2007

Annual Report and Accounts HSBC Bank Middle East Limited

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HSBC

Annual Report and Accounts 2007

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Presentation of Information

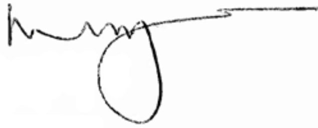
This document comprises the *Annual Report and Accounts 2007* for HSBC Bank Middle East Limited and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Accounts, together with the Auditors' report, as required by the Companies (Jersey) Law 1991.

Notice of the Annual General Meeting

Notice is hereby given that the One-Hundred-and-Eighteenth Annual General Meeting of HSBC Bank Middle East Limited will be held at HSBC House, Esplanade, St Helier, Jersey, Channel Islands on Wednesday 16 April 2008 at 9.00 a.m. to transact the following ordinary business:

1 to receive and consider the Annual Accounts and the Reports of the Directors and of the Auditors for the year ended 31 December 2007;

2 to appoint Auditors and to fix their remuneration.



By Order of the Board
M J Seguss, *Secretary*
Jersey

18 February 2008

Notes:

1 *By virtue of Article 13.6 of the Articles of Association, on a poll, votes may be given either personally, or by proxy.*
2 *By virtue of Article 13.8 of the Articles of Association, any instrument appointing a proxy shall be deposited at the Head Office of HSBC Bank Middle East Limited, or at such other place specified for that purpose in the notice of the meeting or an instrument of proxy issued by HSBC Bank Middle East Limited, before the time appointed for holding the meeting.*
3 *By virtue of Article 13.7 of the Articles of Association, any instrument appointing a proxy may be in any usual form, or as approved by the Directors.*
4 *By virtue of Article 14 of the Articles of Association, any corporation that is a Member of HSBC Bank Middle East Limited may, by Resolution of its Directors or other governing body, authorise such person as it thinks fit to act as its representative at any meeting of HSBC Bank Middle East Limited.*

Report of the Directors

Board of Directors

D H Hodgkinson, *Chairman*

Y A Nasr, *Deputy Chairman*

J B Blanthorne

W F Boustany

J E Coverdale

Abdel Salam El Anwar

M M Hussain

C J M Keirle

C M Meares

J C Tibbo

The present Directors of HSBC Bank Middle East Limited are listed above.

During the year, N S K Booker resigned as a Director and as Deputy Chairman with effect from 22 May 2007, and Y A Nasr was appointed as a Director and as Deputy Chairman with effect from 22 May 2007.

Since the year-end, W A Boustany was appointed as a Director with effect from 18 February 2008.

Principal activities

The group, through its branch network and subsidiary undertakings, provides a range of banking and related financial services in the Middle East. There has been no significant change in this activity.

Profit and dividends

The consolidated profit for the year attributable to the shareholders of the bank was US$703,967 thousand, and has been dealt with as set out in the Consolidated Income Statement on page 8.

A first interim equity dividend of US$150,000 thousand was declared and paid during the year. Since the year-end, the directors have declared a second interim equity dividend of US$100,000 thousand.

Debt securities and non-equity preference share capital

On 20 June 2007, the Directors allotted to the Bank's sole shareholder 100,000 cumulative redeemable preference shares of US$1.00 each, bearing a mandatory earliest redemption date of 20 June 2017 (deferrable at the request of the ordinary shareholders of the Bank to 10-yearly intervals thereafter), but redeemable at the option of the Bank on any date after 20 June 2012, fully paid and at a premium of US$999.00 per share.

Since the year-end, on 8 January 2008, the Bank established a Sukuk Issuance Programme, providing for the issue of up to US$5,000,000,000 in securities in the form of Shari'a-compliant Trust Certificates.

Also since the year-end, on 17 January 2008, the Bank's Debt Issuance Programme, originally established in 2004 and providing for the issue of up to US$1,000,000,000 in debt securities in the form of medium-term Notes, and extended in 2006 to provide for the issue of up to US$3,000,000,000 in debt securities in similar form, was extended to provide for the issue of up to US$7,000,000,000 in debt securities in similar form.

Annual General Meeting

The 2008 Annual General Meeting of the bank will be held on Wednesday 16 April 2008, in accordance with the Notice on page 2.

Report of the Directors (continued)

Auditors

The auditors, KPMG Channel Islands Limited, offer themselves for re-appointment, at fees to be agreed, and a resolution for their re-appointment will be proposed at the forthcoming Annual General Meeting.

On behalf of the Board
M J Seguss, *Secretary*
Jersey

18 February 2008

Statement of Directors' Responsibilities in Relation to the Directors' Report and the Financial Statements

The following statement, which should be read in conjunction with the Auditors' statement of their responsibilities set out in their report on page 6, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditors in relation to the financial statements.

The Directors are responsible for preparing the financial statements in accordance with applicable law and International Financial Reporting Standards as endorsed by the EU.

Company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the Directors are required to:

— select suitable accounting policies and apply them consistently;

— make judgements and estimates which are reasonable and prudent;

— state whether they have been prepared in accordance with International Financial Reporting Standards as adopted by the EU;

— state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and

— prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

David Hodgkinson, *Chairman*

Independent Auditors' Report to the Member of HSBC Bank Middle East Limited

We have audited the group financial statements ("the financial statements") of HSBC Bank Middle East Limited for the year ended 31 December 2007 which comprise the Consolidated Income Statement, the Consolidated Balance Sheet, the Consolidated Statement of Recognised Income and Expense, the Consolidated Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with Article 110 of the Companies (Jersey) Law 1991. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and Auditors

As described in the Statement of Directors' Responsibilities on page 5, the company's Directors are responsible for preparation of the financial statements in accordance with applicable law and International Financial Reporting Standards.

Our responsibility is to audit the financial statements in accordance with the relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007.

We also report to you if, in our opinion, the company has not kept proper accounting records or if we have not received all the information and explanations we require for our audit.

We read the Directors' Report accompanying the financial statements and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements.

It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements:

— give a true and fair view, in accordance with International Financial Reporting Standards, of the state of the group's affairs as at 31 December 2007 and of its profit for the year then ended; and

— have been properly prepared in accordance with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007.

KPMG Channel Islands Limited

KPMG Channel Islands Limited
Chartered Accountants

5 St Andrew's Place
Charing Cross
St Helier
Jersey
JE4 8WQ

7 April 2008

Notes:

a. *The maintenance and integrity of the HSBC Bank Middle East Limited's, or other HSBC Group websites are the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements or audit report since they were initially presented on the website.*

b. *Legislation in Jersey governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.*

Consolidated Income Statement for the Year Ended 31 December 2007

	Notes	**2007 US$000**	2006 US$000
Interest income		**1,751,198**	1,268,509
Interest expense		**(811,600)**	(562,378)
Net interest income		**939,598**	706,131
Fee income		**434,045**	279,523
Fee expense		**(32,218)**	(21,056)
Net fee income		**401,827**	258,467
Trading income excluding net interest income		**207,268**	123,754
Net interest income on trading activities		**16,464**	1,135
Net trading income		**223,732**	124,889
Gains less losses from financial investments		**2,673**	3,595
Dividend income		**1,085**	589
Other operating income		**19,620**	10,664
Net operating income before loan impairment charges		**1,588,535**	1,104,335
Loan impairment charges		**(53,651)**	(43,227)
Net operating income		**1,534,884**	1,061,108
Employee compensation and benefits	*5*	**(394,515)**	(264,231)
General and administrative expenses	*6*	**(251,223)**	(188,741)
Depreciation of property, plant and equipment		**(13,996)**	(12,433)
Amortisation of intangible assets		**(3,710)**	(848)
Total operating expenses		**(663,444)**	(466,253)
Operating profit		**871,440**	594,855
Share of profits in associates		**15,569**	12,188
Profit before tax		**887,009**	607,043
Tax expense	*8*	**(167,975)**	(127,543)
Profit for the year		**719,034**	479,500
Profit attributable to shareholders of the parent company		**703,967**	469,484
Profit attributable to minority interests		**15,067**	10,016

Consolidated Balance Sheet at 31 December 2007

ASSETS	*Notes*	**2007** **US$000**	2006 US$000
Cash and balances at central banks		**861,247**	289,835
Items in the course of collection from other banks		**297,440**	152,301
Trading assets	*12*	**1,503,766**	758,114
Derivatives	*13*	**396,026**	219,541
Loans and advances to banks	*24*	**6,384,369**	7,373,902
Loans and advances to customers	*24*	**18,614,547**	13,616,602
Financial investments	*14*	**7,403,279**	1,530,193
Interests in associates	*15*	**157,756**	147,777
Intangible assets	*16*	**8,207**	7,493
Property, plant and equipment	*17*	**86,070**	88,252
Other assets	*19*	**1,202,158**	762,709
Deferred taxation	*23*	**33,240**	29,332
Prepayments and accrued income		**205,020**	142,525
Total assets		**37,153,125**	25,118,576
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*24*	**3,425,491**	1,361,543
Customer accounts	*24*	**25,648,194**	17,581,720
Items in the course of transmission to other banks		**188,860**	80,956
Trading liabilities	*25*	**84,061**	70,342
Derivatives	*13*	**401,112**	220,188
Debt securities in issue	*20*	**2,981,754**	2,811,969
Retirement benefit liabilities		**46,320**	39,917
Other liabilities	*21*	**1,661,864**	982,306
Current tax liabilities		**193,843**	138,267
Accruals and deferred income		**145,600**	125,070
Provisions	*22*	**6,406**	1,721
Deferred taxation	*23*	**3,557**	3,223
Total liabilities		**34,787,062**	23,417,222
Equity			
Called up share capital	*28*	**431,055**	431,055
Other reserves	*29*	**60,468**	15,143
Retained earnings	*29*	**1,739,413**	1,187,829
Total equity attributable to shareholders of the parent company		**2,230,936**	1,634,027
Minority interests	*29*	**135,127**	67,327
Total equity		**2,366,063**	1,701,354
Total equity and liabilities		**37,153,125**	25,118,576

David Hodgkinson, *Chairman*

The accompanying notes are an integral part of the Consolidated Financial Statements.

Consolidated Statement of Recognised Income and Expense for the Year Ended 31 December 2007

	2007	2006
	US$000	US$000
Available-for-sale investments:		
— valuation gains taken to equity	**51,282**	3,461
— transferred to income statement on disposal or impairment	**(2,923)**	(1,600)
Cash flow hedges:		
— losses taken to equity	**(6,170)**	(4,571)
— transferred to income statement	**838**	180
Exchange differences arising on net investment in foreign operations	**3,625**	154
Actuarial losses on post-employment benefits	**(5,251)**	(739)
	41,401	(3,115)
Net deferred taxation on items taken directly to equity	**(616)**	102
Total net income/(expense) taken directly to equity during the year	**40,785**	(3,013)
Profit for the year	**719,034**	479,500
Total recognised income and expense for the year	**759,819**	476,487
Total recognised income and expense for the year attributable to:		
— shareholders of the parent company	**744,752**	466,471
— minority interests	**15,067**	10,016

Consolidated Cash Flow Statement for the Year Ended 31 December 2007

	Notes	**2007 US$000**	2006 US$000
Cash flows from operating activities			
Profit before tax		**887,009**	607,043
Adjustments for:			
— non-cash items included in profit before tax	*30*	**14,887**	(2,331)
— change in operating assets	*30*	**(6,629,421)**	(3,121,577)
— change in operating liabilities	*30*	**11,089,625**	5,483,373
— elimination of exchange differences[1]		**34,326**	(683)
— net gain from investing activities		**(3,231)**	(3,579)
— share of profits in associates		**(15,569)**	(12,188)
— dividends received from associates		**8,470**	20,260
— tax paid		**(116,374)**	(95,116)
Net cash from operating activities		**5,269,722**	2,875,202
Cash flows used in investing activities			
Purchase of financial investments		**(24,592,968)**	(908,997)
Proceeds from the sale of financial investments		**23,573,567**	839,783
Purchase of property, plant and equipment		**(17,337)**	(23,021)
Proceeds from the sale of property, plant and equipment		**6,709**	198
Purchase of intangible assets		**(4,616)**	(7,003)
Net cash outflow from acquisition of and increase in stake of associates		**(1,500)**	(730)
Net cash used in investing activities		**(1,036,145)**	(99,770)
Cash flows (used in)/from financing activities			
Issue of ordinary share capital		–	100,000
Non-equity preference share capital issued		**100,000**	250,000
Dividends paid to shareholders		**(150,000)**	(200,000)
Dividends paid to minority interests		**(1,962)**	(1,961)
Net cash (used in)/from financing activities		**(51,962)**	148,039
Net increase in cash and cash equivalents		**4,181,615**	2,923,471
Cash and cash equivalents at 1 January		**8,127,907**	5,183,855
Exchange rate and other movements on cash and cash equivalents		**50,324**	20,581
Cash and cash equivalents at 31 December	*30*	**12,359,846**	8,127,907

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 reasonable expense.*

Notes on the Financial Statements

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The group has prepared its consolidated financial statements in accordance with International Financial Reporting Standards ('IFRSs') as endorsed by the European Union ('EU'). EU-endorsed IFRSs may differ from IFRSs as published by the International Accounting Standards Board ('IASB') if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2007, there were no unendorsed standards effective for the year ended 31 December 2007 affecting the consolidated financial statements, and there is no difference between IFRSs endorsed by the EU and IFRSs as issued by the IASB in terms of their application to the group.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

The significant accounting policies applied in the preparation of these financial statements are set out in Note 2 below.

On 1 January 2007, the group adopted IFRIC 10 'Interim Financial Reporting and Impairment'. The application of this interpretation had no significant effect on the consolidated financial statements.

(b) Presentation of Information

The presentation of comparative information in Note 6 has been amended following the adoption by the group of the Institute of Chartered Accountants in England and Wales Technical Release 'Tech 06/06 — Disclosure of Auditor Remuneration'.

(c) Consolidation

The consolidated financial statements of HSBC Bank Middle East Limited comprise the financial statements of the bank and its subsidiaries (together 'the group') made up to 31 December. Newly acquired subsidiaries are consolidated from the date control is transferred to the group. The purchase method of accounting is used to account for the acquisition of subsidiaries by the group. The cost of an acquisition is measured at the fair value of the consideration given at the date of exchange, together with costs directly attributable to that acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities of the business acquired, the difference is recognised immediately in the income statement. Entities that are controlled by the group are consolidated until the date that control ceases.

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, the group controls, and consequently consolidates, an SPE:

- the activities of the SPE are being conducted on behalf of the group according to its specific business needs so that the group obtains benefits from the SPE's operation;
- the group has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the group has delegated these decision-making powers;
- the group has the rights to obtain the majority of benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- the group retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements of the group also include the attributable share of the results and reserves of associates. These are based on financial statements made up to 31 December.

1 Basis of preparation *(continued)*

(d) Future accounting developments

Standards and interpretations issued by the IASB and endorsed by the EU

IFRS 8 'Operating Segments', which replaces IAS 14 'Segment Reporting', was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should report information about its operating segments, based on information about the components of the entity that management uses to make operating decisions. It is anticipated that this standard will be adopted with effect from 1 January 2009, and will have an impact on the group. However, IFRS 8 will only affect reporting of financial and descriptive information about its reportable segments in the financial statements at the reporting date.

IFRIC 11 'Share-based Payments Group and Treasury Share Transactions' was issued on 2 November 2006 and is effective for annual periods beginning on or after 1 March 2007. IFRIC 11 requires a share-based payment arrangement in which an entity receives goods or services as consideration for its own equity instruments to be accounted for as an equity-settled share-based payment transaction, regardless of how the equity instruments required are obtained. The Interpretation also provides guidance on whether share-based payment arrangements in which suppliers of goods or services of an entity are provided with equity instruments of the entity's parent, should be accounted for as cash-settled or equity-settled in the entity's financial statements. It is anticipated that this interpretation will be adopted with effect from 1 January 2008, and will have an impact on the group.

Standards and interpretations issued by the IASB but not endorsed by the EU

The IASB issued a revised IAS 23 'Borrowing Costs' on 29 March 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised Standard eliminates the option of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. Adoption of the revised Standard is not expected to have a significant impact on group results.

IFRIC 12 'Service Concession Arrangements' ('IFRIC 12') was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2008. IFRIC 12 provides guidance on service concession arrangements by which a government or other public sector entity grants contracts for the supply of public services to the private sector operators. IFRIC 12 addresses how service concession operators should apply existing IFRSs to account for the obligations they undertake and the rights they receive in service concession arrangements. IFRIC 12 is unlikely to have a material effect on the group.

IFRIC 13 'Customer Loyalty Programmes' ('IFRIC 13') was issued on 28 June 2007 and is effective for annual periods beginning on or after 1 July 2008. IFRIC 13 addresses how companies that grant their customers loyalty award credits (often called 'points') when buying goods or services should account for their obligation to provide free or discounted goods or services, if and when the customers redeem the points. IFRIC 13 requires companies to allocate some of the proceeds of the initial sale to the award credits and recognise these proceeds as revenue only when they have fulfilled their obligations to provide the goods or services. Adoption of this interpretation is not expected to have a significant impact on the group.

IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction' ('IFRIC 14') was issued on 5 July 2007 and is effective for annual periods beginning on or after 1 January 2008. IFRIC 14 provides guidance regarding the circumstances under which refunds and future reductions in contributions from a defined benefit plan can be regarded as available to an entity for the purpose of recognising a net defined benefit asset. Additionally, in jurisdictions where there is both a minimum funding requirement and restrictions over the amounts that companies can recover from the plan, either as refunds or reductions in contribution, additional liabilities may need to be recognised. IFRIC 14 is not expected to have a significant impact on the group.

A revised IAS 1 'Presentation of Financial Statements', which is applicable for annual periods beginning on or after 1 January 2009, was issued on 6 September 2007. The revised standard aims to improve users' ability to analyse and compare information given in financial statements. Adoption of the revised standard will have no effect on the results reported in the group's consolidated financial statements but will change the presentation of the results and financial position of the group in certain respects.

Notes on the Financial Statements (continued)

1 Basis of preparation *(continued)*

The IASB issued an amendment to IFRS 2 ‘Share-based Payment’ on 17 January 2008. The amendment, which is applicable for annual periods beginning on or after 1 January 2009, clarifies that vesting conditions comprise only service conditions and performance conditions. It also specifies the accounting treatment for a failure to meet a non-vesting condition. Adoption of the amendment is unlikely to have a significant effect on the group’s consolidated financial statements.

A revised IFRS 3 ‘Business Combinations’ and an amended IAS 27 ‘Consolidated and Separate Financial Statements’, were issued on 10 January 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes under the standards are that:

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;
- changes in a parent’s ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- an option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interests) in the entity acquired either at fair value, or at the non-controlling interest’s proportionate share of the net identifiable assets of the entity acquired.

The effect that the changes will have on the results and financial position of the group will depend on the incidence and timing of business combinations occurring on or after 1 January 2010.

The IASB issued amendments to IAS 32 ‘Financial Instruments: Presentation’ and IAS 1 ‘Presentation of Financial Statements’, ‘Puttable Financial Instruments and Obligations Arising on Liquidation’, on 14 February 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. The effect of the amendments, if any, on the consolidated financial statements is currently being assessed by the group.

2 Summary of significant accounting policies

(a) Interest income and expense

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

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

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

2 Summary of significant accounting policies *(continued)*

(b) Non interest income

Fee income

The group earns fee income from a diverse range of services provided to its customers. Fee income is accounted for as follows:

— income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);

— income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and

— income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

Net income from financial instruments designated at fair value

'Net income from financial instruments designated at fair value' includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on those financial instruments are also included, except for debt securities in issue and derivatives managed in conjunction with debt securities in issue. Interest on these instruments is shown in 'Net interest income'.

Trading income

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

(c) Segment reporting

The group's main operations are in the UAE and Qatar, although it also has operations elsewhere in the Middle East, and manages its business through four customer groups: Personal Financial Services; Commercial Banking; Corporate, Global Banking and Markets; and Private Banking. Segment income and expenses include transfers between geographical regions and transfers between customer group segments. These transfers are conducted at arm's length.

(d) Determination of fair value

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

For certain derivatives, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

A number of factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when values are calculated using valuation techniques.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset, or it is extinguished.

(e) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not intended to be sold in the short term and have not been classified either as held for trading or designated at fair value through profit and loss. Loans and advances are recognised when cash is advanced to borrowers and are derecognised when either borrowers repay their obligations, or the loans are sold or written off or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses.

(f) Loan impairment

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on loans assessed collectively. Losses expected from future events, no matter how likely, are not recognised.

Individually assessed loans

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

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

2 Summary of significant accounting policies *(continued)*

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying value. Any loss is charged in the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account.

Collectively assessed loans

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

— for loans subject to individual assessment, to cover losses which have been incurred but have not yet been identified; and

— for homogeneous groups of loans that are not considered individually significant, where there is objective evidence of impairment.

Incurred but not yet identified impairment

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

The collective impairment loss is determined after taking into account:

— historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);

— the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and

— management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

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

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis:

— When appropriate empirical information is available, the group utilises roll rate methodology. This methodology employs a statistical analysis of historical trends of the probability of default and the amount of consequential loss, assessed at each time period for which the customer's contractual payments are overdue. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying value of the portfolio. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.

— In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the group adopts a formulaic approach which allocates progressively higher percentage loss rates in line with the period of time for which a customer's loan is overdue. Loss rates are calculated from the discounted expected future cash flows from a portfolio.

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

2 Summary of significant accounting policies *(continued)*

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from realising the security have been received.

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 reversal is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the income statement.

Renegotiated loans

Personal loans, which are generally subject to collective impairment assessment, whose terms have been renegotiated, are no longer considered to be past due or impaired but are treated as new loans only after the minimum required number of payments under the new arrangements have been received.

Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

(g) Trading assets and trading liabilities

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

(h) Financial instruments designated at fair value

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

— Eliminates or significantly reduces valuation or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by the group are:

2 Summary of significant accounting policies *(continued)*

Long-term debt securities – The interest payable on certain fixed rate long-term debt securities in issue and subordinated liabilities has been matched with receive fixed/pay variable interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities in issue were accounted for at amortised cost, because the related derivatives are measured at fair value with movements in the fair value taken through the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will be recorded in the income statement.

Financial assets and financial liabilities under investment contracts – These are managed on a fair value basis and management information is also prepared on this basis. Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes shown in the income statement. Liabilities to customers under other types of investment contracts would be shown at amortised cost. If no designation was made for the assets relating to the customer liabilities they would be reclassified as available-for-sale and the changes in fair value would be recorded directly in equity. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair value to be recorded in the income statements and presented in the same line.

— Applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis.

— Relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell securities, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured and, except for interest payable on debt securities in issue designated at fair value, gains and losses from changes therein are recognised in 'Net income from financial instruments designated at fair value'.

Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are also included in 'Net income from financial instruments designated at fair value'. Interest on these derivatives is also included in this line, except for interest on derivatives managed with debt securities in issue designated at fair value, which is included in 'Net interest income'. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and receivables that is attributable to changes in their credit risk, is determined as the amount of change in fair value that is not attributable to changes in market conditions.

(i) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2(h)), are classified as 'available-for-sale' or 'held-to-maturity'. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

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

2 Summary of significant accounting policies *(continued)*

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

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of financial assets. This usually arises when circumstances are such that an adverse effect on future cash flows from the asset or group of assets can be reliably estimated. If an available-for-sale security is impaired, the cumulative loss (measured as the difference between the assets acquisition cost and its current fair value, less any impairment loss on that asset previously recognised in the income statement) is removed from equity and recognised in the income statement. Reversals of impairment losses are subject to contrasting treatments depending on the nature of the instrument concerned:

— if the fair value of a debt instrument classified as available-for-sale increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement; and

— impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

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

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

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

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

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

For repos and security lending, if the counterparty has the right to sell or repledge the securities transferred, the securities are presented separately on the balance sheet.

2 Summary of significant accounting policies *(continued)*

(k) Derivatives and hedge accounting

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

In the normal course of business, the fair value of a derivative on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading profit or loss on inception of the derivative. When unobservable market data have a significant impact on the valuation of derivatives, the entire initial change in fair value indicated by the valuation model is not recognised immediately in the income statement. It is instead recognised over the life of the transaction on an appropriate basis, or is recognised in the income statement when the inputs become observable, or when the transaction matures or is closed out.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative are the same as those of a stand-alone derivative; and the combined contract is not held for trading or designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

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

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

Hedge accounting

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

Fair value hedge

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

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

2 Summary of significant accounting policies *(continued)*

Cash flow hedge

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

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

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

Net investment hedge

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

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

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

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

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

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of any derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives related to debt issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'.

(l) Derecognition of financial assets and liabilities

Financial assets are derecognised when the right to receive cash flows from the assets has expired; or when the group has transferred its contractual right to receive the cash flows of the financial assets, and substantially all the risks and rewards of ownership; or where control is not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged, cancelled or expires.

2 Summary of significant accounting policies *(continued)*

(m) Offsetting financial assets and financial liabilities

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

(n) Associates

Investments in associates are recognised using the equity method, initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the group's share of net assets.

Adjustments to the carrying amount of investments in associates that have not been recognised in profit or loss are recognised by the group directly in equity.

Unrealised gains on transactions between the group and its associates are eliminated to the extent of the group's interest in the respective associates. Unrealised losses are also eliminated to the extent of the group's interest in the associates unless the transaction provides evidence of an impairment of the asset transferred.

(o) Intangible assets

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

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

Intangible assets are amortised over their finite useful lives as follows:

Purchased software	over 5 years
Internally generated software	over 5 years

(p) Property, plant and equipment

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

— freehold land is not depreciated;

— freehold buildings are depreciated on cost at the greater of two per cent per annum on a straight-line basis or over their remaining useful lives; and

— leasehold buildings are depreciated on cost on a straight-line basis over the unexpired terms of the leases, or over their remaining useful lives.

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

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

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

(q) Finance and operating leases

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

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

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

(r) Income tax

Income tax on the profit or loss for the year comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in shareholders' equity, in which case it is recognised in shareholders' equity.

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

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

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to set-off exists in the entity.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. From 1 January 2005, deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedges which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

2 Summary of significant accounting policies *(continued)*

(s) Post-employment benefits

The bank contributes to the Government pension and social security schemes in the countries in which it operates, as per local regulations. End of service benefits are calculated and paid in accordance with local law. The bank's net obligation in respect of such end of service benefits is the amount of future benefits that employees have earned in return for their service in current and prior periods. The obligation is calculated by a qualified actuary using the projected unit credit method (using an emerging cash flow model) allowing for assumed future experience. The discount rate used is the yield on long term, high quality corporate bonds or Central Bank certificate of deposits, where appropriate. All actuarial gains or losses are recognised in shareholders' equity.

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

(t) Equity compensation plans

Shares in HSBC Holdings plc awarded to an employee on joining the group that are made available immediately, with no vesting period attached to the award, are expensed immediately. When an inducement is awarded to an employee on commencement of employment with the group, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting. As these awards are made by the group a liability for the shares awarded is recognised on balance sheet over the vesting period, at fair value.

Share option awards are granted by HSBC Holdings to Group employees and are accounted for as equity-settled as they are satisfied by HSBC Holdings transferring shares to the employees.

The compensation expense of share options charged to the income statement is credited to the share-based payment reserve over the vesting period. Compensation expense is determined by reference to the fair value of the options on grant date, and the effect of any non-market vesting conditions such as option lapses. An option may lapse if, for example, an employee ceases to be employed by the group before the end of the vesting period. Estimates of future such employee departures are taken into account when accruing the cost during the service period.

The cost of bonuses awarded in respect of past service, by which an employee is required to complete a specified period of future service to be entitled to the award, is spread over the period of service rendered to the vesting date.

(u) Foreign currencies

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements of HSBC Bank Middle East Limited are presented in US dollars, which is the group's presentation currency.

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 ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of 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.

2 Summary of significant accounting policies *(continued)*

The results of branches, subsidiaries and associates not reporting in US dollars 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 investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are accounted for in a separate foreign exchange reserve. 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 subsidiary financial statements. In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. In accordance with IFRS 1 'First Time Adoption of International Financial Reporting Standards', the group has set the cumulative translation differences for all foreign operations to zero at the date of transition to IFRSs. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

(v) Provisions

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

(w) Debt securities in issue and non-equity preference share capital

Debt securities in issue are initially measured at fair value, which is normally the consideration received net of directly attributable transaction costs incurred. Subsequent measurement is at amortised cost, using the effective interest rate method to amortise the difference between proceeds net of directly attributable transaction costs and the redemption amount over the expected life of the debt, unless the securities are designated at fair value (Note 2(h)). Non-equity preference share capital is measured at amortised cost.

(x) Share capital

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

(y) Cash and cash equivalents

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

3 Use of assumptions and estimates

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2.

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

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality of the items to which the policy is applied, or which involve a high degree of judgement and estimation, are:

3 Use of assumptions and estimates *(continued)*

Impairment of loans

The group's accounting policy for losses in relation to the impairment of customer loans and advances is described in Note 2(f). Further information can be seen in Note 31 'Risk Management'. Impairment is calculated on the basis of discounted estimated future cash flows.

Losses in respect of impaired loans are reported in the group's income statement under the caption 'Loan impairment charges'. An increase in these losses has the effect of reducing the group's profit for the period by a corresponding amount (while a decrease in impairment charges or reversal of impairment charges has the opposite effect).

The group's policy requires a review of the level of impairment allowances on individual facilities above materiality thresholds at least half-yearly, or more regularly when individual circumstances require. This normally includes a review of collateral held (including re-confirmation of its enforceability) and an assessment of actual and anticipated receipts.

In the case of homogenous loans, in normal circumstances, historical experience is the most objective and relevant information from which to assess inherent loss within each portfolio. In circumstances where historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic conditions or regulatory changes, management considers the most recent trends in the portfolio risk factors which may not be fully reflected in its statistical models when calculating the appropriate level of impairment allowances. Key risk factors include recent trends in charge-off and delinquency, economic conditions such as national and local trends in housing markets, changes in product mix and concentration, bankruptcy trends, other market conditions such as changes in interest rates and energy prices, changes in laws and regulations and natural disasters.

The portfolio approach is generally applied to the following types of portfolios:

— Low value, homogenous small business accounts in certain jurisdictions;

— Residential mortgages;

— Credit cards and other unsecured consumer lending products; and

— Motor vehicle financing.

These portfolio allowances are generally reassessed monthly and charges for new allowances, or reversals of existing allowances, are calculated for each separately identified portfolio.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is included in Note 2 and is discussed further within Note 13 'Derivatives' and Note 24 'Fair value of financial instruments'.

When fair values are determined by using valuation techniques which refer to observable market data because independent prices are not available, management will consider the following when applying a model:

— The likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt; and

— An appropriate discount rate for the instrument. Management determines this rate based on its assessment of the appropriate spread of the rate for the instrument over the risk-free rate.

Notes on the Financial Statements (continued)

3 Use of assumptions and estimates *(continued)*

When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared. When valuing instruments on a model basis using the fair value of underlying components, management considers, in addition, the need for adjustments to take account of factors such as bid-offer spread, credit profile and model uncertainty. These adjustments are based on defined policies which are applied consistently across the group.

When unobservable market data have a significant impact on the valuation of derivatives, the entire initial change in fair value indicated by the valuation model is not recognised immediately in the income statement but is recognised in one of the following ways: over the life of the transaction on an appropriate basis; in the income statement when the inputs become observable; or when the transaction matures or is closed out.

Post-employment benefits

The assumptions used are disclosed in Note 5 'Employee compensation and benefits'.

Share-based payments

The assumptions used are disclosed in Note 7 'Share-based payments'.

4 Net operating income

Net operating income for the year ended 31 December 2007 is stated after the following items of income, expense, gains and losses:

	2007	2006
	US$000	US$000
Income		
Interest on financial instruments, excluding interest on financial assets held for trading or designated at fair value	**1,751,198**	1,268,509
Interest recognised on impaired financial assets	**17,379**	13,993
Fees earned on financial assets that are not held for trading or designated at fair value and that are not included in their effective interest rates	**370,609**	169,227
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**37,522**	4,513
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(811,600)**	(562,378)
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**(23,326)**	(9,533)
Gains/(losses)		
Impairment losses on:		
— loans and advances	**(53,651)**	(43,227)
Gains/(losses) on disposal of property, plant and equipment and non-financial investments	**103**	(15)

5 Employee compensation and benefits

	2007	2006
	US$000	US$000
Wages and salaries	**373,467**	247,978
Social security costs	**4,678**	4,109
Post-employment benefits (Note 2(s))	**16,370**	12,144
	394,515	264,231

The average number of persons employed by the group during the year was made up as follows:

	2007	2006
	Number	Number
Personal Financial Services	**1,880**	1,560
Commercial Banking	**1,157**	885
Global Banking and Markets	**329**	245
Private Banking	**6**	3
Other operations (mainly support functions)	**1,962**	1,725
	5,334	4,418

Post-employment benefits

Arrangements for staff retirement benefits in overseas locations vary from country to country and are made in accordance with local regulations and custom. The majority of branches operate staff indemnity schemes for local staff which take the form of gratuity schemes.

The schemes are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the scheme obligations vary according to the economic conditions of the countries in which they are situated.

The principal actuarial financial assumptions used to calculate the scheme obligations at 31 December 2007 were:

	Discount rate	**Inflation assumption**	**Rate of increase for benefits in payment and deferred benefits**	**Rate of pay increase**
	%	%	%	%
At 31 December 2007				
United Arab Emirates	**4.3**	**7.5**	**28.3**	**8.0**
At 31 December 2006				
United Arab Emirates	5.0	7.0	16.6	7.5

The bank determines discount rates in consultation with its actuary based upon the yield on long term, high quality corporate bonds or Central Bank certificate of deposits, where appropriate.

Notes on the Financial Statements (continued)

5 Employee compensation and benefits *(continued)*

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The following table shows the effect of changes in this and other key assumptions on the scheme obligation and costs for the following year:

	United Arab Emirates	
	2007	2006
	US$000	US$000
Discount rate		
Change in scheme obligation at 31 December from a 25bps increase	**32,527**	22,242
Change in scheme obligation at 31 December from a 25bps decrease	**33,705**	22,904
Change in scheme cost from a 25bps increase	**7,259**	5,130
Change in scheme cost from a 25bps decrease	**7,624**	5,363
Rate of inflation		
Change in scheme obligation at 31 December from a 25bps increase	**33,705**	22,910
Change in scheme obligation at 31 December from a 25bps decrease	**32,524**	22,235
Change in scheme cost from a 25bps increase	**7,623**	5,363
Change in scheme cost from a 25bps decrease	**7,259**	5,128
Rate of pay increase		
Change in scheme obligation at 31 December from a 25bps increase	**33,705**	22,910
Change in scheme obligation at 31 December from a 25bps decrease	**32,524**	22,235
Change in scheme cost from a 25bps increase	**7,623**	5,363
Change in scheme cost from a 25bps decrease	**7,259**	5,128

6 General and administrative expenses

Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to US$576 thousand (2006: US$576 thousand). The following remuneration was paid by the group to the group's principal auditor, KPMG Channel Islands Limited and its affiliated firms ('KPMG'):

	2007	2006
	US$000	US$000
Audit fees for HSBC Bank Middle East Limited statutory audit:		
— fees relating to current year	**576**	576
— fees relating to prior year	**1**	(27)
	577	549
Fees payable to KPMG for other services provided to the group:		
— other services pursuant to legislation	**419**	225
— tax services	**59**	11
— valuation and actuarial services	**4**	3
— all other services	**215**	82
	697	321
Total fees payable	**1,274**	870

6 General and administrative expenses *(continued)*

The following is a description of the type of services included within the categories listed in the previous page:

- Audit fees are in respect of fees payable to KPMG Channel Islands Limited and their associates for the statutory audit of the consolidated accounts of HSBC Bank Middle East Limited.
- Other services pursuant to legislation include services for assurance and other services that are in relation to statutory and regulatory filings, including comfort letters and interim reviews.
- Tax services include tax compliance services and tax advisory services.
- All other services include other assurance and advisory services such as translation services, ad-hoc accounting advice and review of financial models.

7 Share-based payments

Share option awards are granted by HSBC Holdings to group employees and are accounted for as equity-settled share-based payments as they are satisfied by HSBC Holdings transferring shares to the employees on exercise.

Where an award of HSBC Holdings shares is made to a group employee by a group entity, the employing entity has an obligation to transfer HSBC Holdings shares to the employee if the vesting conditions of the award are satisfied. The employing entity incurs a liability in respect of the share awards recognised at fair value, remeasured at each reporting date over the vesting period and at the date of settlement. These transactions are accounted for as cash-settled share-based payment transactions.

During 2007, US$5,168 thousand was charged to the income statement in respect of equity-settled share-based payment transactions (2006: US$4,242 thousand). This expense was based on the fair value of the transactions at the date of settlement or at the year end. All of the expense arose under employee share awards made within the group's reward structures.

Calculation of fair values

Fair values of equity instruments at date of grant are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/share awards with vesting dependent on the Group's Total Shareholder Return over a period, these performance targets are incorporated into the model using Monte-Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2007 were as follows:

	1-year Savings Related Share Option Schemes	**3-year Savings Related Share Option Schemes**	**5-year Savings Related Share Option Schemes**	**The HSBC Share Plan**
Risk-free interest rate (%)[1]	**5.6**	**5.5**	**5.4**	**–**
Expected life (years)[2]	**1.0**	**3.0**	**5.0**	**–**
Expected volatility (%)[3]	**17.0**	**17.0**	**17.0**	**–**

1 *The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan awards and UK Savings-Related Share Option Schemes. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.*
2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*
3 *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

Notes on the Financial Statements (continued)

7 Share-based payments *(continued)*

Expected dividends have been incorporated into the valuation model for options and shares, where applicable. Expected dividend growth was determined, denominated in US Dollars, to be 10 per cent for the first 3 years (2006: 9 per cent for the first year) and 8 per cent thereafter (2006: 8 per cent), consistent with consensus analyst forecasts.

The average share price for 2007 was £9.03 (2006: £9.60). The high mid-market price for the year was £9.72 and the low mid-market price was £7.84 (2006: £10.28 and £9.14 respectively).

The significant weighted average assumptions used to estimate the fair value of the options granted in 2006 were as follows:

	Group Share Option Plan	3-year Savings Related Share Option Schemes	3-year Savings Related Share Option Schemes	The HSBC Share Plan
Risk-free interest rate (%)[1]	4.7	4.8	4.7	–
Expected life (years)[2]	1.0	3.0	5.0	–
Expected volatility (%)[3]	17.0	17.0	17.0	–

1 *The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan awards and UK Savings-Related Share Option Schemes. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.*
2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*
3 *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

HSBC Share Plan

The HSBC Share Plan was adopted by the group in 2005. This plan comprises Performance share awards, Restricted share awards and Achievement share awards. The aim of the HSBC Share Plan is to align the interests of executives to the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

Performance share awards

Performance share awards are made to senior executives taking into account individual performance in the prior year. Performance share awards are divided into two equal parts for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return measure, based on HSBC's ranking against a comparator group of 28 major banks. The other half of the award is subject to an Earnings per share target. For each element of the award, shares would be released to the employee according to a sliding scale from 30 to 100 per cent of the award, depending upon the scale of achievement against the benchmarks and providing that a threshold has been passed. If the threshold is not passed, zero per cent will vest for that part of the award. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if the Group performance fails to meet the threshold criteria.

	2007 Number (000's)	2006 Number (000's)
Outstanding at 1 January	**246**	246
Released in the year	**(165)**	–
Transferred in the year	**177**	–
Outstanding at 31 December	**258**	246

The weighted average fair value of shares awarded by HSBC for Performance Share Awards in 2007 was £8.96 (2006: £7.38)

7 Share-based payments *(continued)*

Restricted share awards

Restricted Share awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from date of award.

	2007 Number (000's)	2006 Number (000's)
Outstanding at 1 January	**128**	–
Additions during the year	**300**	140
Released in the year	**(41)**	–
Transferred in the year	**(97)**	
Forfeited in the year	**–**	(12)
Outstanding at 31 December	**290**	128

The weighted average fair value of shares awarded by HSBC for Restricted Share Awards in 2007 was £8.96 (2006: £9.65).

Savings-related share option plans

The savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plan is to align the interests of all employees to the creation of shareholder value. The options are exercisable within six months following either the third or the fifth anniversary of the commencement of the savings contract depending on conditions set at grant. The exercise price is set at a 20 per cent (2006: 20 per cent) discount to the market value at the date of grant.

	2007		2006	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**1,497**	**6.46**	1,558	6.18
Granted in the year	**724**	**7.08**	436	8.89
Exercised in the year	**(356)**	**6.45**	–	–
Transferred in the year	**(66)**	**6.89**	–	–
Forfeited in the year	**(1)**	**6.76**	(497)	6.41
Expired in the year	**(197)**	**6.76**	–	–
Outstanding at 31 December	**1,601**	**6.59**	1,497	6.46

The weighted average fair value of options granted in the year as at the date of grant was £2.12 (2006: £2.50). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2007	2006
Exercise price range (£)	**£5.35-£8.02**	£5.35-£8.02
Number (000's)	**1,601**	1,497
Weighted average exercise price (£)	**6.59**	6.46
Weighted average remaining contractual life (years)	**1.77**	2.08

Notes on the Financial Statements (continued)

7 Share-based payments *(continued)*

Restricted Share Plan 2000

Performance Share awards made under the HSBC Holdings Restricted Share Plan 2000

Performance Share awards under the Restricted Share Plan were granted to Senior Executives from 1996 to 2004. The aim of the plan was to align the interests of executives to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets against a peer group of major banks which must normally be attained in order for the awards to vest. No further awards will be made under this Plan following adoption of the HSBC Share Plan in 2005.

	2007 Number (000's)	2006 Number (000's)
Outstanding at 1 January	**91**	101
Additions during the year	**37**	4
Releases during the year	**(73)**	(13)
Transferred in the year	**45**	(1)
Outstanding at 31 December	**100**	91

The fair value of the shares at 31 December 2007 was £8.42 (2006: £9.31).

The weighted average remaining vesting period as at 31 December 2007 was 10 months (2006: 15 months).

Restricted share awards made under the HSBC Holdings Restricted Share Plan 2000 ('Achievement Shares')

Achievement shares are utilised to promote widespread interest in HSBC Holdings shares among employees and to help foster employee engagement. They are awarded to eligible employees after taking into account the employee's performance in the prior year. Shares are awarded without corporate performance conditions and are released to employees after three years providing the employees have remained continuously employed by the Group for this period.

	2007 Number (000's)	2006 Number (000's)
Outstanding at 1 January	**297**	125
Additions during the year	**318**	172
Releases during the year	**(100)**	–
Transferred in the year	**(22)**	–
Outstanding at 31 December	**493**	297

7 Share-based payments *(continued)*

Other awards made under the Restricted Share Plan

Other awards were made under the HSBC Holdings Restricted Share Plan 2000 as part deferral of annual bonus. Awards were also made for recruitment and retention purposes. The awards generally vest from one to three years from the date of award. Awards made under this plan ceased in May 2005. Awards of restricted shares on or after 27 May 2005 were made under the Rules of the HSBC Share Plan.

	2007 Number (000's)	2006 Number (000's)
Outstanding at 1 January	**43**	63
Additions during the year	**–**	2
Releases during the year	**(28)**	(22)
Transferred in the year	**12**	–
Outstanding at 31 December	**27**	43

No shares were awarded by the group for HSBC Holdings Restricted Share Plan 2000 in 2007 and 2006.

The weighted average remaining vesting period as at 31 December 2007 was 0.14 years (2006: 0.95 years).

Group Share Option Plan

The Group Share Option Plan was a long-term incentive plan available to certain group employees between 2000 and 2005. The aim of the plan was to align the interests of those higher performing employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets which must normally be attained in order for the awards to vest. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

	2007		2006	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**1,255**	**7.82**	1,556	7.74
Granted in the year	**–**	**–**	19	–
Exercised in the year	**(139)**	**6.96**	–	–
Transferred in the year	**301**	**7.72**	–	–
Forfeited in the year	**(50)**	**7.97**	–	–
Expired in the year	**(21)**	**7.97**	(320)	8.02
Outstanding at 31 December	**1,346**	**7.86**	1,255	7.82

No share options were awarded by HSBC for the Group Share Option Plan in 2007 (fair value of options granted in 2006: Nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2007		2006	
Exercise price range (£)	**£6.00-£8.00**	**£8.01-£10.00**	£6.00-£8.00	£8.01-£10.00
Number (000's)	**319**	**1,027**	512	743
Weighted average exercise price (£)	**6.91**	**8.30**	6.91	8.31
Weighted average remaining contractual life (years)	**–**	**0.06**	–	0.52

Notes on the Financial Statements (continued)

7 Share-based payments *(continued)*

Executive Share Option Scheme

The Executive Share Option Scheme was a long-term incentive scheme under which certain senior employees were awarded share options before the adoption of the Group Share Option Plan in 2000. The aim of the plan was to align the interests of those higher performing senior employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets to be attained in order for the awards to vest. Options were granted at market value and were exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. No awards have been made under this plan since 2000 and the remaining unexercised options are summarised below:

	2007		2006	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**155**	**6.82**	221	6.78
Exercised in the year	**(61)**	**6.65**	–	–
Transferred in the year	**95**	**6.85**	–	–
Forfeited in the year	**–**	**–**	(66)	5.94
Expired in the year	**(4)**	**6.84**	–	–
Outstanding at 31 December	**185**	**6.85**	155	6.82

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2007	2006	
Exercise price range (£)	**£6.01-£7.87**	£2.17-£6.00	£6.01-£7.87
Number (000's)	**185**	14	141
Weighted average exercise price (£)	**6.85**	5.02	6.84
Weighted average remaining contractual life (years)	**1.66**	–	2.64

8 Tax expense

The charge for taxation comprises:

	2007 US$000	2006 US$000
Current tax		
Overseas tax – current year	**175,002**	125,891
Overseas tax – adjustment in respect of prior years	**213**	1,090
Overseas tax – irrecoverable withholding tax	**–**	116
	175,215	127,097
Deferred tax		
Origination and reversal of temporary differences	**(7,240)**	446
Effect of write-downs/reversal of write-downs of deferred tax assets	**(7,240)**	446
Tax expense	**167,975**	127,543

8 Tax expense

The bank is not resident in the United Kingdom for taxation purposes. The bank and subsidiary undertakings provide for taxation at the appropriate rates in the countries in which they operate.

	2007		2006	
		Percentage of overall tax		Percentage of overall tax
	US$000	**%**	US$000	%
Analysis of overall tax charge				
Taxation at UAE tax rate of 20 per cent (2006: 20 per cent)	**174,288**	**19.7**	118,971	19.6
Impact of overseas profits in principal locations taxed at different rates[1]	**18,796**	**2.1**	15,802	2.6
Income not subject to tax	**(28,918)**	**(3.3)**	(11,806)	(1.9)
Expenses not deductible for tax purposes	**2,894**	**0.3**	2,319	0.3
Prior period adjustments	**699**	**0.1**	365	0.1
Other items	**216**	**0.0**	1,892	0.3
Overall tax charge	**167,975**	**18.9**	127,543	21.0

1 *Overseas profits taxed at different rates to that which applies in the UAE contributed to a decrease in the effective tax rate of 2.1 per cent (2006: increase of 1.7 per cent). The decrease in the effective tax rate is due to an increase in the proportion of income arising from tax free jurisdictions.*

In addition to the amount charged to the income statement the aggregate amount of deferred taxation, relating to items that are taken directly to equity, was a US$616 thousand reduction in equity (2006: US$102 thousand increase in equity).

The group is subject to income taxes in many jurisdictions and significant judgement is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some time later. The group recognises liabilities for taxation based on estimates of whether additional taxes will be payable. The estimation process includes seeking expert advice where appropriate. Where the final liability for taxation is different from the amounts that were initially recorded, these differences will affect the income tax and deferred taxation provisions in the period in which the estimate is revised or the final liability is established.

9 Dividends

	2007		2006	
	US$ per share	**US$000**	US$ per share	US$000
First interim	**0.348**	**150,000**	0.464	200,000

10 Segment analysis

The allocation of earnings reflects the benefit of shareholders' funds to the extent that these costs are actually allocated to businesses in the segment by way of intra-group capital and funding structures.

(a) By geographical region

Geographical information has been classified by the location of the principal operations of the subsidiary or associate undertaking or, in the case of the bank, by the location of the branch responsible for reporting the results or for advancing the funds.

Notes on the Financial Statements (continued)

10 Segment analysis *(continued)*

	UAE	Qatar	Rest of Middle East	Total
2007	**US$000**	**US$000**	**US$000**	**US$000**
Total operating income				
Net interest income	**651,300**	**101,899**	**186,399**	**939,598**
Dividend income	**1,085**	**–**	**–**	**1,085**
Net fee income	**285,437**	**41,750**	**74,640**	**401,827**
Net trading income	**174,183**	**21,287**	**28,262**	**223,732**
Gains less losses from financial investments	**2,673**	**–**	**–**	**2,673**
Other operating income	**16,818**	**469**	**2,333**	**19,620**
Net operating income before loan impairment charges	**1,131,496**	**165,405**	**291,634**	**1,588,535**
Profit before tax	**603,412**	**98,768**	**184,829**	**887,009**
Profit attributable to shareholders	**484,351**	**67,456**	**152,160**	**703,967**
Depreciation and amortisation	**(11,386)**	**(2,234)**	**(4,086)**	**(17,706)**
Loan impairment charges	**(57,139)**	**(4,395)**	**7,883**	**(53,651)**
Cost to acquire property, plant and equipment	**(12,849)**	**(1,705)**	**(3,205)**	**(17,759)**
Cost to acquire intangibles	**(4,612)**	**–**	**(4)**	**(4,616)**
Total assets	**28,037,340**	**2,556,054**	**6,559,731**	**37,153,125**
Total liabilities	**25,678,433**	**2,555,940**	**6,552,689**	**34,787,062**
2006				
Total operating income				
Net interest income	468,052	83,633	154,446	706,131
Dividend income	567	–	22	589
Net fee income	187,999	23,410	47,058	258,467
Net trading income	96,544	11,382	16,963	124,889
Gains less losses from financial investments	3,595	–	–	3,595
Other operating income	8,159	748	1,757	10,664
Net operating income before loan impairment charges	764,916	119,173	220,246	1,104,335
Profit before tax	414,640	74,485	117,918	607,043
Profit attributable to shareholders	322,800	51,593	95,091	469,484
Depreciation and amortisation	(7,364)	(1,851)	(4,066)	(13,281)
Loan impairment charges	(27,872)	(4,279)	(11,076)	(43,227)
Cost to acquire property, plant and equipment	(6,556)	(3,461)	(13,003)	(23,020)
Cost to acquire intangibles	(6,953)	(39)	(11)	(7,003)
Total assets	18,811,038	1,816,753	4,490,785	25,118,576
Total liabilities	17,113,780	1,816,478	4,486,964	23,417,222

10 Segment analysis *(continued)*

(b) By customer group

The bank's operations include a number of support services and head office functions. The costs of these functions are allocated to business lines, where it is appropriate, on a systematic and consistent basis. In addition, there are a number of items between customer groups and the following analysis includes inter-segment amounts within each customer group.

	2007	2006
	US$000	US$000
Net operating income before loan impairment charges		
Personal Financial Services	**612,749**	438,460
Commercial Banking	**527,387**	394,424
Global Banking and Markets	**462,585**	286,386
Private Banking	**5,909**	3,111
Other	**1,202**	387
Inter-segment income	**(21,297)**	(18,433)
	1,588,535	1,104,335
Profit on ordinary activities before tax		
Personal Financial Services	**190,656**	137,230
Commercial Banking	**363,163**	272,875
Global Banking and Markets	**329,284**	196,783
Private Banking	**3,129**	2,525
Other	**777**	(2,370)
	887,009	607,043
Total assets		
Personal Financial Services	**9,649,768**	6,896,741
Commercial Banking	**12,885,571**	8,494,156
Global Banking and Markets	**29,721,062**	18,681,818
Private Banking	**1,642,889**	1,240,668
Other	**3,622,444**	5,175,238
Inter-segment assets	**(20,368,609)**	(15,370,045)
	37,153,125	25,118,576
Cost to acquire property, plant and equipment		
Personal Financial Services	**1,013**	1,689
Commercial Banking	**91**	92
Global Banking and Markets	**653**	145
Other	**16,002**	21,094
	17,759	23,020
Cost acquire intangibles		
Personal Financial Services	**3,961**	6,530
Commercial Banking	**8**	8
Global Banking and Markets	–	11
Other	**647**	454
	4,616	7,003

Notes on the Financial Statements (continued)

11 Analysis of financial assets and liabilities by measurement bases

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The principal accounting policies in Note 2 describe how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the balance sheet by the class of financial instrument to which they are assigned, and therefore by the measurement basis:

2007	Held for trading US$000	Loans and receivables US$000	Available-for-sale securities US$000	Financial assets and liabilities at amortised cost US$000	Derivatives designated as fair value hedging instruments US$000	Derivatives designated as cash flow hedging instruments US$000	Total US$000
ASSETS							
Cash and balances at central banks	–	–	–	861,247	–	–	861,247
Items in the course of collection from other banks	–	–	–	297,440	–	–	297,440
Trading assets	1,503,766	–	–	–	–	–	1,503,766
Derivatives	395,784	–	–	–	242	–	396,026
Loans and advances to banks	–	6,384,369	–	–	–	–	6,384,369
Loans and advances to customers	–	18,614,547	–	–	–	–	18,614,547
Financial investments	–	–	7,403,279	–	–	–	7,403,279
Other assets	–	–	–	1,200,023	–	–	1,200,023
Accrued income	–	–	–	205,020	–	–	205,020
Total financial assets	1,899,550	24,998,916	7,403,279	2,563,730	242	–	36,865,717
Total non-financial assets							287,408
Total assets							37,153,125
LIABILITIES							
Deposits by banks	–	–	–	3,425,491	–	–	3,425,491
Customer accounts	–	–	–	25,648,194		–	25,648,194
Items in the course of transmission to other banks	–	–	–	188,860	–	–	188,860
Trading liabilities	84,061	–	–	–	–	–	84,061
Derivatives	390,179	–	–	–	919	10,014	401,112
Debt securities in issue	–	–	–	2,981,754	–	– –	2,981,754
Other liabilities	–	–	–	1,656,548	–	–	1,656,548
Accruals	–	–	–	110,698	–	–	110,698
Total financial liabilities	474,240	–	–	34,011,545	919	10,014	34,496,718
Total non-financial liabilities							290,344
Total liabilities							34,787,062

11 Analysis of financial assets and liabilities by measurement bases *(continued)*

2006	Held for trading US$000	Loans and receivables US$000	Available-for-sale securities US$000	Financial assets and liabilities at amortised cost US$000	Derivatives designated as fair value hedging instruments US$000	Derivatives designated as cash flow hedging instruments US$000	Total US$000
ASSETS							
Cash and balances at central banks	–	–	–	289,835	–	–	289,835
Items in the course of collection from other banks	–	–	–	152,301	–	–	152,301
Trading assets	758,114	–	–	–	–	–	758,114
Derivatives	218,319	–	–	–	1,222	–	219,541
Loans and advances to banks	–	7,373,902	–	–	–	–	7,373,902
Loans and advances to customers	–	13,616,602	–	–	–	–	13,616,602
Financial investments	–	–	1,530,193	–	–	–	1,530,193
Other assets	–	–	–	749,085	–		749,085
Accrued income	–	–	–	142,525	–	–	142,525
Total financial assets	976,433	20,990,504	1,530,193	1,333,746	1,222	–	24,832,098
Total non-financial assets							286,478
Total assets							25,118,576
LIABILITIES							
Deposits by banks	–	–	–	1,361,543	–	–	1,361,543
Customer accounts	–	–	–	17,581,720	–	–	17,581,720
Items in the course of transmission to other banks	–	–	–	80,956	–	–	80,956
Trading liabilities	70,342	–	–	–	–	–	70,342
Derivatives	214,828	–	–	–	873	4,487	220,188
Debt securities in issue	–	–	–	2,811,969	–	–	2,811,969
Other liabilities	–	–	–	976,461	–	–	976,461
Accruals	–	–	–	99,660	–	–	99,660
Total financial liabilities	285,170	–	–	22,912,309	873	4,487	23,202,839
Total non-financial liabilities							214,383
Total liabilities							23,417,222

Notes on the Financial Statements (continued)

12 Trading assets

	2007	2006
	US$000	US$000
Trading assets:		
— not subject to repledge or resale by counterparties	**1,503,766**	758,114
	1,503,766	758,114
Debt securities	**379,582**	339,766
Equity securities	**1,124,184**	418,348
	1,503,766	758,114

13 Derivatives

Fair values of derivatives open positions by product contract type held by the group

	At 31 December 2007					
	Assets			**Liabilities**		
	Trading	**Hedging**	**Total**	**Trading**	**Hedging**	**Total**
	US$000	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
Exchange rate	**317,829**	**–**	**317,829**	**(309,516)**	**–**	**(309,516)**
Interest rate	**56,450**	**241**	**56,691**	**(59,157)**	**(10,933)**	**(70,090)**
Equities	**21,506**	**–**	**21,506**	**(21,506)**	**–**	**(21,506)**
Total	**395,785**	**241**	**396,026**	**(390,179)**	**(10,933)**	**(401,112)**

	At 31 December 2006					
	Assets			Liabilities		
	Trading	Hedging	Total	Trading	Hedging	Total
	US$000	US$000	US$000	US$000	US$000	US$000
Exchange rate	118,078	–	118,078	(116,137)	–	(116,137)
Interest rate	90,163	1,222	91,385	(88,613)	(5,360)	(93,973)
Equities	10,078	–	10,078	(10,078)	–	(10,078)
Total	218,319	1,222	219,541	(214,828)	(5,360)	(220,188)

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. Asset values represent the cost to the group of replacing all transactions with a fair value in the group's favour assuming that all group's relevant counterparties default at the same time, and that transactions can be replaced instantaneously. Liability values represent the cost to the group counterparties of replacing all their transactions with the group with a fair value in their favour if the group were to default. Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis.

Use of derivatives

The group transacts derivatives for two primary purposes: to create risk management solutions for clients and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in IAS 39. All other derivative instruments are classified as held-for-trading.

13 Derivatives *(continued)*

The market risk arising on the group's derivative activities to create risk management solutions for clients is managed by entering into offsetting transactions with other HSBC group offices. The group employs the same credit risk management procedures to approve potential credit exposures for derivatives as are used for traditional lending, the calculations and procedures used to assess credit risk for derivatives are more complex.

Trading derivatives

Most of the group's derivative transactions relate to sales 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.

Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Net trading income'. Changes in the fair values of trading derivatives are inclusive of contractual interest, except where the derivatives are managed with debt securities in issue, in which case the contractual interest is shown in interest payable with the interest payable on the issued debt.

Contract amounts of derivatives held-for-trading purposes by product type

	2007	2006
	US$000	US$000
Exchange rate	**40,485,648**	20,639,365
Interest rate	**8,665,096**	6,889,736
Equities	**350,420**	203,655
Total derivatives	**49,501,164**	27,732,756

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

Derivatives valued using models with unobservable inputs

The amount that has yet to be recognised in the income statement relating to the difference between the fair value at initial recognition (the transaction price) and the amount that would have arisen had the market data available at inception been considered observable, less subsequent releases, is as follows:

	2007	2006
	US$000	US$000
Unamortised balance at 1 January	**–**	–
Deferral on new transactions	**3,826**	–
Recognised in the income statement during the period:		
— maturity or termination	**(1,462)**	–
— FX movements and other	**(1,349)**	–
Unamortised balance at 31 December	**1,015**	–

Hedging Instruments

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

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

Notes on the Financial Statements (continued)

13 Derivatives *(continued)*

Contract amounts of derivatives held for hedging purposes by product type

	At 31 December 2007		At 31 December 2006	
	Cash flow hedge US$000	Fair value hedge US$000	Cash flow hedge US$000	Fair value hedge US$000
Interest rate	**250,000**	**61,010**	249,983	61,009

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

Fair value hedges

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

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2007, were assets of US$242 thousand and liabilities of US$919 thousand (2006: assets of US$1,222 thousand and liabilities of US$873 thousand).

Gains or losses arising from the change in fair value of fair value hedges

	2007 US$000	2006 US$000
Gains/(losses) arising from the change in fair value of fair value hedges:		
— on hedged instruments	**(493)**	461
— on hedged items attributable to the hedged risk	**476**	(542)

The amount reported in the income statement in respect of the ineffectiveness of fair value hedges was insignificant in the years ended 31 December 2007 and 31 December 2006.

Cash flow hedges

The group is exposed to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be refunded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. These are initially recognised directly in equity as gains or losses not recognised in the income statement and are transferred to current period earnings when the forecast cash flows affect net profit or loss.

At 31 December 2007, the fair values of outstanding derivatives designated as cash flow hedges of forecast transactions were assets of US$ Nil (2006: US$ Nil) and liabilities of US$10,014 thousand (2006: US$4,487 thousand).

13 Derivatives *(continued)*

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2007 is as follows:

	At 31 December 2007			
	3 months or less US$000	**More than 3 months but less than 1 year US$000**	**5 years or less but more than 1 year US$000**	**More than 5 years US$000**
Cash inflows from assets	**–**	**–**	**–**	**–**
Cash outflows from liabilities	**250,000**	**250,000**	**250,000**	**–**
Net cash inflows/(outflows)	**(250,000)**	**(250,000)**	**(250,000)**	**–**

	At 31 December 2006			
	3 months or less US$000	More than 3 months but less than 1 year US$000	5 years or less but more than 1 year US$000	More than 5 years US$000
Cash inflows from assets	–	–	–	–
Cash outflows from liabilities	249,983	249,983	249,983	–
Net cash inflows/(outflows)	(249,983)	(249,983)	(249,983)	–

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the years to 31 December 2007 and 31 December 2006, no gains or losses were recognised due to hedge ineffectiveness.

Fair value profits on derivatives and complex structured products indicated by a valuation model for which observable market data are not available for key components are not recognised immediately in the income statement. These profits are recognised in the income statement when the model valuation inputs become observable in external markets or when the transaction matures or is closed out. The table below summarises the group's portfolios held at fair value by valuation methodology at 31 December:

	Assets		**Liabilities**	
	Trading securities purchased %	**Derivatives %**	**Trading securities sold %**	**Derivatives %**
At 31 December 2007 Fair value based on:				
Quoted market prices	**91**	**–**	**100**	**–**
Internal models with significant observable market parameters	**9**	**98**	**–**	**100**
Internal models with significant unobservable market parameters	**–**	**2**	**–**	**–**
	100	**100**	**100**	**100**

	Assets		Liabilities	
	Trading %	Derivatives %	Trading %	Derivatives %
At 31 December 2006 Fair value based on:				
Quoted market prices	97	–	100	–
Internal models with significant observable market parameters	3	100	–	100
	100	100	100	100

Notes on the Financial Statements (continued)

14 Financial investments

	2007 US$000	2006 US$000
Financial investments:		
— not subject to repledge or resale by counterparties	**7,403,279**	1,530,193

	2007 Carrying value and fair value US$000	2006 Carrying value and fair value US$000
Treasury and other eligible bills:		
— available-for-sale	**107,987**	432,044
Debt securities:		
— available-for-sale	**7,214,611**	1,080,204
Equity securities:		
— available-for-sale	**80,681**	17,945
Total financial investments	**7,403,279**	1,530,193

15 Interests in associates

Principal associates of the bank

	At 31 December 2007			
Name of associate	**Country of incorporation**	**Principal activity**	**The bank's interest in equity capital**	**Issued equity capital**
Arabian Real Estate Investment Trust Management Limited	Cayman Islands	Real estate	40.00%	US$1.8 million of which US$1.6 million is fully paid
British Arab Commercial Bank Limited	England	Banking	46.51%	US$81 million and £32 million fully paid £5 million nil paid
HSBC Middle East Leasing Partnership	Dubai, UAE	Leasing	15.00%	US$10 million fully paid
MENA Infrastructure Fund (GP) Limited	Dubai, UAE	Private equity fund management	33.33%	US$0.99 million fully paid
Rewards Management Middle East Free Zone Limited Liability Company	Dubai, UAE	Multi-participant loyalty programmes	40.00%	AED0.5 million

15 Interest in associates *(continued)*

On 6 November 2007, the bank purchased 15.00 per cent of the equity share capital of HSBC Middle East Leasing Partnership at a cost of US$1,500 thousand.

British Arab Commercial Bank Limited has issued US$44,478 thousand of subordinated unsecured loan stock in which the group has a 34.66 per cent interest.

The bank's share of associates' contingent liabilities amounted to US$758,380 thousand at 31 December 2007 (2006: US$548,475 thousand).

The associates are unlisted.

Arabian Real Estate Investment Trust Management Limited, HSBC Middle East Leasing Partnership and MENA Infrastructure Fund (GP) Limited operate in Dubai, UAE.

British Arab Commercial Bank Limited operates in North Africa and the Eastern Mediterranean.

Rewards Management Middle East Free Zone Limited Liability Company operates in Dubai, UAE and Qatar.

Movement in investments in associates:

	2007
	US$000
At 1 January 2007	**147,777**
Additions	**1,500**
Retained profits and losses	**7,099**
Exchange and other movements	**1,380**
At 31 December 2007	**157,756**

Summarised aggregated financial information of associates is as follows:

	2007	2006
	US$000	US$000
Assets	**2,351,170**	2,264,233
Liabilities	**2,171,839**	2,117,931
Revenues	**42,510**	33,988
Profit	**21,752**	17,650

Notes on the Financial Statements (continued)

16 Intangible assets

The analysis of the movement of intangible assets for the year ended 31 December 2007 is as follows:

Cost	**Internally generated software**	**Purchased software**	**Total**
	US$000	**US$000**	**US$000**
At 1 January 2007	**6,379**	**5,102**	**11,481**
Additions	**3,565**	**1,051**	**4,616**
Disposals	**–**	**(339)**	**(339)**
Other changes	**–**	**(119)**	**(119)**
At 31 December 2007	**9,944**	**5,695**	**15,639**
Accumulated depreciation			
At 1 January 2007	**(176)**	**(3,812)**	**(3,988)**
Charge for the year[1]	**(2,957)**	**(753)**	**(3,710)**
Disposals	**–**	**339**	**339**
Other changes	**(175)**	**102**	**(73)**
At 31 December 2007	**(3,308)**	**(4,124)**	**(7,432)**
Net book value at 31 December 2007	**6,636**	**1,571**	**8,207**
Cost			
At 1 January 2006	–	4,810	4,810
Additions	6,379	624	7,003
Disposals	–	(1,055)	(1,055)
Exchange translation differences	–	723	723
At 31 December 2006	6,379	5,102	11,481
Accumulated depreciation			
At 1 January 2006	–	(3,491)	(3,491)
Charge for the year	(176)	(672)	(848)
Disposals	–	1,055	1,055
Exchange translation differences	–	(704)	(704)
At 31 December 2006	(176)	(3,812)	(3,988)
Net book value at 31 December 2006	6,203	1,290	7,493

1 *The amortisation charge for the year is recognised within the income statement under 'Amortisation of intangible assets'.*

17 Property, plant and equipment

Cost or fair value	**Freehold land and buildings US$000**	**Short leasehold land and buildings US$000**	**Equipment, fixtures and fittings US$000**	**Total US$000**
At 1 January 2007	**47,241**	**46,155**	**74,905**	**168,301**
Additions at cost	**663**	**5,067**	**12,029**	**17,759**
Disposals	**–**	**(8,753)**	**(6,546)**	**(15,299)**
Exchange translation differences	**84**	**34**	**70**	**188**
Other changes	**(27)**	**–**	**120**	**93**
At 31 December 2007	**47,961**	**42,503**	**80,578**	**171,042**
Accumulated depreciation				
At 1 January 2007	**(1,938)**	**(23,787)**	**(54,324)**	**(80,049)**
Depreciation charge for the year	**(1,201)**	**(3,261)**	**(9,534)**	**(13,996)**
Disposals	**–**	**2,814**	**6,276**	**9,090**
Exchange translation differences	**(15)**	**(9)**	**(35)**	**(59)**
Other changes	**110**	**(120)**	**52**	**42**
At 31 December 2007	**(3,044)**	**(24,363)**	**(57,565)**	**(84,972)**
Net book value at 31 December 2007	**44,917**	**18,140**	**23,013**	**86,070**

Cost or fair value	Freehold land and buildings US$000	Short leasehold land and buildings US$000	Equipment, fixtures and fittings US$000	Total US$000
At 1 January 2006	38,542	43,277	70,542	152,361
Additions at cost	8,557	3,254	11,209	23,020
Disposals	(8)	(378)	(6,062)	(6,448)
Exchange translation differences	140	2	12	154
Other changes	10	–	(796)	(786)
At 31 December 2006	47,241	46,155	74,905	168,301
Accumulated depreciation				
At 1 January 2006	(825)	(21,111)	(52,411)	(74,347)
Depreciation charge for the year	(1,217)	(2,912)	(8,304)	(12,433)
Disposals	3	360	5,701	6,064
Exchange translation differences	(16)	2	(2)	(16)
Other changes	117	(126)	692	683
At 31 December 2006	(1,938)	(23,787)	(54,324)	(80,049)
Net book value at 31 December 2006	45,303	22,368	20,581	88,252

Notes on the Financial Statements (continued)

17 Property, plant and equipment *(continued)*

Included within 'Short leasehold land and buildings' are the following amounts in respect of assets classed as improvements to buildings, which are carried at depreciated historical cost:

	2007		2006	
	Cost	**Accumulated depreciation**	Cost	Accumulated depreciation
	US$000	**US$000**	US$000	US$000
At 1 January	**46,155**	**(23,820)**	43,242	(21,077)
Additions	**5,067**	**–**	3,254	–
Disposals	**(8,753)**	**–**	(378)	183
Depreciation charge for the year	**–**	**(410)**	–	(2,886)
Exchange translation differences	**34**	**7**	–	–
Other changes	**–**	**(27)**	37	(40)
At 31 December	**42,503**	**(24,250)**	46,155	(23,820)
Net book value at 31 December	**18,253**		22,335	

18 Investments

The principal subsidiary undertakings of the Bank are:

	Country of incorporation or registration	**Bank's interest in equity capital**
HSBC Bank Middle East Nominees W.L.L.	Bahrain	95%
HSBC Financial Services (Middle East) Limited	Dubai, UAE	100%
HSBC Middle East Finance Company Limited	Dubai, UAE	80%
HSBC Middle East Securities LLC	Dubai, UAE	100%

On 3 October 2007, the bank purchased 100.00 per cent of the equity share capital of HSBC Middle East Securities LLC at a cost of US$8,170 thousand. In order to comply with local legal requirements, the ownership of the investment in HSBC Middle East Securities LLC is held 49.00 per cent in the name of the bank and 51.00 per cent 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 and equity and liabilities of HSBC Middle East Securities LLC amount to US$8,235 thousand (2006: US$ nil).

All the above make their financial statements up to 31 December.
The subsidiary undertakings are directly owned and are included in the consolidation.
The countries of operation are the same as the countries of incorporation.
The subsidiary undertakings are unlisted.

19 Other assets

	2007	2006
	US$000	US$000
Assets held for sale	**2,135**	1,990
Endorsements and acceptances	**1,108,687**	687,063
Other accounts	**91,336**	73,656
Assets held for sale	**1,202,158**	762,709

	2007	2006
	US$000	US$000
Disposal groups		
Property, plant and equipment	**2,135**	1,990
Non-current assets held for sale	**2,135**	1,990
Total assets classified as held for sale	**2,135**	1,990

The property, plant and equipment classified as held for sale is a result of repossession of property and motor vehicles that had been pledged as collateral by customers. No fair value is calculated for repossessed properties. Repossessed motor vehicles are held at fair value. Gains and losses recognised on impairment of these assets to fair value are reported in 'Loan impairment charges'.

20 Debt securities in issue

	2007		2006	
	Book value	Fair value	Book value	Fair value
	US$000	US$000	US$000	US$000
Medium term notes	**1,995,607**	**1,994,190**	1,993,900	1,990,996
Other debt securities in issue	**136,147**	**136,142**	68,069	68,068
Non-equity preference shares	**850,000**	**844,488**	750,000	748,335
Debt securities in issue	**2,981,754**	**2,974,820**	2,811,969	2,807,399

The following table analyses the carrying amounts of medium-term notes in issue at 31 December 2007 with original maturities greater than one year.

	2007	2006
	US$000	US$000
Variable interest rate		
Vanilla debt – 5.00% to 5.99%: due 2009 to 2011	**1,995,607**	1,993,900

Medium-term notes

On 11 October 2004, the bank established a Debt Issuance Programme providing for the issue of up to US$1,000,000,000 in debt securities in the form of medium-term notes. On 14 December 2004, the bank issued, under the Programme, a first tranche of US$300,000,000 floating rate notes due 14 December 2009. On 5 May 2005, the bank issued, under the Programme, a second tranche of US$700,000,000 floating rate notes due 5 May 2010. On 28 September 2006, the bank's Debt Issuance Programme was extended to provide for the issue of up to US$3,000,000,000 in debt securities in similar form. On 14 November 2006, the bank issued, under the Programme, a third tranche of US$1,000,000,000 floating rate notes due 14 November 2011. The costs of the issue have been amortised over the life of the notes. The notes are listed on the Main Official List of the United Kingdom Listing Authority.

20 Debt securities in issue *(continued)*

Non-equity preference share capital

Authorised

The authorised non-equity preference share capital of the bank at 31 December 2007 and 31 December 2006 was 1,250,000 cumulative redeemable preference shares of US$1.00 each.

Issued

The issued preference shares comprise a first issue on 29 October 1997 of 50,000 perpetual cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a second issue on 1 April 1998 of 25,000 perpetual cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a third issue on 17 December 2003 of 225,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a fourth issue on 26 August 2004 of 100,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a fifth issue on 19 December 2005 of 100,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a sixth issue on 14 March 2006 of 100,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share and 150,000 perpetual cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share and a seventh issue on 20 June 2007 of 100,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share.

Each share carries one vote at meetings of the shareholders of the bank.

On the first issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.35 per cent on the issue price of each perpetual share are payable annually.

The first issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 31 October 2002. 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.

On the second issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.70 per cent on the issue price of each perpetual share are payable annually.

The second issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 2 April 2003. 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.

On the third issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.50 per cent on the issue price of each dated share are payable annually.

The redemption of the third issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 17 December 2013 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 on any date after 17 December 2008, 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.

On the fourth issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.48 per cent on the issue price of each dated share are payable annually.

20 Debt securities in issue *(continued)*

The redemption of the fourth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 26 August 2014 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 on any date after 26 August 2009, 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.

On the fifth issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.30 per cent on the issue price of each dated share are payable annually.

The redemption of the fifth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 19 December 2015 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 on any date after 19 December 2010, 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.

On the sixth issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.40 per cent on the issue price of each dated share are payable annually.

The redemption of the sixth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 14 March 2016 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 on any date after 14 March 2011, 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.

On the sixth issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.65 per cent on the issue price of each perpetual share are payable annually.

The sixth issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 15 March 2011. 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.

On the seventh issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.33 per cent on the issue price of each dated share are payable annually.

The redemption of the seventh issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 20 June 2017 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 on any date after 20 June 2012, 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.

In the event of a winding up, the US dollar 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.

Notes on the Financial Statements (continued)

21 Other liabilities

	2007	2006
	US$000	US$000
Share-based payments	**5,316**	–
Obligations under finance leases	**–**	5,845
Endorsements and acceptances	**1,108,687**	687,063
Other liabilities	**547,861**	289,398
	1,661,864	982,306
Obligations under finance leases falling due:		
— within 1 year	**–**	503
— between 1 and 5 years	**–**	2,009
— over 5 years	**–**	3,333
	–	5,845

The main branch in Qatar was located in a leasehold building, which was vacated during October 2007, at which point the leasehold obligation was released.

22 Provisions

	2007	2006
	US$000	US$000
At 1 January	**1,721**	5,023
Additional provisions/increase in provisions	**3,152**	316
Provisions utilised	**(1,668)**	(1,041)
Amounts reversed	**(6)**	(8)
Exchange and other movements	**3,207**	(2,569)
At 31 December	**6,406**	1,721

Included within 'Provisions' is an amount of US$1,749 thousand (2006: US$731 thousand) relating to the "HSBC In The Community Middle East Foundation". This is a charitable trust established by the bank, whose aim is to provide funding to Middle East nationals, primarily for educational purposes and for environmental projects in the region. Funding is provided on a case by case basis, throughout the year.

23 Deferred taxation

	2007			2006		
	Deferred tax asset	**Deferred tax liability**	**Total**	Deferred tax asset	Deferred tax liability	Total
	US$000	**US$000**	**US$000**	US$000	US$000	US$000
Temporary differences:						
— retirement benefits	**–**	**604**	**604**	–	(604)	(604)
— provision for loan impairment charges	**19,872**	**–**	**19,872**	19,380	–	19,380
— revaluation of property	**–**	**(2,569)**	**(2,569)**	–	(2,608)	(2,608)
— available-for-sale securities	**(1,605)**	**(1,533)**	**(3,138)**	(125)	(11)	(136)
— cash-flow hedges	**1,944**	**–**	**1,944**	878	–	878
— share based payments	**166**	**(59)**	**107**	–	–	–
— other short-term timing differences	**12,863**	**–**	**12,863**	9,199	–	9,199
At 31 December	**33,240**	**(3,557)**	**29,683**	29,332	(3,223)	26,109

24 Fair value of financial instruments

The following table provides an analysis of the fair value of financial instruments not measured at fair value in the balance sheet. For all other instruments the fair value is equal to the carrying value:

	2007		2006	
	Carrying Value US$000	**Fair value US$000**	Carrying Value US$000	Fair value US$000
Assets				
Loans and advances to banks	**6,384,369**	**6,384,215**	7,373,902	7,374,000
Loans and advances to customers	**18,614,547**	**18,676,780**	13,616,602	13,637,364
Liabilities				
Deposits by banks	**3,425,491**	**3,422,329**	1,361,543	1,363,392
Customer accounts	**25,648,194**	**25,642,865**	17,581,720	17,578,542
Debt securities in issue: Medium-term notes (Note 20)	**1,995,607**	**1,994,190**	1,993,900	1,990,996

The methods used to determine fair values for financial instruments for the purpose of measurement and disclosure are set out in Note 2. The majority of the group's financial instruments measured at fair value are valued using quoted market prices or valuation techniques based on observable market data. Observable market prices are not, however, available for many of the group's financial assets and liabilities not measured at fair value. The determination of the fair values of the assets and liabilities in the table above are as follows:

(i) Loans and advances to banks and customers

The fair values of personal and commercial loans and advances are estimated by discounting anticipated cash flows (including interest at contractual rates).

Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and the coupon rates of the loans within each pool. In general, cash flows are discounted using current market rates for instruments with similar maturity, repricing and credit risk characteristics. For fixed rate loans, assumptions are made on the expected prepayment rates appropriate to the type of loan.

For non-performing uncollateralised commercial loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered. For non-performing commercial loans where collateral exists, fair value is the lower of the carrying values of the loans net of impairment allowances, and the fair value of the collateral, discounted as appropriate.

(ii) Deposits by banks and customer accounts

Deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying either market rates, where applicable, or current rates offered for deposits of similar remaining maturities.

(iii) Debt securities in issue

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

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

The fair values of intangible assets, such as values placed on portfolios of core deposits, credit card relationships and customer goodwill, are not included above, because they are not financial instruments.

Notes on the Financial Statements (continued)

24 Fair value of financial instruments *(continued)*

As other financial institutions use different valuation methodologies and assumptions in determining fair values, comparisons of fair values between financial institutions may not be meaningful and users are advised to exercise caution when using this data.

In addition, the following table lists those financial instruments where the carrying amount is a reasonable approximation of fair value, for example, because they are either short term in nature or reprice to current market rates frequently.

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission
Items in the course of collection	Endorsements and acceptances
Endorsements and acceptances	Short-term payables within 'Other Liabilities'
Short-term receivables within 'Other Assets'	

25 Trading liabilities

	Carrying amount	
	2007	2006
	US$000	US$000
Debt securities in issue	**(23,837)**	–
Other liabilities – net short positions	**107,898**	70,342
	84,061	70,342

26 Maturity analysis of liabilities

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

	On demand US$000	**Due within 3 months US$000**	**Due between 3 and 12 months US$000**	**Due between 1 and 5 years US$000**	**Due after 5 years US$000**	**Total US$000**
Deposits by banks	**1,418,338**	**1,828,010**	**185,369**	**7,119**	**–**	**3,438,836**
Customer accounts	**13,367,917**	**10,720,491**	**1,376,426**	**334,538**	**19,565**	**25,818,937**
Debt securities in issue	**–**	**44,474**	**122,021**	**2,773,895**	**1,064,060**	**4,004,450**
Other financial liabilities	**14,749**	**729,505**	**208,127**	**11,344**	**–**	**963,725**
Loan commitments	**4,099,523**	**2,929,760**	**9,430,985**	**797,251**	**229,042**	**17,486,561**
Total at 31 December 2007	**18,900,527**	**16,252,240**	**11,322,928**	**3,924,147**	**1,312,667**	**51,712,509**

	On demand US$000	Due within 3 months US$000	Due between 3 and 12 months US$000	Due between 1 and 5 years US$000	Due after 5 years US$000	Total US$000
Deposits by banks	166,962	1,153,981	41,080	7,411	–	1,369,434
Customer accounts	7,486,610	8,898,590	1,026,224	295,706	2,694	17,709,824
Debt securities in issue	–	110,846	111,134	2,605,802	975,726	3,803,508
Other financial liabilities	16,090	537,067	148,098	8,308	9,178	718,741
Loan commitments	1,993,051	2,048,486	7,863,082	326,408	24,069	12,255,096
Total at 31 December 2006	9,662,713	12,748,970	9,189,618	3,243,635	1,011,667	35,856,603

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 in under one year, and after one year.

26 Maturity analysis of liabilities *(continued)*

Contractual maturity is considered to be a reasonable approximation of expected maturity for the assets and liabilities analysed below. However, for items such as demand deposits and overdrafts, the contractual maturities could differ from expected maturities.

Trading assets, trading liabilities and derivatives are expected to be recovered or settled no more than twelve months after the balance sheet date, and therefore are excluded from this analysis.

	At 31 December 2007		
	Due within 1 year	**Due after more than 1 year**	**Total**
Assets	**US$000**	**US$000**	**US$000**
Loans and advances to banks	**6,266,673**	**117,696**	**6,384,369**
Loans and advances to customers	**12,223,498**	**6,391,049**	**18,614,547**
Financial investments	**6,989,544**	**413,735**	**7,403,279**
Other financial assets	**1,095,098**	**13,589**	**1,108,687**
	26,574,813	**6,936,069**	**33,510,882**
Liabilities			
Deposits by banks	**3,419,159**	**6,332**	**3,425,491**
Customer accounts	**25,336,359**	**311,835**	**25,648,194**
Debt securities in issue	**–**	**2,981,754**	**2,981,754**
Other financial liabilities	**1,095,833**	**12,854**	**1,108,687**
	29,851,351	**3,312,775**	**33,164,126**

	At 31 December 2006		
	Due within 1 year	Due after more than 1 year	Total
Assets	US$000	US$000	US$000
Loans and advances to banks	7,309,700	64,202	7,373,902
Loans and advances to customers	9,098,364	4,518,238	13,616,602
Financial investments	1,109,216	420,977	1,530,193
Other financial assets	680,819	6,244	687,063
	18,198,099	5,009,661	23,207,760
Liabilities			
Deposits by banks	1,355,211	6,332	1,361,543
Customer accounts	17,314,405	267,315	17,581,720
Debt securities in issue	68,069	2,743,900	2,811,969
Other financial liabilities	681,322	11,586	692,908
	19,419,007	3,029,133	22,448,140

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

Notes on the Financial Statements (continued)

27 Foreign currency exposures

Structural currency exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity investments in subsidiary undertakings, branches and associates. Gains or losses on structural foreign currency exposures are recognised directly in equity.

The group's management of structural foreign currency exposures is discussed in Note 31(d).

Net structural currency exposures

Currency of structural exposure	**2007**	2006
	US$000	US$000
Bahraini dinar	**104,418**	90,402
Jordanian dinar	**116,023**	92,322
Kuwaiti dinar	**65,541**	50,180
Lebanese pound	**50,417**	31,969
Omani rial	**139,613**	114,986
Qatari rial	**197,245**	149,818
Sterling	**281**	96
UAE dirham	**2,181,284**	1,643,721
Total	**2,854,822**	2,173,494

28 Called up share capital

Authorised

The authorised ordinary share capital of the bank at 31 December 2007 and 2006 was 1,000,000,000 ordinary shares of US$1 each.

Issued and fully paid	**Number of ordinary shares**	US$000
At 1 January and 31 December 2007	**431,055,000**	431,055
At 1 January 2006	**331,055,000**	331,055
Shares issued	**100,000,000**	100,000
At 31 December 2006	**431,055,000**	431,055

29 Reserves

	2007								
			Other reserves						
	Called up share capital US$000	Retained earnings US$000	Available-for-sale fair value reserve US$000	Cash flow hedging reserve US$000	Foreign exchange reserve US$000	Share-based payment reserve US$000	Total share-holders' equity US$000	Minority interests US$000	Total equity US$000
At 1 January	431,055	1,187,829	15,023	(3,513)	248	3,385	1,634,027	67,327	1,701,354
New share capital subscribed	–	–	–	–	–	–	–	–	–
Profit for the year attributable to shareholders	–	703,967	–	–	–	–	703,967	–	703,967
Dividends to shareholders of the parent company	–	(150,000)	–	–	–	–	(150,000)	–	(150,000)
Share of changes recognised directly in equity in the associate's equity	–	(7,090)	–	–	–	–	(7,090)	–	(7,090)
Actuarial losses on post-employment benefits schemes	–	(5,251)	–	–	–	–	(5,251)	–	(5,251)
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	–	–	–	–	3,625	–	3,625	–	3,625
Fair value gains/ (losses) taken to equity	–	–	51,282	(6,170)	–	–	45,112	–	45,112
Amounts transferred to the income statement	–	–	(2,923)	838	–	–	(2,085)	–	(2,085)
Charge to the income statement in respect of equity settled share-based payment transactions	–	–	–	–	–	530	530	–	530
Tax on items taken directly to equity	–	1,208	(2,891)	1,067	–	–	(616)	–	(616)
Exchange and other movements	–	8,750	(33)	–	–	–	8,717	–	8,717
Profit attributable to minority interests	–	–	–	–	–	–	–	15,067	15,067
Dividends to minority interests	–	–	–	–	–	–	–	(1,962)	(1,962)
Increase in minority interest stake and other	–	–	–	–	–	–	–	54,695	54,695
At 31 December	431,055	1,739,413	60,458	(7,778)	3,873	3,915	2,230,936	135,127	2,366,063

Notes on the Financial Statements (continued)

29 Reserves *(continued)*

	2006								
			Other reserves						
	Called up share capital US$000	Retained earnings US$000	Available-for-sale fair value reserve US$000	Cash flow hedging reserve US$000	Foreign exchange reserve US$000	Share-based payment reserve US$000	Total share-holders' equity US$000	Minority interests US$000	Total equity US$000
At 1 January	331,055	903,662	13,334	–	94	2,110	1,250,255	4,077	1,254,332
New share capital subscribed	100,000	–	–	–	–	–	100,000	–	100,000
Profit for the year attributable to shareholders	–	469,484	–	–	–	–	469,484	–	469,484
Dividends to shareholders of the parent company	–	(200,000)	–	–	–	–	(200,000)	–	(200,000)
Share of changes recognised directly in equity in the associate's equity	–	(4,526)	–	–	–	–	(4,526)	–	(4,526)
Actuarial losses on post-employment benefits schemes	–	(739)	–	–	–	–	(739)	–	(739)
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	–	–	–	–	154	–	154	–	154
Fair value gains/ (losses) taken to equity	–	–	3,461	(4,571)	–	–	(1,110)	–	(1,110)
Amounts transferred to the income statement	–	–	(1,600)	180	–	–	(1,420)	–	(1,420)
Charge to the income statement in respect of equity settled share-based payment transactions	–	–	–	–	–	1,275	1,275	–	1,275
Tax on items taken directly to equity	–	(604)	(172)	878	–	–	102	–	102
Exchange and other movements	–	20,552	–	–	–	–	20,552	–	20,552
Profit attributable to minority interests	–	–	–	–	–	–	–	10,016	10,016
Dividends to minority interests	–	–	–	–	–	–	–	(1,961)	(1,961)
Increase in minority interest stake and other	–	–	–	–	–	–	–	55,195	55,195
At 31 December	431,055	1,187,829	15,023	(3,513)	248	3,385	1,634,027	67,327	1,701,354

30 Reconciliation of profit before tax to net cash flow from operating activities

Non-cash items included in profit and loss

	2007	2006
	US$000	US$000
Depreciation and amortisation	**17,689**	13,281
Loan impairment losses	**53,651**	43,227
Loans written off net of recoveries	**(54,786)**	(58,106)
Provisions raised	**1**	308
Provisions utilised	**(1,668)**	(1,041)
	14,887	(2,331)

Change in operating assets

	2007	2006
Change in prepayments and accrued income	**(62,494)**	(44,643)
Change in net trading securities and net derivatives	**(922,137)**	(628,123)
Change in loans and advances to banks	**(204,110)**	(90,335)
Change in loans and advances to customers	**(5,001,230)**	(2,208,336)
Change in other assets	**(439,450)**	(150,140)
	(6,629,421)	(3,121,577)

Change in operating liabilities

	2007	2006
Change in accruals and deferred income	**20,530**	54,246
Change in deposits by banks	**2,063,949**	603,256
Change in customer accounts	**8,066,474**	3,407,294
Change in debt securities in issue	**45,949**	997,641
Change in other liabilities	**892,723**	420,936
	11,089,625	5,483,373

Cash and cash equivalents comprise

	2007	2006
Cash and balances at central banks	**861,247**	289,835
Items in the course of collection from other banks	**297,440**	152,300
Loans and advances to banks of one month or less	**5,738,087**	6,931,820
Treasury bills, other bills and certificates of deposit less than three months	**5,651,932**	834,908
Less: items in the course of transmission to other banks	**(188,860)**	(80,956)
	12,359,846	8,127,907

Notes on the Financial Statements (continued)

31 Risk management

All the group's activities involve analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The most important types of risk arising from financial instruments are credit risk (which includes country and cross-border risk), liquidity risk and market risk. Market risk includes foreign exchange, interest rate and equity price risk.

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

(a) Credit risk management

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, treasury and leasing activities. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities.

HSBC Holdings plc is responsible for the formulation of high-level credit policies. It also reviews the application of the HSBC Group's universal facility grading system. Historically, the group's risk rating framework has consisted of a minimum of seven grades, taking into account the risk of default and the availability of security or other credit risk mitigation, the first three of which are applied to differing levels of satisfactory risk. Accounts in grade 4 and 5 require different degrees of special attention and grades 6 and 7 indicate non-performing status. A more sophisticated risk rating framework for banks and other customers, based on default probability and loss estimates and comprising up to 22 categories, is being progressively implemented across the HSBC Group and is already operative in most major business units.

This new approach will increasingly allow a more granular analysis of risk and trends. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk rating processes are increasingly in use, for the larger facilities ultimate responsibility for setting risk grades rests with the final approving executive in each case. It is policy to review grades frequently and implement amendments promptly when required.

The HSBC Group's credit risk limits to counterparties in the financial and government sectors are managed centrally to optimise the use of credit availability and to avoid excessive risk concentration. Cross-border risk is controlled through the imposition of country limits, which are determined by taking into account economic and political factors, and local business knowledge, with sub-limits by maturity and type of business. Transactions with counterparties in higher risk countries are considered on a case-by-case basis.

Within the overall framework of the HSBC Group policy, the bank has an established risk management process encompassing credit approvals, the control of exposures (including those to borrowers in financial difficulty), credit policy direction to business units and the monitoring and reporting of exposures both on an individual and a portfolio basis which includes the management of adverse trends. Local management is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to build and maintain risk assets of high quality. Regular reviews are undertaken to assess and evaluate levels of risk concentration, including those to individual industry sectors and products, or to individual geographic areas.

Special attention is paid to the management of problem loans. Where deemed appropriate, specialist units are established to provide intensive management and control to maximise recoveries of doubtful debts.

31 Risk management *(continued)*

Maximum exposure to credit risk

Maximum exposure to credit risk, collateral held or other credit enhancements.

	Maximum exposure 2007 US$000	Maximum exposure 2006 US$000
Items in course of collection from other banks	**297,440**	152,301
Trading assets	**379,582**	339,766
— debt securities	**379,582**	339,766
Derivatives	**396,026**	219,541
Loans and advances to banks	**6,384,394**	7,373,902
Loans and advances to customers	**18,614,547**	13,616,602
Financial investments	**7,322,598**	1,512,248
— treasury and other similar bills	**107,987**	432,044
— debt securities	**7,214,611**	1,080,204
Other assets		
— endorsements and acceptances	**1,108,687**	687,063
Off-balance sheet		
— financial guarantees and other credit related contingent liabilities	**9,075,005**	6,160,989
— loan commitments and other credit related commitments	**19,204,076**	13,387,286
	62,782,355	43,449,698

Collateral and other credit enhancements

Loans and advances

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

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

Other securities

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

31 Risk management *(continued)*

Concentrations of exposure

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 highly diversified with no exposures to individual industries or economic groupings totalling more than 10 per cent of consolidated total assets, except as follows:

— the majority of the bank's exposure to credit risk is concentrated in the Middle East. Within the Middle East, the bank's credit risk is diversified over a wide range of industrial and economic groupings; and

— the bank's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2007 and 31 December 2006 was concentrated in mainland Europe and the Middle East.

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

Credit quality

Loans and advances

	At 31 December 2007		At 31 December 2006	
	Loans and advances to customers US$000	**Loans and advances to banks US$000**	Loans and advances to customers US$000	Loans and advances to banks US$000
Gross loans and advances:				
— neither past due nor impaired	**16,934,622**	**6,384,369**	12,443,990	7,370,745
— past due but not impaired	**1,631,112**	**–**	1,057,181	–
— impaired	**273,954**	**25**	337,285	3,272
	18,839,688	**6,384,394**	13,838,456	7,374,017

Distribution of loans and advances neither past due nor impaired

The credit quality of the portfolio of loans and advances that were neither past due nor impaired at 31 December 2007 can be assessed by reference to HSBC's standard credit grading system. The following information is based on that system:

	At 31 December 2007		At 31 December 2006	
	Loans and advances to customers US$000	**Loans and advances to banks US$000**	Loans and advances to customers US$000	Loans and advances to banks US$000
Grade 1 — low risk	**861,350**	**5,055,745**	1,414,016	5,138,355
Grade 2 — satisfactory risk	**6,180,769**	**810,157**	4,230,206	1,846,715
Grade 3 — fair risk	**9,428,610**	**482,635**	6,381,737	339,246
Grade 4 — watch list	**372,529**	**35,832**	345,355	46,429
Grade 5 — sub-standard but not impaired	**91,364**	**–**	72,676	–
	16,934,622	**6,384,369**	12,443,990	7,370,745

Grades 1 and 2 represent corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to values ratios, and other retail accounts which are not impaired and are maintained within product guidelines.

Grade 3 represents satisfactory risk and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios than grades 1 and 2, all non-impaired credit card exposures, and other retail exposures which operate outside product guidelines without being impaired.

Grade 4 and 5 represent corporate facilities that require various degrees of special attention and all retail exposures that are progressively between 30 and 90 days past due.

Grade 6 and 7 indicate impaired status including all retail accounts that are progressively more than 90 days past due.

Loans and advances which were past due but not impaired

Loans and advances which were past due at 31 December 2007 but not impaired were as follows:

	Loans and advances to customers	
	2007	2006
	US$000	US$000
Past due up to 29 days	**1,378,441**	951,519
Past due 30 – 59 days	**153,904**	50,766
Past due 60 – 89 days	**38,350**	26,093
	1,570,695	1,028,378
Past due 90 – 179 days	**22,141**	18,224
Past due over 180 days but less than 1 year	**37,970**	10,318
Past due more than 1 year	**306**	262
	1,631,112	1,057,182

The past due ageing analysis includes loans and advances less than 90 days past due that have collective impairment allowances set aside to cover credit losses on loans which are in the early stages of arrears.

There are a variety of reasons why certain loans designated as 'past due' are not regarded as impaired. Unless other information is available to indicate to the contrary, all loans less than 90 days past due are not considered impaired. It is also not unusual for short-term trade finance facilities to extend beyond 90 days past due for reasons that do not reflect any concern on the creditworthiness of the counterparty, such as delays in documentation. In addition, past due loans secured in full by cash collateral are not considered impaired and, where appropriate, neither are residential mortgages in arrears by more than 90 days where the value of collateral is sufficient to repay both the debt and all potential interest for at least one year.

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

Loans and advances to customers and to banks – net total credit risk

Loans and advances against which the group had legally enforceable rights to offset with financial liabilities at 31 December 2007 were as follows:

	At 31 December 2007	At 31 December 2006
	Book Value and Net total credit risk[1]	Book Value and Net total credit risk[1]
	US$000	US$000
Loans and advances to customers	**18,612,780**	13,614,744
Loans and advances to banks	**5,376,352**	6,716,697
	23,989,132	20,331,441

1 *Excluding the value of any collateral or security held*

Other securities

Debt securities and other bills by rating agency designation

The following table presents an analysis of debt and similar securities, other than loans, by rating agency designation at 31 December 2007, based on Standard and Poor's ('S&P') ratings or their equivalent:

	At 31 December 2007		
	Treasury bills	Debt securities	Total
	US$000	US$000	US$000
AAA	–	38,784	38,784
AA- to AA +	–	185,317	185,317
A- to A +	65,981	955,905	1,021,886
Lower than A-	42,006	189,945	231,951
Unrated	–	6,224,242	6,224,242
Total	107,987	7,594,193	7,702,180
Of which issued by:			
— governments	107,987	7,152,554	7,260,541
— local authorities	–	12,500	12,500
— corporates	–	220,224	220,224
— other	–	208,915	208,915
	107,987	7,594,193	7,702,180
Of which classified as:			
— available-for-sale securities	107,987	7,214,611	7,322,598
— held for trading	–	379,582	379,582
	107,987	7,594,193	7,702,180

	At 31 December 2006		
	Treasury bills	Debt securities	Total
	US$000	US$000	US$000
AAA	317,139	17,916	335,055
AA- to AA +	–	13,181	13,181
A- to A +	–	355,059	355,059
Lower than A-	18,428	146,186	164,614
Unrated	96,477	887,629	984,106
Total	432,044	1,419,971	1,852,015
Of which issued by:			
— governments	432,044	851,390	1,283,434
— local authorities	–	–	–
— corporates	–	186,418	186,418
— other	–	382,163	382,163
	432,044	1,419,971	1,852,015
Of which classified as:			
— available-for-sale securities	432,044	1,080,204	1,512,248
— held for trading	–	339,767	339,767
	432,044	1,419,971	1,852,015

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

Debt securities and other bills – net total credit risk

Debt securities and other bills against which the group had legally enforceable rights to offset with financial liabilities at 31 December 2007 were as follows:

	At 31 December 2007	At 31 December 2006
	Book Value and Net total credit risk[1]	Book Value and Net total credit risk[1]
	US$000	US$000
Trading assets:		
— debt securities	**379,582**	339,766
	379,582	339,766
Derivatives	**396,026**	219,541
Financial investments:		
— treasury and other similar bills	**107,987**	432,044
— debt securities	**7,214,611**	1,080,204
	7,322,598	1,512,248
Other assets		
Acceptances and endorsements	**1,108,687**	687,063
	9,206,893	2,758,618

1 *Excluding the value of any collateral or security held*

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

Impairment assessment

It is HSBC's policy that each operating company makes allowance for impaired loans promptly when required and on a consistent basis in accordance with established HSBC Group guidelines.

HSBC's rating process for credit facilities extended by members of the HSBC Group is designed to highlight exposures requiring greater management attention based on a higher probability of default and potential loss. Management particularly focuses on facilities to those borrowers and portfolio segments classified below satisfactory grades. Amendments to risk grades, where necessary, are required to be undertaken promptly. Management also regularly evaluates the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions.

Two types of impairment allowance are in place: individually assessed and collectively assessed. These are discussed in Note 2.

HSBC Group policy requires a review of the level of impairment allowances on individual facilities that are above materiality thresholds at least half-yearly, and more regularly where individual circumstances require. The policy requires that this will normally include a review of collateral held (including re-confirmation of its enforceability) and an assessment of actual and anticipated receipts. For significant commercial and corporate debts, specialised loan 'work-out' teams with experience in insolvency and specific market sectors are used to determine likely losses. Reversals on individually calculated impairment allowances are recognised whenever the HSBC Group has reasonable objective evidence that the established estimate of loss has been reduced.

Portfolio allowances are generally reassessed monthly and charges for new allowances, or releases of existing allowances, are calculated for each separately identified portfolio.

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

Non-performing loans

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

Charge-offs

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

31 Risk management *(continued)*

Impaired loans

Individually impaired loans by industry sector

	At 31 December 2007		At 31 December 2006	
	Gross loans and advances to customers US$000	**Gross loans by industry sector as a % of total gross loans %**	Gross loans and advances to customers US$000	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	**268**	**0.00**	272	0.00
Other personal	**68,908**	**0.37**	63,050	0.46
Total personal	**69,176**	**0.37**	63,322	0.46
Corporate and commercial				
Commercial, industrial and international trade	**102,155**	**0.55**	102,143	0.74
Other property-related	**21,784**	**0.12**	21,707	0.16
Government	**209**	**0.00**	175	0.00
Other commercial	**29,013**	**0.15**	31,405	0.23
Total corporate and commercial	**153,161**	**0.82**	155,430	1.13
Financial				
Non-bank financial institutions	**2,802**	**0.01**	3,101	0.02
Total impaired loans and advances to customers	**225,139**	**1.20**	221,853	1.61

Impairment allowances

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

Movement in allowance accounts for total loans and advances

	At 31 December 2007		
	Individually assessed US$000	**Collectively assessed US$000**	**Total US$000**
At 1 January	**115,566**	**106,402**	**221,968**
Amounts written off	**(5,053)**	**(77,839)**	**(82,892)**
Recoveries of loans and advances written off in previous years	**9,099**	**19,098**	**28,197**
Charge to income statement	**(12,524)**	**66,175**	**53,651**
Exchange and other movements	**3,550**	**665**	**4,215**
At 31 December	**110,638**	**114,501**	**225,139**

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

	At 31 December 2006		
	Individually assessed US$000	Collectively assessed US$000	Total US$000
At 1 January	166,422	91,993	258,415
Amounts written off	(48,592)	(53,716)	(102,308)
Recoveries of loans and advances written off in previous years	3,663	19,278	22,941
Charge to income statement	(5,078)	48,305	43,227
Exchange and other movements	(849)	542	(307)
At 31 December	115,566	106,402	221,968

Following a review of the personal unsecured lending portfolio US$77,831 thousand (2006: US$53,716 thousand) of impaired loans, for which there was no realistic possibility of recovery, were written-off.

Impairment allowances against loans and advances to customers

	2007 %	2006 %
Total impairment allowances to gross lending[1]		
Individually assessed impairment allowances	**0.59**	0.84
Collectively assessed impairment allowances	**0.61**	0.77
Total	**1.20**	1.61

1 *Net of settlement accounts*

Net impairment charge to income statement by geographical region

	December 2007 Middle East US$000	December 2006 Middle East US$000
Individually assessed impairment allowances		
New allowances	**20,053**	32,653
Release of allowances no longer required	**(23,478)**	(34,068)
Recoveries of amounts previously written off	**(9,099)**	(3,663)
	(12,524)	(5,078)
Collectively assessed impairment allowances		
New allowances	**102,770**	99,711
Release of allowances no longer required	**(17,497)**	(32,128)
Recoveries of amounts previously written off	**(19,098)**	(19,278)
	66,175	48,305
Total charge for impairment losses		
Bank	**(92)**	(652)
Customer	**53,743**	43,879
Customer charge for impairment losses as a percentage of closing gross loans and advances	**0.29%**	0.32%

31 Risk management *(continued)*

31 December **Balances outstanding**		
Non-performing loans	**273,979**	340,557
Impairment allowances	**225,139**	221,968
Gross loans and advances	**18,839,686**	13,838,456
Total allowances cover as a percentage of non-performing loans and advances	**82.17%**	65.18%

Collateral and other credit enhancements obtained

The group has assets obtained by taking control of collateral accepted as security, or through other credit enhancements amounting to US$2,135 thousand (2006: US$1,990 thousand) as outlined in Note 19. During 2007 additional assets amounting to US$415 thousand (2006: US$Nil) were obtained.

Procedures for the disposal of assets not readily convertible into cash are established at operating company level, and depend on the nature of the asset concerned.

Renegotiated loans

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

Renegotiated loans that would otherwise be past due or impaired

	2007 **US$000**	2006 US$000
Loans and advances to customers	**10,358**	16,858
Loans and advances to banks	–	–
	10,358	16,858

(b) Liquidity and funding management

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

The management of liquidity and funding is primarily carried out locally in the operating companies of the HSBC Group in accordance with practice and limits set by the group Risk Management Meeting. These limits vary by local financial unit to take account of the depth and liquidity of the market in which the entity operates. It is the HSBC Group's general policy that each banking entity should be self-sufficient with regard to funding its own operations. Exceptions are permitted to facilitate the efficient funding of certain short-term treasury requirements and start-up operations or branches which do not have access to local deposit markets, all of which are funded under strict internal and regulatory guidelines and limits from the HSBC Group's largest banking operations. These internal and regulatory limits and guidelines serve to place formal limitations on the transfer of resources between HSBC group entities and are necessary to reflect the broad range of currencies, markets and time zones within which the HSBC Group operates.

31 Risk management *(continued)*

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

The Group's liquidity and funding management process requires:

— projecting cash flows by major currency and considering the level of liquid assets necessary in relation thereto;

— monitoring balance sheet liquidity ratios against internal and regulatory requirements;

— maintaining a diverse range of funding sources with adequate back-up facilities;

— managing the concentration and profile of debt maturities;

— maintaining debt financing plans;

— monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and

— maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises while minimising adverse long-term implications for the business.

(c) Primary sources of funding

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

The group accesses professional markets in order to provide funding for non-banking subsidiaries that do not accept deposits, to maintain a presence in local money markets and to optimise the funding of asset maturities not naturally matched by core deposit funding.

Of total liabilities of US$34,787,062 thousand at 31 December 2007, funding from customers amounted to US$25,648,194 thousand, of which US$25,464,834 thousand was contractually repayable within one year. However, although the contractual repayments of many customer accounts are on demand or at short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.

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 26.

Liabilities in trading portfolios have not been analysed by contractual maturity because trading assets and liabilities are typically held for short periods of time.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US$13,457,286 thousand), included cash, central bank balances, items in the course of collection and treasury and other bills (US$1,266,674 thousand); loans to banks (US$6,384,369 thousand, including US$6,266,698 thousand repayable within one year); and loans to customers (US$18,614,547 thousand, including US$12,448,637 thousand 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 would meet unexpected net cash outflows by selling securities and accessing additional funding sources such as interbank or asset-backed markets.

A key measure used by the group for managing liquidity risk is the ratio of net liquid assets to customer liabilities. Generally, liquid assets comprise cash balances, short-term interbank deposits and highly rated debt securities available for immediate sale and for which a deep and liquid market exists. Net liquid assets are

31 Risk management *(continued)*

liquid assets less all wholesale market funds, and all funds provided by customers deemed to be professional, maturing in the next 30 days. The definition of a professional customer takes account of the size of the customer's total deposits.

Minimum liquidity ratio limits are set for each operating entity. Limits reflect the local market place, the diversity of funding sources available, and the concentration risk of large depositors.

Although consolidated data is not utilised in the management of the bank's liquidity, the consolidated liquidity ratio figures of net liquid assets to customer liabilities shown in the following table provide a useful insight into the overall liquidity position of the bank's banking entities.

Ratio of net liquid assets to customer liabilities

	At 31 December 2007		Average	Maximum	Minimum
	2007	2006	**during 2007**	**in 2007**	**in 2007**
The bank:	**31.3%**	16.0%	**28.2%**	**45.7%**	**15.6%**

(d) Market risk management

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

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

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

Value at risk ('VAR')

One of the principal tools used by HSBC to monitor and limit market risk exposure is VAR. VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence (for HSBC, 99 per cent). HSBC calculates VAR daily. The VAR model used by HSBC is predominantly based on historical simulation. The historical simulation model derives plausible future scenarios from historical market rates time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years.

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

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

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

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

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

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

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

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

Total	**US$000**
At 31 December 2007	**2,813**
At 31 December 2006	1,462

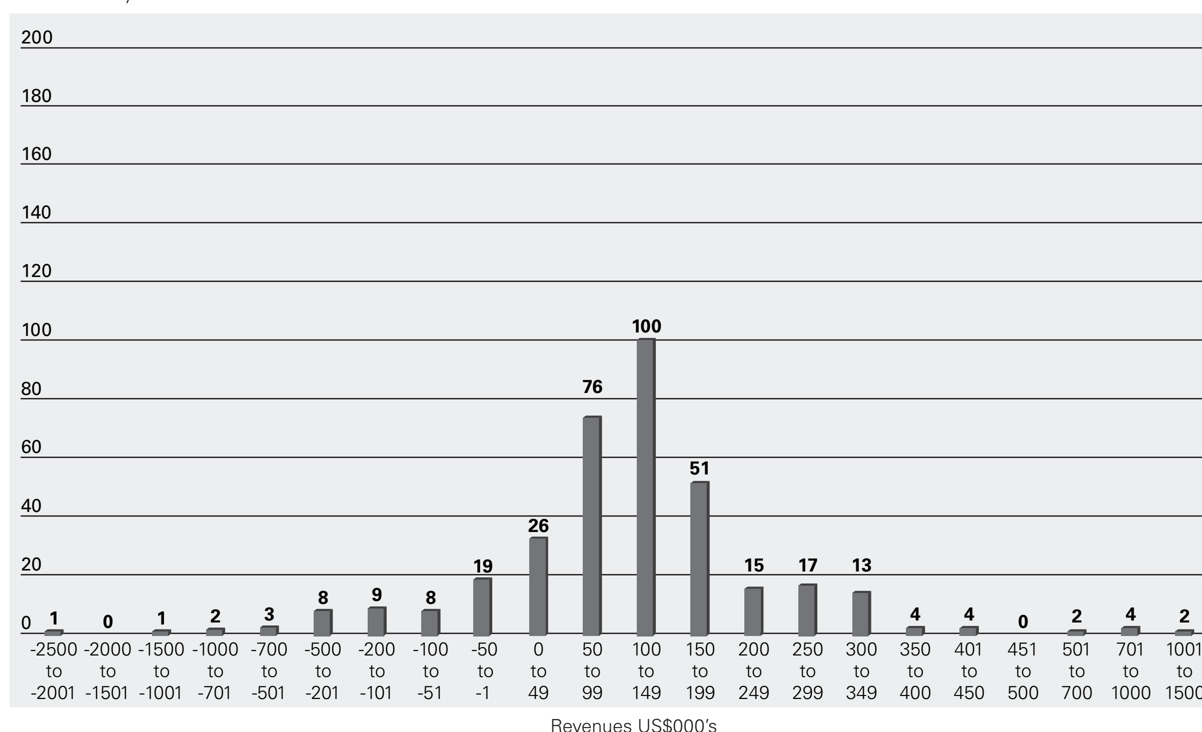
	Average US$000	**Minimum US$000**	**Maximum US$000**
2007	**1,881**	**1,217**	**2,921**
2006	2,073	1,086	3,001

The daily revenue earned from market risk-related treasury activities includes net interest income and funding related to dealing positions. The histogram below illustrates the frequency of daily revenue arising from all Global Markets' business and other trading activities.

The average daily revenue earned from Global Markets' business and other trading activities in 2007, including accrual book net interest income and funding of dealing positions, was US$105 thousand compared with US$83 thousand in 2006. The standard deviation of these daily revenues was US$245 thousand compared with US$48 thousand in 2006. The standard deviation measures the variation of daily revenues about the mean value of those revenues.

An analysis of the frequency distribution of daily revenues shows that there were 51 days with negative revenues during 2007 compared with 7 days in 2006. The most frequent result was a daily revenue of between US$100 thousand and US$149 thousand, with 100 occurrences.

Daily distribution of Global Markets' trading, Balance Sheet Management and other trading revenues in 2007

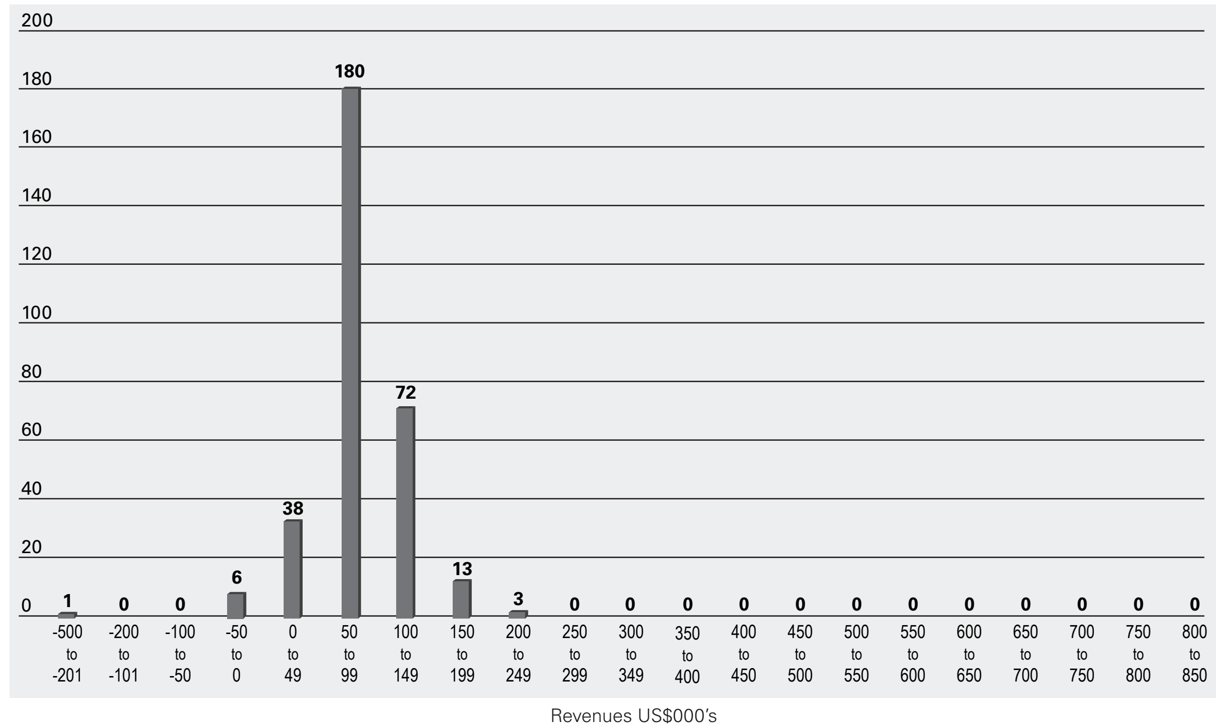


31 Risk management *(continued)*

Daily distribution of Global Markets' trading, Balance Sheet Management and other trading revenues in 2006

Daily Distribution of Market Risk Revenues in 2006
HSBC Bank Middle East Limited Treasury

Number of days



Fair value and price verification control

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

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

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

Trading

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

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

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

HSBC's policy on hedging is to manage economic risk in the most appropriate way without regard as to whether hedge accounting is available, within limits regarding the potential volatility of reported earnings. Trading VAR is further analysed below by risk type, by positions taken with trading intent and by positions taken without trading intent:

Total trading VAR by risk type

	Foreign exchange US$000	Interest rate trading US$000	Total US$000
At 31 December 2007	**670**	**234**	**650**
At 31 December 2006	149	96	179
Average			
2007	**289**	**110**	**357**
2006	183	26	200
Minimum			
2007	**107**	**27**	**148**
2006	98	2	119
Maximum			
2007	**825**	**338**	**1,121**
2006	367	154	333

Non-trading

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

Market risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts. This prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the auspices of the local ALCO.

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

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

31 Risk management *(continued)*

Net interest income

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

The impact on future net interest income of a 25 basis points parallel fall or rise in all yield curves worldwide in each quarter during the 12 month period from 1 January 2008 would decrease or increase net interest income by US$29,206 thousand ($9,805 thousand from 1 January 2007).

The figures represent the effect of the proforma 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 that could be taken by Global Markets or in the business units to mitigate the impact of this interest rate risk. In reality, Global Markets would seek to proactively change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections also make other simplifying assumptions, including that all positions run to maturity.

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

- Core deposit franchises: these are exposed to changes in the value of the deposits raised and spreads against wholesale funds; in a low interest rate environment, the value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is, however, asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.

- Global Markets: the residual interest rate risk is managed within Global Markets. This reflects the group's policy of transferring all interest rate risk, other than structural risk, to Global Markets to be managed within defined limits and with flexibility as to the instruments used.

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

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

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

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

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

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

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

Following the adoption of IFRS, the group monitors the sensitivity of reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cashflow hedges due to parallel movements of plus or minus 100bps in all yield curves. The table below describes the sensitivity to these movements at 31 December 2007 and the maximum and minimum month figures during the year then ended:

	At 31 December 2007 US$000	Maximum impact US$000	Minimum impact US$000
+ 100 basis point parallel move all in yield curves	**(10,220)**	**(10,220)**	**2,696**
As a percentage of shareholders' funds at 31 December 2007	**(0.46)%**	**(0.46)%**	**0.12%**
– 100 basis point parallel move all in yield curves	**10,220**	**10,220**	**(2,696)**
As a percentage of shareholders' funds at 31 December 2007	**0.46%**	**0.46%**	**0.12%**

Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associated undertakings, the functional currencies of which are currencies other than the US dollar or Gulf currencies linked to the US dollar.

Revaluation gains and losses on structural exposures are recorded in the consolidated statement of recognised income and expense. The main operating (or functional) currencies of the group are UAE dirhams and other Gulf currencies linked to the US dollar.

The group's structural foreign currency exposures are required to be managed with the primary objective of ensuring, where practical, that the group's tier 1 capital ratio is protected from the effect of changes in exchange rates. This is usually achieved by holding qualifying tier 1 capital broadly in proportion to the corresponding foreign-currency-denominated risk-weighted assets. The group considers hedging structural foreign currency exposures only in limited circumstances, to protect the tier 1 capital ratio or the US dollar value of capital invested. Such hedging would be undertaken using forward foreign exchange contracts or by financing with borrowings in the same currencies as the functional currencies involved.

As the group is generally able to balance adequately foreign currency tier 1 capital with foreign currency risk-weighted assets, the group's foreign currency structural exposures are usually unhedged, including exposures due to foreign-currency-denominated profits arising during the year.

(e) Operational risk management

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

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

The HSBC Group has codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance issued in January 2005. This explains how the HSBC Group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The processes undertaken to manage operational risk are determined by reference to the scale and nature of each HSBC Group operation. The HSBC Group standard covers the following:

31 Risk management *(continued)*

- Operational risk management responsibility is assigned at senior management level within the business operation;
- Information systems are used to record the identification and assessment of operational risks and generate appropriate, regular management reporting;
- Operational risks are identified by assessments covering operational risks facing each business and risks inherent in processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;
- Operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the Group Audit Committee and the Risk Management Meeting; and
- Risk mitigation, including insurance, is considered where this is cost-effective.

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

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

(f) Capital management

The Jersey Financial Services Commission (JFSC) supervises the group on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the group as a whole. Individual branches and subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements.

Under the Banking Business (Jersey) Law 1991, the JFSC requires each bank and banking group to maintain a ratio of total capital to risk-weighted assets taking into account both balance sheet assets and off-balance sheet transactions.

The group's capital is divided into two tiers:

- Tier 1 capital comprises shareholders' funds and minority interests in tier 1 capital, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy.
- Tier 2 capital comprises qualifying non-equity preference share capital, collective impairment allowances (previously, general provisions) and reserves arising from the revaluation of properties.

Various limits are applied to elements of the capital base. Qualifying tier 2 capital cannot exceed tier 1 capital, and qualifying term non-equity preference share capital may not exceed 50 per cent of tier 1 capital.

There are also limitations on the amount of collective impairment allowances which may be included as part of tier 2 capital. From the total of tier 1 and tier 2 capital are deducted the net asset value of investments in associates and the book value of investments in the capital of banks.

Risk-weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. Off-balance-sheet items giving rise to credit, foreign exchange or interest rate risk are assigned weights appropriate to the category of the counterparty, taking into account any eligible collateral or guarantees.

Following the implementation of IFRS, there will be changes to the measurement of banks' capital adequacy in a number of ways. The most significant of these changes for the group is that under IFRS, dividends are not recognised on the balance sheet until they are declared. This gives rise to an increase in shareholders' funds at the reporting date compared with the previous accounting, which is reversed when the relevant dividend is subsequently declared. Banks reflect the benefit of this increase in their regulatory capital until the dividend declaration, in line with the accounting treatment.

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

During 2007 and 2006 the group complied with the Jersey Financial Services Commission's ('JFSC') capital adequacy requirements.

32 Contingent liabilities and contractual commitments

Contingent liabilities and commitments	**2007**	2006
	US$000	US$000
Contract amounts		
Contingent liabilities:		
Guarantees and assets pledged as collateral security:		
— guarantees and irrevocable letters of credit	**9,075,005**	6,160,989
	9,075,005	6,160,989
Commitments:		
Documentary credits and short-term trade-related transactions	**1,647,515**	1,132,190
Undrawn note issuing and revolving underwriting facilities	**70,000**	–
Undrawn formal standby facilities, credit lines and other commitments to lend:		
— one year and under	**16,422,827**	11,956,464
— over one year	**1,063,734**	298,632
	19,204,076	13,387,286

The above table discloses the nominal principal amounts of off-balance sheet transactions.

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

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

	2007	2006
	US$000	US$000
Guarantees and assets pledged by the bank as collateral security	**752,607**	623,428
Documentary credits and short-term trade-related transactions	**21,044**	7,080
	773,651	630,508

32 Contingent liabilities and contractual commitments *(continued)*

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 2007 were as follows:

	At 31 December 2007		At 31 December 2006	
	Guarantees in favour of third parties US$000	**Guarantees by the group in favour of other HSBC group entities US$000**	Guarantees in favour of third parties US$000	Guarantees by the group in favour of other HSBC group entities US$000
Guarantee Type				
Financial guarantees[1]	**529,171**	**221,386**	371,239	225,086
Standby letters of credit which are financial guarantees[2]	**690,421**	**–**	666,113	–
Other direct credit substitutes[3]	**583,812**	**–**	242,546	–
Performance bonds[4]	**3,614,076**	**228,075**	2,450,451	236,836
Bid bonds[4]	**546,203**	**65,634**	248,165	27,674
Other transaction-related guarantees[4]	**2,358,715**	**237,512**	1,559,047	133,832
Total	**8,322,398**	**752,607**	5,537,561	623,428

1 *Financial guarantees include undertakings to fulfill the obligations of customers or group entities should the obligated party fail to do so. Intra-group financial guarantees include a guarantee of a capital nature issued by the group to a group entity for inclusion as capital support by the latter's regulator.*
2 *Standby letters of credit which are financial guarantees are irrevocable obligations on the part of the group to pay a third party when a customer fails to meet a commitment.*
3 *Other direct credit substitutes include re-insurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*
4 *Performance bonds, bid bonds and other transaction-related guarantees are undertakings by which the requirement to make payment under the guarantee depends on the outcome of a future event which is unconnected to the creditworthiness of the customer.*

The amounts disclosed in the above table 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.

Approximately 92% of the above guarantees have a term of less than one year (2006: Approximately 77%). Guarantees with terms of more than one year are subject to the group's annual credit review process.

When the group gives a guarantee on behalf of a customer, it retains the right to recover from that customer amounts paid under the guarantee.

Provisions in respect of the group's obligations under outstanding guarantees

	2007 US$000	2006 US$000
Other items	**1**	308
	1	308

Notes on the Financial Statements (continued)

32 Contingent liabilities and contractual commitments *(continued)*

The group had commitments to purchase from a number of suppliers within one year, land and buildings and other fixed assets for a value of US$1,574 thousand at 31 December 2007 (2006: US$23,658 thousand).

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

Finance lease commitments

	2007			2006		
	Total future minimum payments US$000	**Unearned finance income US$000**	**Present value US$000**	Total future minimum payments US$000	Unearned interest income US$000	Present value US$000
No later than one year	–	–	–	503	–	503
Later than one year and no later than five years	–	–	–	2,009	–	2,009
Later than five years	–	–	–	3,333	–	3,333
	–	–	–	5,845	–	5,845

Operating lease commitments

At 31 December 2007, 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.

	2007	2006
Future minimum lease payments under non-cancellable operating leases were:	**US$000**	US$000
Land and buildings expiring:		
— no later than one year	**17,298**	18,798
— later than one year and no later than five years	**49,076**	56,260
— later than five years	**47,403**	70,301
	113,777	145,359

In 2007, US$13,523 thousand (2006: US$3,635 thousand) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

Finance lease receivables

	2007			2006		
	Total future minimum payments US$000	**Unearned finance income US$000**	**Present value US$000**	Total future minimum payments US$000	Unearned finance income US$000	Present value US$000
No later than one year	**3,899**	–	**3,899**	–	–	–
Later than one year and no later than five years	**16,411**	–	**16,411**	1,724	–	1,724
Later than five years	**24**	–	**24**	16,620	–	16,620
	20,334	–	**20,334**	18,344	–	18,344

33 Lease commitments *(continued)*

Operating lease receivables

	2007	2006
Future minimum lease payments under non-cancellable operating leases were:	**US$000**	US$000
Land and buildings expiring:		
— no later than one year	**–**	118

34 Litigation

The bank, through a number of its branches, is named in and is defending legal actions in various jurisdictions arising from its normal business. No material adverse impact on the financial position of the group is expected to arise from these proceedings.

35 Related party transactions

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

All 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.

(a) Transactions, arrangements and agreements involving Directors and others

The table below sets out transactions which fall to be disclosed under IAS24 'Related Party Disclosures' between the group and the Key Management Personnel and their connected persons or controlled companies.

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the group and includes members of the Board of Directors.

	2007			2006		
	Number of persons	**Highest balance during the year[1] US$000**	**Balance at year end[1] US$000**	Number of persons	Highest balance during the year[1] US$000	Balance at year end[1] US$000
Key Management Personnel and connected persons and companies controlled by them						
Loans	**2**	**612**	**554**	3	587	568
Credit cards	**3**	**14**	**11**	1	14	7
	5	**626**	**565**	4	601	575

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

In addition to the disclosures of related party transactions, under IAS24 the group is required to disclose an estimate of the cost of services provided by Key Management Personnel to the group, to whom no remuneration is paid.

	2007	2006
	US$000	US$000
Short-term employee benefits	**176**	161

Notes on the Financial Statements (continued)

35 Related party transactions *(continued)*

Transactions with other related parties

	2007		2006	
	Highest balance during the year[1]	**Balance at the year end**[1]	Highest balance during the year[1]	Balance at the year end[1]
Amounts due from associates	**US$000**	**US$000**	US$000	US$000
— Subordinated	**15,415**	**15,415**	15,415	15,415
— Unsubordinated	**461**	**409**	253	253
	15,876	**15,824**	15,668	15,668
Amounts due to associates	**17,467**	**8,379**	11,088	6,573
Subsidiaries				
Assets:				
Cash and balances at central banks	**7**	**5**	15	14
Trading assets	**1,198,441**	**1,198,441**	491,505	491,505
Loans and advances to banks	**56**	**56**	1,226	1,226
Loans and advances to customers	**744,508**	**741,320**	676,597	676,597
Financial investments	**70,197**	**35,709**	39,066	39,066
Intangible assets	**394**	**230**	619	444
Property, plant and equipment	**110**	**51**	111	82
Other assets	**141,352**	**99,220**	44,779	41,976
Prepayments and accrued income	**7,971**	**7,971**	4,892	4,639
Liabilities:				
Deposits by banks	**–**	**4,030**	–	–
Items in the course of transmission to other banks	**3,057**	**3,057**	3,875	3,875
Other liabilities	**756,639**	**1,869,421**	1,134,742	1,134,742
Accruals and deferred income	**1,177**	**1,566**	2,298	1,840
Income Statement:				
Interest income	**17,234**	**61,209**	13,278	48,154
Interest expense	**(10,386)**	**(39,012)**	(7,969)	(26,509)
Trading income	**8,219**	**17,956**	8,235	9,366
Gains less losses from financial investments	**192**	**480**	2,271	2,851
Dividend income	**426**	**1,079**	207	565
Fee income	**2,390**	**6,557**	1,756	5,349
Fee expense	**(1,428)**	**(3,762)**	(1,247)	(3,904)
Other operating income	**222**	**794**	402	735
Loan impairment charges and other credit risk provisions	**(641)**	**(980)**	1,818	1,989
General and administrative expenses	**(5,014)**	**(17,942)**	(4,199)	(13,363)

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

36 Ultimate holding company

The group's ultimate holding company is HSBC Holdings plc, which is registered in England.

The largest and smallest group in which the financial statements of the bank are consolidated is that headed by HSBC Holdings plc. Copies of the HSBC Holdings plc *Annual Review 2007 and/or Annual Report and Accounts 2007* may be obtained by writing to Group Communications, HSBC Holdings plc, 8 Canada Square, London E14 5HQ, United Kingdom; or from the HSBC web site, www.hsbc.com.

37 Events after the balance sheet date

Since the year-end, on 8 January 2008, the bank established a Sukuk Issuance Programme, providing for the issue of up to US$5,000,000,000 in securities in the form of Shari'a-compliant Trust Certificates. On 17 January 2008 the bank's Debt Issuance Programme (Note 20) was extended to provide for the issue of up to US$7,000,000,000 in debt securities in the form of medium-term notes.

On 18 February 2008, the Board of Directors authorised the financial statements for issue.

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Seef *Main Office*
Manama
Adliya
Muharraq
Seef Wholesale Banking Unit

Iran
Tehran *Representative Office*

Jordan
Western Amman *Main Office*
Jebel Hussein
Abdoun Branch

Kuwait
Kuwait City *Main Office*

Lebanon
Beirut *Main Office*
Dora
Ras Beirut
Verdum
Zouk

Libya
Libyan *Representative Office*

Oman
Bait Al Falaj *Main Office*
Muscat
Qurum
Salalah
Seeb
Sohar

Palestinian Autonomous Area
Ramallah *Main Office*

Qatar
Grand Hamad *Main Office*
Al Sadd
Rayyan
West Bay
Mesaieed
Financial Tower Branch

United Arab Emirates
Abu Dhabi
Abu Dhabi *Main Office*
Al Ain

Dubai
Gate District - DIFC
Bur Dubai *Main Office*
Deira
Jebel Ali

Fujairah
Fujairah

Ras Al Khaimah
Ras Al Khaimah

Sharjah
Sharjah

PRINCIPAL SUBSIDIARY COMPANIES

HSBC Financial Services (Middle East) Limited
Dubai

HSBC Middle East Finance Company Limited
Dubai *Main Office*
Abu Dhabi
Al Ain
Ras Al Khaimah

ASSOCIATED COMPANIES

Arabian Real Estate Investment Trust Management Limited
Cayman Islands

British Arab Commercial Bank Limited*
London

Rewards Management Middle East Free Zone Limited Liability Company*
Dubai

MENA Infrastructure Fund (GP) Limited
Dubai

HSBC Middle East Securities LLC
Dubai

HSBC Middle East Leasing Partnership
Dubai

SPECIAL CONNECTIONS EXIST WITH

Dar Es Salaam Investment Bank
Baghdad *Head Office*
and 13 branches

HSBC Bank plc Cyprus

HSBC Bank Egypt S.A.E.
Cairo *Head office*, 52 other branches
and 14 mini-bank units

Gibbs Gulf Insurance Consultants Limited

HSBC Insurance Brokers Limited

HSBC Bank International Limited

HSBC Securities (Egypt) S.A.E.

HSBC Saudi Arabia Limited

The Hongkong and Shanghai Banking Corporation Limited
Muharraq *Offshore Banking Unit*

The Saudi British Bank*
Riyadh Head Office, 75 other
branches including 12 sections or
branches for ladies

** HSBC Group associated company*

Incorporated in Jersey, Channel Islands — number 85600

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