
| Total ECL Charge for the period | – | (100) | – | (43,885) | – | (18,844) | – | (62,829) |

## Credit quality of financial instruments

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

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

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

Credit quality classification

| | Debt securities and other bills<br>External credit rating | Wholesale lending<br>Internal credit rating | Retail lending<br>Internal credit rating[2] |
|---|---|---|---|
| **Quality classification** | | | |
| Strong | **A– and above** | **CRR[1]1 to CRR2** | **Band 1 and 2** |
| Good | **BBB+ to BBB–** | **CRR3** | **Band 3** |
| Satisfactory | **BB+ to B and unrated** | **CRR4 to CRR5** | **Band 4 and 5** |
| Sub-standard | **B– to C** | **CRR6 to CRR8** | **Band 6** |
| Impaired | **Default** | **CRR9 to CRR10** | **Band 7** |

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

Quality classification definitions

- 'Strong' exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss.
- 'Good' exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk.
- 'Satisfactory' exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk.
- 'Sub-standard' exposures require varying degrees of special attention and default risk is of greater concern.
- 'Impaired' exposures have been assessed as impaired. These also include retail accounts classified as Band 1 to Band 6 that are delinquent by more than 90 days, unless individually they have been assessed as not impaired; and renegotiated loans that have met the requirements to be disclosed as impaired and have not yet met the criteria to be returned to the unimpaired portfolio.

## Risk rating scales

The customer risk rating ('CRR') 10-grade scale summarises a more granular underlying 23-grade scale of obligor probability of default ('PD'). All HSBC customers are rated using the 10- or 23-grade scale, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

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

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

## Distribution of financial instruments by credit quality

| | Gross carrying/notional amount | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Strong | Good | Satisfactory | Sub-standard | Credit impaired | Total | Allowance for ECL | Net |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| In-scope for IFRS 9 | | | | | | | | |
| Loans and advances to customers held at amortised cost | **5,805,304** | **6,522,422** | **6,817,823** | **649,050** | **1,338,011** | **21,132,610** | **(1,059,235)** | **20,073,375** |
| Loans and advances to banks held at amortised cost | **4,089,114** | **677,967** | **291,785** | **—** | **—** | **5,058,866** | **(1,558)** | **5,057,308** |
| Cash and balances at central banks | **1,170,499** | **—** | **—** | **—** | **—** | **1,170,499** | **(140)** | **1,170,359** |
| Items in the course of collection from other banks | **81,984** | **—** | **—** | **—** | **—** | **81,984** | **—** | **81,984** |
| Reverse repurchase agreements – non-trading | **225,912** | **271,718** | **257,454** | **—** | **—** | **755,084** | **(8)** | **755,076** |
| Other financial assets held at amortised cost | **—** | **—** | **—** | **—** | **—** | **—** | **—** | **—** |
| Other assets | **76,000** | **145,636** | **539,457** | **16,309** | **—** | **777,402** | **(484)** | **776,918** |
| – endorsements and acceptances | **37,679** | **145,162** | **307,316** | **16,309** | **—** | **506,466** | **(484)** | **505,982** |
| – accrued income and other | **38,321** | **474** | **232,141** | **—** | **—** | **270,936** | **—** | **270,936** |
| Debt instruments measured at fair value through other comprehensive income[24] | **2,332,094** | **—** | **3,363,479** | **—** | **—** | **5,695,573** | **(1,112)** | **5,694,461** |
| Out-of-scope for IFRS 9 | | | | | | | | |
| Trading assets | **41,851** | **11,390** | **181,644** | **11,271** | **—** | **246,156** | **—** | **246,156** |
| Derivatives | **795,974** | **88,074** | **64,486** | **4,688** | **—** | **953,222** | **—** | **953,222** |
| Total gross carrying amount on balance sheet | **14,618,732** | **7,717,207** | **11,516,128** | **681,318** | **1,338,011** | **35,871,396** | **(1,062,537)** | **34,808,859** |
| Loan and other credit related commitments | **3,141,026** | **1,536,192** | **936,769** | **34,042** | **604** | **5,648,633** | **(2,736)** | **5,645,897** |
| Financial guarantee and similar contracts | **5,851,288** | **4,494,695** | **3,328,894** | **637,839** | **104,000** | **14,416,716** | **(30,302)** | **14,386,414** |
| Total nominal amount off balance sheet | **8,992,314** | **6,030,887** | **4,265,663** | **671,881** | **104,604** | **20,065,349** | **(33,038)** | **20,032,311** |
| At 31 Dec 2018 | **23,611,046** | **13,748,094** | **15,781,791** | **1,353,199** | **1,442,615** | **55,936,745** | **(1,095,575)** | **54,841,170** |

| | 31 Dec 2017 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Neither past due not impaired | | | | | | | | |
| | Strong | Good | Satisfactory | Sub-standard | Past due but not impaired | Impaired | Total gross amount | Impairment allowance | Total |
| | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 |
| Cash and balances at central banks | 412,471 | 258,969 | — | — | — | — | 671,440 | — | 671,440 |
| Items in the course of collection from other banks | — | — | 64,419 | — | — | — | 64,419 | — | 64,419 |
| Trading assets | 175,920 | 52,474 | 206,757 | 5,473 | — | — | 440,624 | — | 440,624 |
| Derivatives | 786,228 | 57,088 | 116,743 | 3,043 | — | — | 963,102 | — | 963,102 |
| Loans and advances to customers held at amortised cost | 8,203,402 | 4,838,749 | 3,778,032 | 582,220 | 652,199 | 1,333,677 | 19,388,279 | (1,071,499) | 18,316,780 |
| Loans and advances to banks held at amortised cost | 4,970,773 | 1,112,464 | 119,965 | — | — | — | 6,203,202 | — | 6,203,202 |
| Reverse repurchase agreements – non-trading | 927,235 | 19,242 | 440,777 | — | — | — | 1,387,254 | — | 1,387,254 |
| Financial investments | 1,778,092 | — | 4,850,179 | — | — | — | 6,628,271 | — | 6,628,271 |
| Other assets | 19,648 | 152,263 | 394,197 | 4,874 | 12,110 | 4,448 | 587,540 | — | 587,540 |
| At 31 Dec 2017 | 17,273,769 | 6,491,249 | 9,971,069 | 595,610 | 664,309 | 1,338,125 | 36,334,131 | (1,071,499) | 35,262,632 |

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

| | Gross carrying/notional amount | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Strong | Good | Satisfactory | Sub-standard | Credit impaired | Total | Allowance for ECL | Net |
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Gross carrying amount on balance sheet | **13,780,907** | **7,617,743** | **11,269,998** | **665,359** | **1,338,011** | **34,672,018** | **(1,062,537)** | **33,609,481** |
| – stage 1 | **13,347,394** | **7,403,873** | **9,924,199** | **374,109** | **—** | **31,049,575** | **(68,688)** | **30,980,887** |
| – stage 2 | **433,513** | **213,870** | **1,345,799** | **291,250** | **—** | **2,284,432** | **(92,254)** | **2,192,178** |
| – stage 3 | **—** | **—** | **—** | **—** | **1,301,233** | **1,301,233** | **(864,817)** | **436,416** |
| – POCI | **—** | **—** | **—** | **—** | **36,778** | **36,778** | **(36,778)** | **—** |
| Nominal amount off balance sheet | **8,992,314** | **6,030,887** | **4,265,663** | **671,881** | **104,604** | **20,065,349** | **(33,038)** | **20,032,311** |
| – stage 1 | **8,989,132** | **5,222,443** | **2,743,132** | **215,326** | **—** | **17,170,033** | **(9,338)** | **17,160,695** |
| – stage 2 | **3,182** | **808,444** | **1,522,531** | **456,555** | **—** | **2,790,712** | **(17,983)** | **2,772,729** |
| – stage 3 | **—** | **—** | **—** | **—** | **104,604** | **104,604** | **(5,717)** | **98,887** |
| – POCI | **—** | **—** | **—** | **—** | **—** | **—** | **—** | **—** |
| **At 31 Dec 2018** | **22,773,221** | **13,648,630** | **15,535,661** | **1,337,240** | **1,442,615** | **54,737,367** | **(1,095,575)** | **53,641,792** |

### Past due but not impaired gross financial instruments

Past due but not impaired gross financial instruments are those loans where, although customers have failed to make payments in accordance with the contractual terms of their facilities, they have not met the impaired loan criteria. This is typically when a loan is less than 90 days past due and there are no other indicators of impairment.

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

The following table provides an analysis of gross loans and advances to customers held at amortised cost which are past due but not considered impaired. There are no other significant balance sheet items where past due balances are not considered impaired.

Ageing analysis of days for past due but not impaired gross financial instruments

| | Up to 29 days | 30-59 days | 60-89 days | 90-179 days | 180 days and over | Total |
|---|---|---|---|---|---|---|
| | US$000 | US$000 | US$000 | US$000 | US$000 | US$000 |
| Loans and advances to customers held at amortised cost | **271,541** | **40,088** | **49,556** | **—** | **—** | **361,185** |
| – personal | **36,892** | **16,862** | **15,140** | **—** | **—** | **68,894** |
| – corporate and commercial | **234,389** | **23,226** | **34,416** | **—** | **—** | **292,031** |
| – non-bank financial institutions | **260** | **—** | **—** | **—** | **—** | **260** |
| **At 31 Dec 2018** | **271,541** | **40,088** | **49,556** | **—** | **—** | **361,185** |
| | | | | | | |
| Loans and advances to customers held at amortised cost | 540,346 | 52,147 | 35,541 | 10,234 | 13,931 | 652,199 |
| – personal | 51,141 | 25,815 | 17,497 | — | — | 94,453 |
| – corporate and commercial | 474,023 | 26,332 | 18,036 | 10,234 | 13,926 | 542,551 |
| – non-bank financial institutions | 15,182 | — | 8 | — | 5 | 15,195 |
| At 31 Dec 2017 | 540,346 | 52,147 | 35,541 | 10,234 | 13,931 | 652,199 |

### Impaired loans

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

- Wholesale loans and advances classified as Customer Risk Rating ('CRR') 9 or CRR 10. These grades are assigned when the group considers that either the customer is unlikely to pay their credit obligations in full without recourse to security, or when the customer is more than 90 days past due on any material credit obligation to the group.
- Retail loans and advances classified as Band 10 . These grades are typically assigned to retail loans and advances more than 90 days past due unless individually they have been assessed as not impaired.
- Renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment.

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

| | 2017 | | | |
|---|---|---|---|---|
| | | Customers | | |
| | Banks individually assessed | Individually assessed | Collectively assessed | Total |
| | US$000 | US$000 | US$000 | US$000 |
| **At 1 Jan** | — | 946,230 | 198,237 | 1,144,467 |
| Amounts written off | — | (131,548) | (108,734) | (240,282) |
| Recoveries of loans and advances previously written off | — | 334 | 21,022 | 21,356 |
| Charge to income statement | — | 87,243 | 53,985 | 141,228 |
| Exchange and other movements | — | 5,401 | (671) | 4,730 |
| **At 31 Dec** | — | 907,660 | 163,839 | 1,071,499 |

## Renegotiated loans and forbearance

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

### Identifying renegotiated loans

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

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

### Credit Quality of Renegotiated Loans

Under IFRSs, an entity is required to assess whether there is objective evidence that financial assets are impaired at the end of each reporting period. A loan is impaired and an impairment allowance is recognised when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated.

When the group grants a concession to a customer that the group would not otherwise consider, as a result of their financial difficulty, this is objective evidence of impairment and impairment losses are measured accordingly.

A renegotiated loan is presented as impaired when:

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

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

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

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

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

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

Renegotiated loans and advances to customers by industry sector

| | First lien residential mortgages | Other personal lending | Corporate and commercial | Non-bank financial institutions | Renegotiated loans |
|---|---|---|---|---|---|
| | US$000 | US$000 | US$000 | US$000 | US$000 |
| Stage 1 | — | — | **348,750** | **14,785** | **363,535** |
| Stage 2 | — | — | **117,285** | — | **117,285** |
| Stage 3 | **125,129** | **15,875** | **697,066** | — | **838,070** |
| **Renegotiated loans At 31 Dec 2018** | **125,129** | **15,875** | **1,163,101** | **14,785** | **1,318,890** |
| Allowance for expected credit losses on renegotiated loans | | | | | **547,893** |
| | | | | | |
| Neither past due nor impaired | 23,707 | 12,986 | 74,854 | 248,276 | 359,823 |
| Past due but not impaired | 4,166 | 638 | 16,097 | — | 20,901 |
| Impaired | 85,243 | 14,801 | 615,884 | 45,007 | 760,935 |
| Renegotiated loans At 31 Dec 2017 | 113,116 | 28,425 | 706,835 | 293,283 | 1,141,659 |
| Impairment allowances on renegotiated loans | | | | | 487,889 |

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

For details of our impairment policies on loans and advances and financial investments, see Note 2.2(i) on the Financial Statements.

## Collateral and other credit enhancements held

### Loans and advances held at amortised cost

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

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

The group may also manage its risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised or partially collateralised may benefit from such credit mitigants.

## Personal lending: residential mortgage loans including loan commitments by level of collateral

| | Gross carrying/nominal |
|---|---|
| | US$000 |
| **Stage 1** | |
| Fully collateralised | **1,702,109** |
| LTV ratio: | |
| – less than 50% | **286,974** |
| – 51% to 60% | **191,743** |
| – 61% to 70% | **308,881** |
| – 71% to 80% | **532,624** |
| – 81% to 90% | **296,163** |
| – 91% to 100% | **85,724** |
| Partially collateralised (A): | **104,048** |
| LTV ratio: | |
| – 101% to 110% | **59,451** |
| – 111% to 120% | **12,514** |
| – greater than 120% | **32,083** |
| – *collateral value on A* | **101,464** |
| **Total** | **1,806,157** |
| **Stage 2** | |
| Fully collateralised | **32,652** |
| LTV ratio: | |
| – less than 50% | **4,995** |
| – 51% to 60% | **1,746** |
| – 61% to 70% | **3,966** |
| – 71% to 80% | **11,464** |
| – 81% to 90% | **7,892** |
| – 91% to 100% | **2,589** |
| Partially collateralised (B): | **3,696** |
| LTV ratio: | |
| – 101% to 110% | **1,985** |
| – 111% to 120% | **355** |
| – greater than 120% | **1,356** |
| – *collateral value on B* | **2,331** |
| **Total** | **36,348** |
| **Stage 3** | |
| Fully collateralised | **58,117** |
| LTV ratio: | |
| – less than 50% | **12,064** |
| – 51% to 60% | **5,850** |
| – 61% to 70% | **9,893** |
| – 71% to 80% | **13,027** |
| – 81% to 90% | **13,928** |
| – 91% to 100% | **3,355** |
| Partially collateralised (C): | **108,055** |
| LTV ratio: | |
| – 101% to 110% | **7,503** |
| – 111% to 120% | **11,274** |
| – greater than 120% | **89,278** |
| – *collateral value on C* | **108,055** |
| **Total** | **166,172** |
| **At 31 Dec 2018** | **2,008,677** |

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

The LTV ratio is calculated as the gross on balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The methodologies for obtaining residential property collateral values vary throughout the group, but are typically determined through a combination of professional appraisals, house price indices or statistical analysis. Valuations must be updated on a regular basis and, as a minimum, at intervals of every three years.

## Other personal lending

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

## Collateral on loans and advances

### *Commercial real estate loans and advances*

Collateral held is analysed separately below for commercial real estate and for other corporate, commercial and financial (non-bank) lending. The analysis includes off‑balance sheet loan commitments, primarily undrawn credit lines.

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

| | Gross carrying/nominal amount |
|---|---|
| | US$000 |
| **Stage 1** | |
| Not collateralised | **2,096,358** |
| Fully collateralised | **62,612** |
| LTV ratio: | |
| – less than 50% | **19,887** |
| – 51% to 75% | **13,771** |
| – 76% to 90% | **–** |
| – 91% to 100% | **28,954** |
| Partially collateralised (A): | **291,120** |
| – *collateral value on A* | **250,289** |
| **Total** | **2,450,090** |
| **Stage 2** | |
| Not collateralised | **202,884** |
| Fully collateralised | **22,143** |
| LTV ratio: | |
| – less than 50% | **–** |
| – 51% to 75% | **19,251** |
| – 76% to 90% | **–** |
| – 91% to 100% | **2,892** |
| Partially collateralised (B): | **–** |
| – *collateral value on B* | **–** |
| **Total** | **225,027** |
| **Stage 3** | |
| Not collateralised | **30,699** |
| Fully collateralised | **6,900** |
| LTV ratio: | |
| – less than 50% | **6,900** |
| – 51% to 75% | **–** |
| – 76% to 90% | **–** |
| – 91% to 100% | **–** |
| Partially collateralised (C): | **171,080** |
| – *collateral value on C* | **163,180** |
| **Total** | **208,679** |
| **At 31 Dec 2018** | **2,883,796** |

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

The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of valuing collateral for commercial real estate, local valuation policies determine the frequency of review based on local market conditions. Revaluations are sought with greater frequency when, as part of the regular credit assessment of the obligor, material concerns arise in relation to the transaction which may reflect on the underlying performance of the collateral, or in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation (i.e. the obligor's credit quality classification indicates it is at the lower end, that is sub-standard, or approaching impaired). Where such concerns exist the revaluation method selected will depend upon the loan-to-value relationship, the direction in which the local commercial real estate market has moved since the last valuation and, most importantly, the specific characteristics of the underlying commercial real estate which is of concern.

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

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

| | Gross carrying/nominal US$000 |
|---|---|
| **Stage 1** | |
| Not collateralised | **22,307,080** |
| Fully collateralised | **225,816** |
| LTV ratio: | |
| – less than 50% | **53,703** |
| – 51% to 75% | **24,811** |
| – 76% to 90% | **42,405** |
| – 91% to 100% | **104,897** |
| Partially collateralised (A): | **1,228,335** |
| – *collateral value on A* | **273,996** |
| **Total** | **23,761,231** |
| **Stage 2** | |
| Not collateralised | **2,046,132** |
| Fully collateralised | **8,290** |
| LTV ratio: | |
| – less than 50% | **361** |
| – 51% to 75% | **2,547** |
| – 76% to 90% | **5,185** |
| – 91% to 100% | **197** |
| Partially collateralised (B): | **168,220** |
| – *collateral value on B* | **70,693** |
| **Total** | **2,222,642** |
| **Stage 3** | |
| Not collateralised | **701,751** |
| Fully collateralised | **90,958** |
| LTV ratio: | |
| – less than 50% | **2,830** |
| – 51% to 75% | **21,303** |
| – 76% to 90% | **66,825** |
| – 91% to 100% | **–** |
| Partially collateralised (C): | **134,277** |
| – *collateral value on C* | **51,433** |
| **Total** | **926,986** |
| **POCI** | |
| Not collateralised | **36,778** |
| Fully collateralised | **–** |
| LTV ratio: | |
| – less than 50% | **–** |
| – 51% to 75% | **–** |
| – 76% to 90% | **–** |
| – 91% to 100% | **–** |
| Partially collateralised (C): | **–** |
| – *collateral value on C* | **–** |
| **Total** | **36,778** |
| **At 31 Dec 2018** | **26,947,637** |

## Other credit risk exposures

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

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

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

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

## Derivatives

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

Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions.

### Concentration of exposure

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

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

- the majority of the group's exposure to credit risk is concentrated in the Middle East. Within the Middle East, the group's credit risk is diversified over a wide range of industrial and economic groupings; and
- the group's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2018 and 31 December 2017 was concentrated in the Middle East.

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

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

| | Gross loans and advances to customers | |
|---|---|---|
| | Total | As a % of total gross loans |
| **At 31 Dec 2018** | **US$000** | **%** |
| **Personal** | | |
| – residential mortgages | **2,008,677** | **9.51%** |
| – other personal | **1,908,830** | **9.03%** |
| | **3,917,507** | **18.54%** |
| **Corporate and commercial** | | |
| – commercial, industrial and international trade | **9,347,222** | **44.23%** |
| – commercial real estate | **912,243** | **4.32%** |
| – other property-related | **1,952,717** | **9.24%** |
| – government | **1,640,769** | **7.76%** |
| – other commercial | **3,114,514** | **14.74%** |
| | **16,967,465** | **80.29%** |
| **Financial** | | |
| – non-bank financial institutions | **247,638** | **1.17%** |
| **Total gross loans and advances to customers** | **21,132,610** | **100.00%** |
| Impaired loans | | |
| – as a percentage of gross loans and advances to customers | **6.33%** | |
| **Total impairment allowances** | | |
| – as a percentage of gross loans and advances to customers | **5.01%** | |
| At 31 Dec 2017 | | |
| Personal | | |
| – residential mortgages | 1,922,061 | 9.91% |
| – other personal | 2,126,199 | 10.97% |
| | 4,048,260 | 20.88% |
| Corporate and commercial | | |
| – commercial, industrial and international trade | 9,362,937 | 48.29% |
| – commercial real estate | 485,073 | 2.50% |
| – other property-related | 1,583,928 | 8.17% |
| – government | 1,356,987 | 7.00% |
| – other commercial | 2,470,570 | 12.74% |
| | 15,259,495 | 78.70% |
| Financial | | |
| – non-bank financial institutions | 80,524 | 0.42% |
| Total gross loans and advances to customers | 19,388,279 | 100.00% |
| Impaired loans | | |
| – as a percentage of gross loans and advances to customers | 6.88% | |
| Total impairment allowances | | |
| – as a percentage of gross loans and advances to customers | 5.53% | |

## Areas of special interest

Whilst geopolitical risk in the Middle East moderated slightly during 2018, it remained heightened with economic and diplomatic sanctions on Qatar continuing and Kingdom of Saudi Arabia facing challenges on the international stage. However, the majority of the group's exposures in the region continued to be concentrated in the UAE, where the political and economic landscape remained stable.

Elsewhere across the region where the group has presence, economic and political change including social unrest are carefully monitored with risk appetite adjusted accordingly. 2018 saw some further recovery in oil prices which relieved pressure on fiscal budgets regionally but did not translate into any material improvement in underlying economic activity as subsidy reform, introduction of VAT and impact of Qatar dispute all combined to offset any positive impact of higher oil prices. Whilst oil prices softened towards the end of 2018, this is not expected to result in any change in Government fiscal activity as long as prices remain broadly where they are. On that assumption, there should be an improvement in economic activity as the impact of VAT and other negatives work their way through the system but any improvement is likely to be modest with limited impact on companies financial performance during the year.

### Wholesale lending

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions and corporate entities. The group's wholesale portfolios are well diversified across industry sectors throughout the region, with exposure subject to portfolio controls.

Subdued economic activity continues to create challenging market conditions across all sectors such as Retail, Automotive Dealership, Commercial Real Estate, and Tourism etc. The Contracting sector continues to experience challenges as paymasters delay payments placing increased pressure on main and sub-contractors. In addition, the volume of new projects has slowed resulting in severe competition and squeezed margins being seen for new projects.

The outlook for hydrocarbon production and prices remains a key determinant of confidence in the region and continues to bring uncertainty into the region's economies.

During 2018, the group continued to manage its counterparty exposures in Middle East countries most at risk from the uncertain political environment. A number of measures are taken by conducting portfolio stress testing, using lending guidelines dynamically, monitoring of sector concentrations in addition to regular reviews of industries including Oil and Gas, Contracting, Retail and Auto Dealer sectors. Second order risk continues to be a concern and reviews have been completed on Large Concentration risks and Cross Border exposure. The Regional Portfolio Oversight Council continues to review both internal and external portfolio trends.

### Commercial real estate

In the light of reduced economic activity in the regional market, Commercial real estate continues to witness a slowdown in performance with a reduction in number of transactions, fall in rentals and plateauing of prices and a fundamental supply/demand imbalance. Whilst portfolio credit quality across this sector remained broadly stable, there continues to be evidence of softening valuations which is in line with overall market sentiment and there remains risk of stress given the cyclical nature of the sector. Accordingly, across the group's portfolios, credit risk is mitigated by long-standing and conservative policies on asset origination which focus on relationships with long-term customers and limited initial leverage. HSBC Group Risk, in conjunction with major subsidiaries, designates real estate as a Specialised Lending/Controlled Sector and, accordingly, implements enhanced exposure approval, monitoring and reporting procedures. For example, the Group monitors risk appetite limits for the sector at regional level to detect and prevent higher risk concentrations. Given the developing legal environment and the region being more prone to volatility, further conservatism is adopted in the Middle East.

### Sovereign counterparties

The overall quality of the group's sovereign portfolio remained strong during the period with the large majority of both in-country and cross-border limits extended to countries with strong internal credit risk ratings. Higher oil prices has brought some relief in budget deficits and more expansive fiscal measures for 2019. The group regularly updates its assessment of higher risk countries and adjusts its risk appetite to reflect prevalent market conditions as appropriate.

## Liquidity and funding risk management framework

The group has an internal liquidity and funding risk management framework ('LFRF') which aims to allow it to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations. Liquidity risk is the risk that the group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. The risk arises from mismatches in the timing of cash flows. Funding risk arises when illiquid asset positions cannot be funded at the expected terms and when required.

### Structure and organisation of the liquidity risk management function

The management of liquidity and funding is primarily undertaken locally (by country) in the operating entities in compliance with the Group's LFRF, and with practices and limits set by the Group Management Board ('GMB') through the Risk Management Meeting ('RMM') and approved by the Holdings Board for the largest entities ('RMM operating entities'): the UAE branch of the group is one such operating entity. Limits for non-RMM operating entities within the group are established by the intermediate parent company Asset Liability Committee ('ALCO'). The group ALCO is responsible for setting limits for the group non-RMM operating entities. The group's general policy is that each defined operating entity should be self-sufficient in funding its own activities.

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

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

The primary responsibility for managing liquidity and funding within the Group's framework and risk appetite resides with the local operating entities' ALCOs, Holdings ALCO and the RMM. The UAE branch of the bank, being an RMM operating entity, is overseen by the group ALCO, HSBC Holdings ALCO and the HSBC Group Risk Management Meeting. The remaining smaller operating entities are overseen by the group ALCO, with appropriate escalation of significant issues to HSBC Holdings ALCO and the HSBC Group Risk Management Meeting. Operating entities are predominately defined on a country basis to reflect the Group's local management of liquidity and funding.

### Overall liquidity risk profile

The LFRF is delivered using the following key aspects:

- A liquidity adequacy measure: LCR
- Single currency liquidity management
- A funding profile measure: NSFR
- A deposit concentration measure
- Wholesale Market term funding maturity concentration measures
- Analysis of off-balance sheet commitments, including limits on undrawn facilities
- Intraday liquidity
- Individual Liquidity Adequacy Assessment and Liquidity Stress Testing
- Liquidity Funds Transfer Pricing
- Contingency Funding Plans
- Forward Looking Funding Status Assessments
- Asset encumbrance

## Liquidity and funding risk

### Liquidity coverage ratio ('LCR')

The LCR aims to ensure that a bank has sufficient unencumbered high-quality liquid assets ('HQLA') to meet its liquidity needs in a 30 calendar day liquidity stress scenario. For the calculation of the LCR, the group follows the guidelines set by the European Commission.

### Net stable funding ratio ('NSFR')

HSBC uses the NSFR as a basis for establishing stable funding. The net stable funding ratio ('NSFR') measures stable funding relative to required stable funding, and reflects a bank's long-term funding profile (funding with a term of more than a year). It is designed to complement the LCR.

### Depositor concentration and wholesale market term funding maturity concentration

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

The group monitors depositor concentration and term funding maturity concentration. Both metrics are subject to limits which are approved by the group Board.

### Liquid assets

Liquid assets are held and managed on a stand-alone operating entity basis. Most are held directly by each operating entity's Balance Sheet Management ('BSM') department, primarily for the purpose of managing liquidity risk in line with the LFRF.

Liquid assets also include any unencumbered liquid assets held outside BSM departments for any other purpose. The LFRF gives ultimate control of all unencumbered assets and sources of liquidity to BSM.

### Contingency Funding Plan (CPF)

The CFP ensures that the group can cope in the event of a liquidity stress, by having an actionable plan in place.

### Management of liquidity risk

#### Liquidity coverage ratio ('LCR')

The LCR metric is designed to promote the short-term resilience of a bank's liquidity profile, and became a minimum regulatory standard from 1 October 2015, under European Commission ('EC') Delegated Regulation 2015/61.

Delegated Act ('DA') LCR

| Unaudited | 2018 | 2017 |
|---|---|---|
| | % | % |
| HSBC Bank Middle East Limited | **214** | 235 |

The group additionally computes and reports a DFSA-basis LCR, which differs from the Delegated Act ('DA') LCR primarily with respect to the haircuts applied to liquid securities under DA issued by Gulf Cooperation Council ('GCC') sovereign issuers and outflow percentages applied for off-balance sheet items and retail deposits.

DFSA LCR

| Unaudited | 2018 | 2017 |
|---|---|---|
| | % | % |
| HSBC Bank Middle East Limited | **205** | 239 |

## Net stable funding ratio ('NSFR')

The European calibration of NSFR is pending following the Basel Committee's final recommendation in October 2014. The group calculates NSFR in line with Basel Committee on Banking Supervision's publication number 295 (BCBS295).

### NSFR-295

| Unaudited | 2018 | 2017 |
|---|---|---|
| | % | % |
| HSBC Bank Middle East Limited | **138** | 147 |

The DFSA implementation of NSFR was effective from June 2018. It differs from the Group NSFR with respect to weightings applied for off-balance sheet items and retail deposits and in the calculation for derivatives.

### DFSA NSFR

| Unaudited | 2018 | 2017 |
|---|---|---|
| | % | % |
| HSBC Bank Middle East Limited | **138** | N/A |

### Components of Net Stable Funding Ratio (Unaudited)

| | | Unweighted value by residual maturity | | | | |
|---|---|---|---|---|---|---|
| | **In currency amount (US$000)** | **No maturity** | **< 6 months** | **6 months to < 1yr** | **≥ 1yr** | **Weighted values** |
| **ASF (available stable funds) Item** | | | | | | |
| **1** | **Capital** | **—** | **—** | **—** | **5,551,322** | **5,551,322** |
| 2 | Regulatory Capital | — | — | — | 5,551,322 | 5,551,322 |
| 3 | Other capital | — | — | — | — | — |
| **4** | **Retail deposits/PSIAs and deposits/PSIAs from small business customers:** | **—** | **10,717,833** | **—** | **—** | **9,646,050** |
| 5 | Stable Deposits/PSIAs | — | — | — | — | — |
| 6 | Less stable deposits/PSIAs | — | 10,717,833 | — | — | 9,646,050 |
| **7** | **Wholesale funding:** | **—** | **11,572,711** | **1,461,992** | **295,776** | **6,158,857** |
| 8 | Operational deposits / operational accounts | | 5,170,533 | — | — | 2,585,266 |
| 9 | Other wholesale funding | | 6,402,178 | 1,461,992 | 295,776 | 3,573,591 |
| **10** | **Liabilities with matching interdependent assets** | **—** | **—** | **—** | **—** | **—** |
| **11** | **Other liabilities:** | **—** | **1,786,775** | **1,501,128** | **1,298,617** | **2,049,181** |
| 12 | NSFR derivative liabilities and net liabilities for Shari'a compliant hedging contracts | — | — | — | — | — |
| 13 | All other liabilities and equity not included in the above categories | — | 1,786,775 | 1,501,128 | 1,298,617 | 2,049,181 |
| **14** | **Total ASF** | **—** | **24,077,319** | **2,963,120** | **7,145,715** | **23,405,410** |
| **RSF (Required stable funds) Item** | | | | | | |
| **15** | **Total NSFR high-quality liquid assets (HQLA)** | **—** | **6,837,125** | **320,492** | **2,284,456** | **248,951** |
| **16** | **Deposits/PSIAs held at other financial institutions for operational purposes** | **—** | **—** | **—** | **—** | **—** |
| **17** | **Performing loans and securities (including Shari'a compliant securities):** | **—** | **9,541,319** | **3,590,890** | **10,478,895** | **13,867,794** |
| 18 | Performing loans to financial institutions secured by Level 1 HQLA | — | 425,981 | 21,569 | — | 53,383 |
| 19 | Performing loans to financial institutions secured by non-Level 1 HQLA and unsecured performing loans to financial institutions | — | 2,068,040 | 105,334 | 1,049,361 | 1,412,234 |
| 20 | Performing loans to non- financial corporate clients, loans to retail and small business customers, and loans to sovereigns, Central Banks and PSEs, of which: | — | 6,887,128 | 3,362,201 | 7,610,052 | 11,045,062 |
| 21 | With a risk weight of less than or equal to 50% | — | 1,649,759 | 292,425 | 2,740,735 | 2,752,570 |
| 22 | Performing residential mortgages, of which: | — | 96,969 | 90,496 | 1,602,119 | 1,135,110 |
| 23 | With a risk weight of less than or equal to 50% | — | 96,969 | 90,496 | 1,602,119 | 1,135,110 |
| 24 | Securities that are not in default and do not qualify as HQLA, including exchange-traded equities | — | 63,201 | 11,290 | 217,363 | 222,005 |
| **25** | **Assets with matching interdependent liabilities** | **—** | **—** | **—** | **—** | **—** |
| **26** | **Other Assets** | **—** | **93,657** | **66,526** | **1,155,358** | **1,315,541** |
| 27 | Physical traded commodities, including gold | — | — | — | — | — |
| 28 | Assets posted as initial margin for derivative contracts/Shari'a compliant hedging contracts and contributions to default funds of CCPs | — | — | — | — | — |
| 29 | NSFR derivative assets | — | — | — | 1,285 | 1,285 |
| 30 | NSFR derivative liabilities before deduction of variation margin posted | — | — | — | 182,560 | 182,560 |
| 31 | All other assets not included in the above categories | — | 93,657 | 66,526 | 971,513 | 1,131,696 |
| **32** | **Off-balance sheet items** | **—** | **30,967,975** | **—** | **—** | **1,510,523** |
| **33** | **Total RSF** | **—** | **47,440,076** | **3,977,908** | **13,918,709** | **16,942,809** |
| **34** | **Net Stable Funding Ratio (%)** | | | | | **138%** |

## Primary sources of funding

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

Of total liabilities of US$30,980 million at 31 December 2018, funding from customers amounted to US$21,823 million, of which US$21,775 million was contractually repayable within one year.

An analysis of cash flows payable by the group under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 25.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US$15,906 million), included cash, central bank balances, items in the course of collection and treasury and other bills (US$1,928 million); loans to banks (US$5,057 million, including US$2,596 million repayable within one year); and loans to customers (US$20,073 million, including US$10,359 million repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended.

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

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

## Market risk

### Market risk management

Market risk is the risk that movements in market factors, such as foreign exchange rates, interest rates, credit spreads, equity prices and commodity prices, will reduce our income or the value of our portfolios.

The group's exposure to market risk is separated into trading or non-trading portfolios. Trading portfolios comprise positions arising from market-making and warehousing of customer-derived positions. Non-trading portfolios include positions that primarily arise from the interest rate management of the group's retail and commercial banking assets and liabilities and financial investments designated as fair value through other comprehensive income.

### Market risk measures

#### Monitoring and limiting market risk exposures

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

- sensitivity measures include sensitivity of net interest income and sensitivity for structural foreign exchange, which are used to monitor the market risk positions within each risk type;
- value at risk ('VaR') is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence; and
- in recognition of VaR's limitations the group augments VaR with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables.

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

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

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

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

#### Sensitivity analysis

Sensitivity analysis measures the impact of individual market factor movements on specific instruments or portfolios, including interest rates, foreign exchange rates and equity prices, such as the effect of a one basis point change in yield. We use sensitivity measures to monitor the market risk positions within each risk type. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

#### Value at risk

Value at risk ('VaR') is a technique that estimates the potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence.

The VaR models used by the group are predominantly based on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates, such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures. The historical simulation models assess potential market movements with reference to data from the past two years and calculate VaR to a 99% confidence level and for a one-day holding period.

The group routinely validates the accuracy of its VaR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the group would expect to see losses in excess of VaR only 1% of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

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

- the use of a one-day holding period assumes that all positions can be liquidated or the risks offset in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VaR is unlikely to reflect loss potential on exposures that only arise under conditions of significant market movement.

### Trading and non-trading portfolio

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

| | Footnotes | Portfolio | |
|---|---|---|---|
| | | Trading | Non-trading |
| **Risk type** | | | |
| Foreign exchange and commodity | 1 | VaR | VaR |
| Interest rate | | VaR | VaR |
| Credit spread | | VaR | VaR |

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

### Value at risk of the trading and non-trading portfolio

The group VaR, both trading and non-trading, is below:

#### Value at risk

| | **2018** | 2017 |
|---|---|---|
| | **US$000** | US$000 |
| **At 31 Dec** | **2,437** | 10,909 |
| Average | **7,415** | 5,875 |
| Maximum | **12,124** | 10,979 |
| Minimum | **2,437** | 3,104 |

## Trading portfolios

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

Market-making and position-taking is undertaken within Global Markets. The VaR for such trading intent activity at 31 December 2018 was US$2 million (2017: US$11 million).

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

| | Footnotes | **Foreign exchange (FX)** | **Interest rate** | **Credit spread** | **Total** |
|---|---|---|---|---|---|
| | | **US$000** | **US$000** | **US$000** | **US$000** |
| **At 31 Dec 2018** | 1, 2 | **1,583** | **1,132** | **612** | **1,931** |
| Average | | **5,182** | **2,794** | **487** | **5,557** |
| Maximum | | **12,647** | **4,191** | **1,252** | **11,977** |
| Minimum | | **1,332** | **599** | **208** | **1,608** |
| | | | | | |
| At 31 Dec 2017 | | 11,738 | 2,852 | 372 | 11,011 |
| Average | | 3,833 | 2,809 | 414 | 4,654 |
| Maximum | | 11,944 | 4,248 | 1,047 | 11,301 |
| Minimum | | 201 | 1,387 | 122 | 1,472 |

1 *The total VaR is non-additive across risk types due to diversification effects.*
2 *The increase in VaR in 2017 was driven by the volatility in certain currencies, mainly Qatari Riyal (QAR) and Egyptian Pound (EGP). This was a result of the current regional situation and the devaluation of the EGP, respectively.*

## Non Trading portfolios

Non-trading VaR of the Group includes contributions from all global businesses. There is no commodity risk in the non-trading portfolios. Non-trading VaR includes the interest rate risk in the banking book transferred to and managed by Balance Sheet Management ('BSM') and the non-trading financial instruments held by BSM.

VaR by risk type for the non-trading activities

| | Interest rate | Credit spread | Total |
|---|---|---|---|
| | US$000 | US$000 | US$000 |
| **At 31 Dec 2018** | **2,033** | **489** | **2,043** |
| Average | **4,211** | **921** | **4,568** |
| Maximum | **5,850** | **2,181** | **6,949** |
| Minimum | **2,033** | **350** | **2,043** |
| | | | |
| At 31 Dec 2017 | 3,623 | 917 | 3,815 |
| Average | 2,640 | 669 | 2,664 |
| Maximum | 3,623 | 1,221 | 3,819 |
| Minimum | 1,893 | 317 | 1,771 |

### Gap risk

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

Given the characteristics, these transactions, they will make little or no contribution to VaR or to traditional market risk sensitivity measures. The group captures the risks for such transactions within the stress testing scenarios and monitor gap risk on an ongoing basis.

The group incurred no material losses arising from gap risk movements in the underlying market price on such transactions in the 12 months ended 31 December 2018.

### De-peg risk

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

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

## Non-trading portfolios

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

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

The control of market risk in the non-trading portfolios is based on transferring the risks to the books managed by Global Markets and Balance Sheet Management ('BSM') or the local ALCO. The net exposure is typically managed through the use of interest rate swaps within agreed limits. The VaR for these portfolios is included within the group VaR.

Market risk arises on equity securities held at fair value through other comprehensive income. The fair value of these securities at 31 December 2018 was US$257 million (2017: US$118 million).

### Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associates, the functional currencies of which are currencies other than the US dollar. An entity's functional currency is the currency of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recorded in 'Other comprehensive income'. The main operating currencies of the group are UAE dirham and other Gulf currencies that are linked to the US dollar.

The group's policy is to hedge structural foreign currency exposures only in limited circumstances. The group's structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that the group's capital ratio is protected from the effect of changes in exchange rates. This is usually achieved by ensuring that the rates of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio. The group considers hedging structural foreign currency exposures only in limited circumstances to protect the capital ratio or the US dollar value of capital invested. Such hedging would be undertaken using forward foreign exchange controls or by financing the borrowings in the same currencies as the functional currencies involved.

### Net interest income sensitivity

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

For simulation modelling, businesses use a combination of scenarios relevant to their local businesses and markets and standard scenarios which are required throughout the HSBC Group. The latter are consolidated to illustrate the combined pro forma effect on the group's consolidated portfolio valuations and net interest income.

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

### Defined benefit pension scheme

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

## Operational risk

Operational risk is the risk to achieving the strategy or objectives as a result of inadequate or failed internal processes, people and systems, or from external events.

Responsibility for minimising operational risk lies with all the group's employees. They are required to manage the operational risks of the business for which they are responsible.

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

### Operational risk management framework

#### Overview

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

#### Key developments in 2018

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

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

#### Governance and structure

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

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

#### Key risk management processes

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

A Group-wide risk management system is used to record the results of the operational risk management process. Operational risk and control self-assessments, along with issue and action plans, are entered and maintained by business units. Business and functional management monitor the progress of documented action plans to address shortcomings. To help ensure that operational risk losses are consistently reported and monitored, businesses and functions are required to report individual losses when the net loss is expected to exceed $10,000. Losses are entered into the Group-wide risk management system and reported to governance on a monthly basis.

#### Continuity of business operations

Every department within the organisation undertakes business continuity management, which incorporates the development of a plan including a business impact analysis assessing risk when business disruption occurs.

The group maintains dedicated work area recovery sites. Regular testing of these facilities is carried out with representation from each business and support function, to ensure business continuity plans remain accurate, relevant and fit for purpose. Where possible, it is ensured that critical business systems are not co-located with business system users, thereby reducing concentration risk.

## Legal risk

The group implements processes and procedures in place to manage legal risk that conform to HSBC Group standards.

Legal risk falls within the definition of operational risk and includes the risk of a member of the group suffering financial loss, legal or regulatory action or reputational damage due to:

- contractual risk, which is the risk that any group member enters into inadequate or unenforceable customer contracts or ancillary documentation, inadequate or unenforceable non-customer contracts or ancillary documentation and/or contractual fiduciary;

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

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

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

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

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

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

## Capital management

The Dubai Financial Services Authority ('DFSA') is the lead regulator of the bank.

The bank's objective is to ensure that capital resources are at all times adequate and efficiently used. This implies assessing the bank's capital demand and maintaining the capital supply at the required level. The bank's approach to capital management is driven by strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which it operates in. The bank's policy on capital management is underpinned by a capital management process and the internal capital adequacy assessment process, which enables it to manage its capital in a consistent manner.

The DFSA supervises the bank and, receives information on the capital adequacy of, and sets capital requirements for, the bank. Individual branches and subsidiaries are directly regulated by their local banking supervisors, where applicable, who set and monitor their capital adequacy requirements.

The DFSA's capital requirements are prescribed in the DFSA Prudential – Investment, Insurance Intermediation and Banking Module ('PIB'). In accordance with the PIB:

1. the capital requirement for an authorised firm is calculated, subject to (2), as the higher of:
   a. the applicable Base Capital Requirement as set out in the PIB or
   b. its Risk Capital Requirement as set out in the PIB.
2. where 1(b) is the higher and the authorised firm has an Individual Capital Requirement ('ICR') imposed on it then the Capital Requirement is its ICR plus Risk Capital Requirement.

An authorised firm must calculate its Risk Capital Requirement as the sum of the following:

- the Credit Risk Capital Requirement;
- the Market Risk Capital Requirement;
- the Operational Risk Capital Requirement; and
- the Displaced Commercial Risk Capital Requirement, where applicable.

Further, the bank is subject to a Capital Conservation Buffer of 25% of Risk Capital Requirements.

The PIB requires an authorised firm to:

- appropriately apply a risk-weight to all on-balance sheet assets and off-balance sheet exposures for capital adequacy purposes. A risk-weight is based on a Credit Quality Grade aligned with the likelihood of counterparty default;
- calculate the Credit Risk Capital Requirement for its on-balance sheet assets and off-balance sheet exposures; and
- reduce the Credit Risk Capital Requirement for its on-balance sheet assets and off-balance sheet exposures where the exposure is covered fully or partly by some form of eligible Credit Risk mitigant.

The DFSA has granted approval to the bank to use HSBC Group internal models for the purposes of calculating Market Risk Requirements.

The bank uses the Standardised Approach for the calculation of Operational Risk Capital Requirement.

The bank's regulatory capital is divided into two tiers:

- Tier 1 capital comprises equity share capital, share premium, retained earnings, other comprehensive income and other reserves. This is adjusted for the amount of cash flow hedge reserve related to gains or losses on cash flow hedges of financial instruments, all unrealized gains or losses on liabilities that are valued at fair value and which result from changes in the bank's own credit quality and deduction for intangible assets.
- Tier 2 capital comprises qualifying non-equity preference share capital, share premium and general provisions limited to 1.25% of Credit Risk Weighted Assets.

The bank maintains its capital requirements at all times in accordance with the DFSA requirements.

Capital structure at 31 December (solo basis)

| Unaudited | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| **Composition of regulatory capital** | | |
| Common Equity Tier 1 capital | **4,523,090** | 4,317,311 |
| Additional Tier 1 capital | **—** | — |
| Total Tier 1 capital | **4,523,090** | 4,317,311 |
| Tier 2 capital | **1,028,232** | 1,098,121 |
| Total regulatory capital | **5,551,322** | 5,415,432 |
| **Risk-weighted assets** | | |
| Credit and counterparty risk | **25,514,540** | 25,477,895 |
| Market risk | **1,850,063** | 2,074,120 |
| Operational risk | **3,105,202** | 3,190,290 |
| | **30,469,805** | 30,742,305 |
| **Capital ratio** | | |
| Capital adequacy ratio | **18.22%** | 17.62% |

## 32 Contingent liabilities, contractual commitments and guarantees

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| **Guarantees and other contingent liabilities** | | |
| **Guarantees** | **14,416,716** | 14,361,374 |
| **Commitments** | | |
| Documentary credits and short-term trade-related transactions | **509,106** | 620,512 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | **15,397,314** | 16,310,919 |
| **At 31 Dec** | **15,906,420** | 16,931,431 |

The above table discloses the nominal principal amounts which represents the maximum amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Included in the above are the following contingent liabilities on account of other members of the HSBC Group:

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| Guarantees and assets pledged by the bank as collateral security | **2,836,474** | 2,626,646 |
| Documentary credits and short-term trade-related transactions | **130,983** | 75,909 |
| **At 31 Dec** | **2,967,457** | 2,702,555 |

### Guarantees

The group provides guarantees and similar undertakings on behalf of both third-party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December were as follows:

| | | 2018 | | 2017 | |
|---|---|---|---|---|---|
| | | Guarantees in favour of third parties | Guarantees by the group in favour of other HSBC Group entities | Guarantees in favour of third parties | Guarantees by the group in favour of other HSBC Group entities |
| | Footnotes | US$000 | US$000 | US$000 | US$000 |
| Financial guarantees | 1 | **1,322,212** | **506,298** | 1,808,159 | 665,281 |
| Credit-related guarantees | 2 | **3,707,579** | **833,465** | 3,739,796 | 603,104 |
| Other guarantees | | **6,550,451** | **1,496,711** | 6,186,773 | 1,358,261 |
| **At 31 Dec** | | **11,580,242** | **2,836,474** | 11,734,728 | 2,626,646 |

1 *Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due.*
2 *Credit-related guarantees are contracts that have similar features to financial guarantee contracts but fail to meet the strict definition of a financial guarantee contracts under IAS 39.*

The amounts disclosed in the above table are nominal principal amounts and reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance

with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

**Other commitments**

In addition to the commitments disclosed above, at 31 December 2018 the group had capital commitments to purchase, within one year, land and building and other fixed assets for a value of US$ Nil (2017: US$222 million).

### Associates

The group and its operations are contingently liable with respect to lawsuits and other matters that arise in the normal course of business. Management is of the opinion that the eventual outcome of the legal and financial liability is not expected to materially affect the group's financial position and operations.

## 33 Lease commitments

### Operating lease commitments

At 31 December 2018, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

| | Land and buildings | |
|---|---|---|
| | **2018** | 2017 |
| | **US$000** | US$000 |
| Future minimum lease payments under non-cancellable operating leases expiring: | | |
| – no later than one year | **9,762** | 18,600 |
| – later than one year and no later than five years | **20,664** | 20,610 |
| – later than five years | **1,941** | 1,707 |
| **At 31 Dec** | **32,367** | 40,917 |

In 2018, US$30.3 million (2017: US$25 million) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

### Finance lease receivables

The group leases a variety of assets to third parties under finance leases. At the end of lease terms, assets may be sold to third parties or leased for further terms. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

| | **2018** | | | 2017 | | |
|---|---|---|---|---|---|---|
| | **Total future minimum payments** | **Unearned finance income** | **Present value** | Total future minimum payments | Unearned finance income | Present value |
| | **US$000** | **US$000** | **US$000** | US$000 | US$000 | US$000 |
| Lease receivables: | | | | | | |
| – no later than one year | **129,773** | **(2,463)** | **127,310** | 135,247 | (1,975) | 133,272 |
| – later than one year and no later than five years | **56,035** | **(4,397)** | **51,638** | 15,869 | (6,284) | 9,585 |
| – later than five years | **25,386** | **(5,594)** | **19,792** | 69,748 | (2,732) | 67,016 |
| **At 31 Dec** | **211,194** | **(12,454)** | **198,740** | 220,864 | (10,991) | 209,873 |

## 34 Legal proceedings and regulatory matters

The group is party to legal proceedings and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, the group considers that none of these matters are material. The recognition of provisions is determined in accordance with the accounting policies set out in Note 2 of the group's Annual Report and Accounts 2018. While the outcome of legal proceedings and regulatory matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of these matters as at 31 December 2018. Where an individual provision is material, the fact that a provision has been made is stated and quantified, except to the extent doing so would be seriously prejudicial. Any provision recognised does not constitute an admission of wrongdoing or legal liability. It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

### Anti-money laundering and sanctions-related

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

In October 2010, HSBC Bank USA entered into a consent cease-and-desist order with the Office of the Comptroller of the Currency (the 'OCC'), and HSBC North America Holdings Inc. ('HNAH') entered into a consent order with the Federal Reserve Board (the 'FRB') (each an 'Order' and together, the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including risk management related to the Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. In 2012, an additional consent order was entered into with the OCC that required HSBC Bank USA to correct the circumstances noted in the OCC's report and imposed restrictions on HSBC Bank USA acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, without the OCC's approval. Between June and September 2018, the OCC and FRB terminated each of these Orders having determined that HSBC had satisfied their requirements.

In December 2012, among other agreements, HSBC Holdings entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions, consented to a cease-and-desist order with the FRB, entered into a 5 year deferred prosecution agreement with, among others, the US Department of Justice (the "US DPA") and agreed

to an undertaking with the UK FCA to comply with certain forward-looking AML and sanctions-related obligations and to retain an independent compliance monitor to produce annual assessments of the Group's AML and sanctions compliance programme

(the "Independent Consultant"). In February 2018, the Independent Consultant delivered his fourth annual follow-up review report and the fifth annual follow-up review report is expected to be delivered in February 2019. The Independent Consultant will continue working in his capacity as a skilled person and independent consultant for a period of time at the FCA's and FRB's discretion.

Through his country-level reviews, the Independent Consultant identified potential anti-money laundering and sanctions compliance issues that HSBC is reviewing further with the FRB and/or FCA. In December 2017, the US DPA expired and the charges deferred by the US DPA were dismissed. Additionally, HSBC is the subject of other ongoing investigations and reviews by the DoJ and HSBC Bank plc is the subject of an investigation by the FCA into its compliance with UK money laundering regulations and financial crime systems and controls requirements.

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

In November 2014, a complaint was filed in the US District Court for the Eastern District of New York on behalf of representatives of US persons alleged to have been killed or injured in Iraq between April 2004 and November 2011 ("ATA Case 1"). The complaint was filed against HSBC Holdings, HSBC Bank plc, HSBC Bank USA and HSBC Bank Middle East Limited, as well as other non-HSBC banks and the Islamic Republic of Iran. The plaintiffs allege that the defendants violated the US Anti-Terrorism Act ('US ATA') by altering or falsifying payment messages involving Iran, Iranian parties and Iranian banks for transactions processed through the US. The defendants filed a Motion to Dismiss in May 2015 and an amended Motion to Dismiss in September 2017, following the filing by the Plaintiffs of a Second Amended Complaint in July 2017. In July 2017, the various motions before the Court were referred for review and for the issuance of a judicial report and recommendations, which was issued in July 2018, and which concluded that the New York District Court should deny the defendants' motion to dismiss. The defendants have challenged this conclusion. The future of ATA Case 1 remains under the consideration of the judge and the motion to dismiss filed by the HSBC defendants, including the group remains pending before the court,

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

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

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

### Foreign exchange rate investigations and litigation

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

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

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

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

## 35 Related party transactions

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

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

HSBC Holdings plc

8 Canada Square

London

E14 5HQ

Related parties of the group include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for HSBC employees, Key Management Personnel as defined by IAS 24 'Related Party Disclosures', close family members of Key Management Personnel and entities which are controlled, jointly controlled or significantly influenced by Key Management Personnel or their close family members. Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Bank Middle East Limited and the group and includes members of the Boards of Directors of HSBC Bank Middle East Limited.

Particulars of transactions with related parties are tabulated below. The disclosure of the year-end balance and the highest amounts outstanding during the year is considered to be the most meaningful information to represent the amount of the transactions and outstanding balances during the year.

## Key Management Personnel

The emoluments of a number of the Key Management Personnel are paid by other HSBC Group companies who make no recharge to the group. The Directors are also Directors of a number of other HSBC Group companies and it is not possible to make a reasonable apportionment of their emoluments in respect of each of the companies. Accordingly, no emoluments in respect of the Directors paid by other HSBC Group companies and applicable to the group has been included in the following disclosure.

## Transactions, arrangements and agreements including Key Management Personnel

Compensation of Key Management Personnel

| | 2018 | 2017 |
|---|---|---|
| | US$000 | US$000 |
| Remuneration (wages and bonus) | 6,307 | 6,516 |
| Post-employment benefits | 290 | 231 |
| Share-based payments | 2,049 | 2,357 |
| **Year ended 31 Dec** | **8,646** | 9,104 |

The table below sets out transactions which fall to be disclosed under IAS 24 between the group and the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, and their connected persons or controlled companies.

Transactions and balances during the year with Key Management Personnel

| | | 2018 | | 2017 | |
|---|---|---|---|---|---|
| | | Balance at 31 Dec | Highest amounts outstanding during year | Balance at 31 Dec | Highest amounts outstanding during year |
| | *Footnotes* | US$000 | US$000 | US$000 | US$000 |
| Key Management Personnel | 1 | | | | |
| Loans | | 835 | 855 | 861 | 1,239 |
| Credit cards | | 8 | 35 | 271 | 271 |

1 *Includes Key Management Personnel, close family members of Key Management Personnel and entities that are controlled or jointly controlled by Key Management Personnel or their close family members.*

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

## Transactions with other related parties

### Associates

Transactions and balances during the year with associates

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | Highest balance during the year | Balance at 31 Dec | Highest balance during the year | Balance at 31 Dec |
| | US$000 | US$000 | US$000 | US$000 |
| Amounts due from associates | — | — | — | — |
| Amounts due to associates | 1,279 | 1,279 | 1,088 | 1,088 |

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

### Transactions of the group with HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Holdings plc

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | Highest balance during the year | Balance at 31 Dec | Highest balance during the year | Balance at 31 Dec |
| | US$000 | US$000 | US$000 | US$000 |
| **Assets** | | | | |
| Loans and advances to customers | 2,463 | 1,413 | 1,400 | 1,021 |
| **Liabilities** | | | | |
| Customer accounts | 9,692 | 3,433 | 9,069 | 7,362 |

| | For the year ended 31 Dec 2018 | For the year ended 31 Dec 2017 |
|---|---|---|
| | US$000 | US$000 |
| **Income statement** | | |
| Fee expense | — | — |
| Other operating income | 1,618 | 884 |
| General and administrative expenses | 21,082 | 18,885 |

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | **Highest balance during the year** | **Balance at 31 Dec** | Highest balance during the year | Balance at 31 Dec |
| | **US$000** | **US$000** | US$000 | US$000 |
| **Assets** | | | | |
| Trading assets | **870,540** | **37,596** | 279,991 | 53,231 |
| Derivatives | **904,772** | **648,869** | 741,414 | 681,295 |
| Loans and advances to banks (including reverse repos) | **2,237,126** | **949,901** | 2,318,277 | 2,114,401 |
| Financial investments | **—** | **—** | 61,346 | 59,630 |
| **Liabilities** | | | | |
| Trading liabilities | **199,984** | **2,242** | 217,003 | 6,457 |
| Deposits by banks | **1,661,620** | **482,541** | 2,846,052 | 1,614,023 |
| Derivatives | **930,712** | **863,808** | 1,250,075 | 783,896 |
| Subordinated amounts due | **950,000** | **950,000** | 950,000 | 950,000 |
| **Off-balance sheet** | | | | |
| Guarantees | **3,231,514** | **2,836,474** | 2,626,646 | 2,626,646 |
| Documentary credit and short-term trade-related transactions | **179,904** | **130,983** | 108,402 | 75,909 |

| | **For the year ended 31 Dec 2018** | For the year ended 31 Dec 2017 |
|---|---|---|
| | **US$000** | US$000 |
| **Income Statement** | | |
| Interest income | **2,238** | 5,317 |
| Interest expense | **68,572** | 63,506 |
| Fee income | **63,706** | 61,716 |
| Fee expense | **18,508** | 21,142 |
| Other operating income | **77,070** | 46,304 |
| General and administrative expenses | **143,395** | 111,407 |

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

**Transactions between HSBC Bank Middle East Limited and its subsidiaries**

Transactions detailed below include amounts due to/from HSBC Bank Middle East Limited and its subsidiaries

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | **Highest balance during the year** | **Balance at 31 Dec** | Highest balance during the year | Balance at 31 Dec |
| | **US$000** | **US$000** | US$000 | US$000 |
| **Assets** | | | | |
| Loans and advances to customers | **6,369** | **1,888** | 300,347 | 5,535 |
| **Liabilities** | | | | |
| Customer accounts | **49,015** | **26,168** | 49,015 | 49,015 |

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

## 36 Events after the balance sheet date

A second interim dividend for 2018 of US$ 0.1074 per ordinary share (a distribution of US$100 million) was declared by the Directors on 12 February 2019.

These accounts were approved by the Board of Directors on 19 February 2019 and authorised for issue.

## HSBC Bank Middle East Limited

Head Office
Level 1, Building No. 8, Gate Village
Dubai International Financial Centre
DIFC, PO Box 502601, Dubai, UAE

## Middle East Management Office

HSBC Tower
Downtown
P O Box 66
Dubai
United Arab Emirates

## ALGERIA

El Mohammadia branch
Hydra branch
Oran branch

## BAHRAIN

Seef – Main Branch
Adliya
Manama – Batelco Building
Sanad

## KUWAIT

Kuwait City – Sharq Area

## QATAR

Doha – Airport Road (Main Branch)
Doha – City Centre
Doha – Salwa Road

## UNITED ARAB EMIRATES

Abu Dhabi – Old Airport Road
Dubai – Deira Al Muraqqabat
Dubai – Bur Dubai
Dubai – Jumeirah
Jebel Ali – Free Trade Zone
Fujairah – Hamad Bin Abdulla St
Ras Al Khaimah – Al Dhait
Sharjah – King Faisal Road
7 Customer Service Units and 2 Management Offices

### Principal Subsidiary Companies

HSBC Financial Services (Middle East) Limited
HSBC Middle East Securities LLC
HSBC Middle East Finance Company Limited
HSBC Insurance Services (Lebanon) S.A.L.
HSBC Bank Middle East Representative Office Morocco S.A.R.L.

### Associated Companies

MENA Infrastructure Fund (GP) Limited

### Special Connections With These Members Of The HSBC Group

HSBC Bank Oman S.A.O.G.
HSBC Bank Egypt S.A.E.
HSBC Bank International Limited
HSBC Securities (Egypt) S.A.E.
HSBC Electronic Data Service Delivery (Egypt) S.A.E.
HSBC Saudi Arabia Limited
The Saudi British Bank
HSBC Private Bank (Suisse) SA (DIFC Branch)
HSBC Middle East Leasing Partnership
HSBC Bank A.S.

HSBC BANK MIDDLE EAST LIMITED
*Incorporated in the Dubai International Financial Centre number – 2199*
*Regulated by the Dubai Financial Services Authority.*

REGISTERED OFFICE
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