SUPPLEMENTARY LISTING PARTICULARS

HSBC Bank Middle East Limited

(a public company incorporated with limited liability in Jersey with registered number 85600)
as Issuer

U.S.$ 7,000,000,000 DEBT ISSUANCE PROGRAMME

This second supplement (the "**Second Supplement**") to the information memorandum prepared by HSBC Bank Middle East Limited, as issuer (the "**Issuer**") relating to the U.S.$ 7,000,000,000 Debt Issuance Programme and approved on 15 July 2013 (the "**Information Memorandum**", which constitutes listing particulars for the purposes of listing on the Official List of the Irish Stock Exchange ("**Listing**") and trading on the Global Exchange Market of the Irish Stock Exchange and, for the avoidance of doubt, which does not constitute (i) a prospectus for the purposes of Part VI of the Financial Services and Markets Act (as amended) or (ii) a base prospectus for the purposes of Directive 2003/71/EC (as amended)) constitutes supplementary listing particulars (pursuant to rule 3.10 of the Global Exchange Market Listing and Admission to Trading – Rules) for the purposes of Listing.

Terms defined in the Information Memorandum have the same meaning when used in this Second Supplement.

This Second Supplement is supplemental to, and should be read in conjunction with, the Information Memorandum and the first supplement dated 12 February 2014 (the "**First Supplement**").

Application has been made for this Second Supplement to be approved by the Irish Stock Exchange for the purposes of Listing.

The Issuer accepts responsibility for the information contained in this Second Supplement. To the best of the knowledge of the Issuer (having taken all reasonable care to ensure that such is the case) the information contained in this Second Supplement is in accordance with the facts and does not omit anything likely to affect the import of such information.

The purpose of this Second Supplement is to disclose that the Issuer has published its Annual Report and Accounts for the year ended 31 December 2013 (the "**2013 Annual Accounts**") (a copy of which is set out in the Annex hereto).

To the extent that there is any inconsistency between (a) any statement in this Second Supplement and (b) any other statement in or incorporated by reference in the Information Memorandum or the First Supplement prior to the date of this Second Supplement, the statement in this Second Supplement will prevail.

Save as disclosed in this Second Supplement, there has been no significant change and no significant new matter has arisen since the publication of the First Supplement.

2 May 2014

ANNEX

HSBC Bank Middle East Limited Annual Report and Accounts for the year ended 31 December 2013

HSBC Bank Middle East Limited

Annual Report and Accounts 2013

Annual Report and Accounts 2013

Contents

Presentation of Information

This document comprises the *Annual Report and Accounts 2013* for HSBC Bank Middle East Limited ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Accounts, together with the Auditors' report, as required by the Companies (Jersey) Law 1991. References to 'HSBC' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries.

Report of the Directors

Board of Directors

D G Eldon, Chairman
M M Al Tuwaijri, Chief Executive Officer and Deputy Chairman
S N Cooper
R B Gray
A M Keir
C J M Keirle
A R D Monro-Davies
A H M H B Mostafawi
Sir W C Patey
A M Sharaf
T L Slattery
N G Winsor

Changes in Directors

- M M Al Tuwaijri was appointed as Chief Executive Officer and Deputy Chairman on 1 October 2013;
- S N Cooper resigned as Chief Executive Officer and Deputy Chairman on 1 October 2013 and as a Director on 13 February 2014;
- A M Keir was appointed as a Director on 4 February 2014; and
- R B Gray resigned as a Director on 13 February 2014.

The Directors who held office during the year and up to the date the Annual Report and Accounts were approved are listed above.

Principal activities

The group through its branch network and subsidiary undertakings provides a range of banking and related financial services in the Middle East and North Africa. There have been some changes to the branch network as outlined below.

The sale of the bank's Pakistan operations to an identified buyer has been terminated due to State Bank of Pakistan regulatory approval not having been received. The bank will now explore alternative strategic options to exit its business in Pakistan.

In January 2014, the bank announced that it has entered into an agreement to sell its banking operations in Jordan to Arab Jordan Investment Bank. The transaction is expected to complete during 2014.

Disposal of interest in subsidiary

On 9 December 2013, HSBC Insurance Services (Lebanon) SAL, a wholly owned subsidiary of the bank went into formal liquidation.

Profit/loss and dividends

The profit attributable to the shareholders of the parent company amounted to US$837 million (2012: US$599 million) as set out in the consolidated income statement on page 6.

During the year, first and second interim dividends for 2013 of US$65 million and US$100 million (2012: US$135 million) were declared on 2 May 2013 and 31 October 2013 and paid on 15 May 2013 and 12 November 2013, respectively.

A third interim dividend for 2013 of US$70 million was declared by the Directors on 13 February 2014.

Non-equity preference share capital

On 20 June 2013 the bank redeemed 100,000 cumulative redeemable preference shares of US$1.00 each (the 'Sixth Issue'), issued at a premium of US$999.00 per share.

Report of the Directors (continued)

Registered office

The bank is incorporated in Jersey, Channel Islands with number 85600. Its head office and registered office is HSBC House, Esplanade, St Helier, Jersey, JE4 8UB, Channel Islands.

Auditors

The shareholders of the bank having agreed to dispense with the requirement to hold annual general meetings, the auditors, KPMG Channel Islands Limited are deemed to be re-appointed, and continue in office at fees to be agreed by the Directors.

On behalf of the Board
J A Tothill, *Secretary*
13 February 2014

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 Auditor’s statement of their responsibilities set out in their report on page 4, 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 adopted 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 group and of the profit or loss of the group for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and apply them consistently;
- make judgments 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;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group 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 group 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, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005. They are also responsible for safeguarding the assets of the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

On behalf of the Board

M M Al Tuwaijri, Chief Executive Officer & Deputy Chairman

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

We have audited the consolidated financial statements ('the financial statements') of HSBC Bank Middle East Limited for the year ended 31 December 2013 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of financial position, the consolidated statement of cash flows, the consolidated statement of changes in equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the EU.

This report is made solely to the company's members, as a body, in accordance with Article 113A 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 explained more fully in the Statement of Directors' Responsibilities set out on page 3, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion, the financial statements:

- give a true and fair view of the state of the group's affairs as at 31 December 2013 and of its profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU; and
- have been prepared in accordance with the requirements of 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, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005.

Independent Auditor's Report to the Member of HSBC Bank Middle East Limited (continued)

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies (Jersey) Law 1991 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company; or
- returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- we have not received all the information and explanations we require for our audit.

Eric Bertrand
for and on behalf of KPMG Channel Islands Limited
Chartered Accountants
37 Esplanade
St Helier
Jersey
JE4 8WQ

21 February 2014

Notes:

- The maintenance and integrity of the HSBC Bank Middle East Limited and/or other HSBC Group websites is the responsibility of the directors; the work carried out by auditors does not involve consideration of these matters and accordingly, KPMG Channel Islands Limited accepts no responsibility for any changes that may have occurred to the financial statements or our audit report since 21 February 2014. KPMG Channel Islands Limited has carried out no procedures of any nature subsequent to 21 February 2014 which in any way extends this date.

- Legislation in Jersey governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions. The directors shall remain responsible for establishing and controlling the process for doing so, and for ensuring that the financial statements are complete and unaltered in any way.

Financial Statements

Consolidated income statement for the year ended 31 December 2013

	Notes	2013 US$000	2012 US$000
Interest income		**1,356,533**	1,440,464
Interest expense		**(239,934)**	(337,761)
Net interest income		**1,116,599**	1,102,703
Fee income		**605,043**	575,712
Fee expense		**(69,295)**	(71,640)
Net fee income		**535,748**	504,072
Trading income excluding net interest income		**336,918**	312,595
Net interest expense on trading activities		**(8,240)**	(780)
Net trading income		**328,678**	311,815
Net expense from financial instruments designated at fair value	*4*	**(2,340)**	(12,492)
Gains less losses from financial investments		**3,918**	9,370
Dividend income		**9,233**	5,162
Other operating income		**64,004**	68,295
Net operating income before loan impairment charges and other credit risk provisions		**2,055,840**	1,988,925
Loan impairment (charges)/recoveries and other credit risk provisions	*5*	**36,230**	(245,651)
Net operating income		**2,092,070**	1,743,274
Employee compensation and benefits	*6*	**(547,470)**	(549,707)
General and administrative expenses		**(504,659)**	(408,188)
Depreciation and impairment of property, plant and equipment	*19*	**(26,700)**	(32,227)
Amortisation and impairment of intangible assets	*18*	**(12,834)**	(10,464)
Total operating expenses		**(1,091,663)**	(1,000,586)
Operating profit	*5*	**1,000,407**	742,688
Share of profit/(loss) in associates	*17*	**559**	(3,866)
Profit before tax		**1,000,966**	738,822
Tax expense	*8*	**(148,723)**	(102,077)
Profit for the year		**852,243**	636,745
Profit attributable to shareholders of the parent company		**837,036**	598,545
Profit attributable to non-controlling interests		**15,207**	38,200

The accompanying notes on pages 12 to 109 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2013

	2013 US$000	2012 US$000
Profit for the year	**852,243**	636,745
Other comprehensive income/(expense)		
Items that will be reclassified subsequently to profit or loss when specific conditions are met:		
Available-for-sale investments	**15,175**	8,811
– fair value gains	**5,870**	5,133
– fair value gains transferred to income statement on disposal	**10,005**	3,396
– income taxes	**(700)**	282
Cash flow hedges	**(1,934)**	1,459
– fair value losses	**(2,768)**	(1,922)
– fair value losses transferred to income statement	**–**	4,644
– income taxes	**834**	(1,263)
Exchange differences	**(4,559)**	(8,530)
Items that will not be reclassified subsequently to profit or loss:		
Remeasurement of defined benefit asset/liability	**(3,925)**	(4,483)
– before income taxes	**(4,713)**	(4,131)
– income taxes	**788**	(352)
Other comprehensive income/(expense) for the year, net of tax	**4,757**	(2,743)
Total comprehensive income for the year	**857,000**	634,002
Total comprehensive income for the year attributable to:		
– shareholders of the parent company	**837,501**	594,247
– non-controlling interests	**19,499**	39,755
	857,000	634,002

The accompanying notes on pages 12 to 109 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of financial position at 31 December 2013

	Notes	2013 US$000	2012 US$000
Assets			
Cash and balances at central banks		**1,573,701**	892,603
Items in the course of collection from other banks		**67,483**	116,083
Trading assets	*12*	**515,374**	580,613
Derivatives	*15*	**1,135,352**	1,436,242
Loans and advances to banks	*27*	**7,616,777**	9,537,777
Loans and advances to customers	*27*	**23,629,718**	24,015,266
Financial investments	*16*	**11,267,242**	11,206,230
Assets held for sale	*21*	**901,032**	541,736
Other assets	*21*	**1,133,222**	1,472,361
Current tax assets		**6,289**	-
Prepayments and accrued income		**137,574**	196,665
Interests in associates	*17*	**30,642**	30,632
Intangible assets	*18*	**56,284**	65,824
Property, plant and equipment	*19*	**153,048**	166,168
Deferred tax assets	*8*	**203,934**	198,722
Total assets		**48,427,672**	50,456,922
Liabilities and equity			
Liabilities			
Deposits by banks	*27*	**1,379,473**	1,803,014
Customer accounts	*27*	**31,315,682**	32,038,176
Items in the course of transmission to other banks		**561,153**	569,835
Trading liabilities	*22*	**1,235,000**	1,090,962
Financial liabilities designated at fair value	*23*	**503,448**	508,989
Derivatives	*15*	**1,132,836**	1,418,636
Debt securities in issue	*24*	**3,206,249**	4,876,509
Liabilities of disposal groups held for sale	*25*	**1,004,983**	457,400
Other liabilities	*25*	**1,936,508**	2,261,340
Current tax liabilities		**151,475**	130,623
Accruals and deferred income		**135,492**	151,259
Provisions	*26*	**64,008**	42,893
Deferred tax liabilities	*8*	**7,781**	6,761
Retirement benefit liabilities	*6*	**95,473**	80,238
Total liabilities		**42,729,561**	45,436,635
Equity			
Called up share capital	*31*	**931,055**	931,055
Other reserves		**43,498**	36,989
Retained earnings		**4,319,879**	3,664,579
Total equity attributable to shareholders of the parent company		**5,294,432**	4,632,623
Non-controlling interests		**403,679**	387,664
Total equity		**5,698,111**	5,020,287
Total equity and liabilities		**48,427,672**	50,456,922

The accompanying notes on pages 12 to 109 form an integral part of these financial statements.

M M Al Tujwaijri, *Chief Executive Officer and Deputy Chairman*

Financial Statements (continued)

Consolidated statement of cash flows for the year ended 31 December 2013

	Notes	2013 US$000	2012 US$000
Cash flows from operating activities			
Profit before tax		**1,000,966**	738,822
Adjustments for:			
– other non-cash items included in profit before tax	*32*	**60,979**	393,300
– change in operating assets	*32*	**564,463**	(4,672,312)
– change in operating liabilities	*32*	**(2,526,921)**	3,971,451
– elimination of exchange differences[1]		**(5,584)**	(47,298)
– net loss from investing activities		**(4,443)**	(8,595)
– share of (profits)/losses in associates		**(559)**	3,866
– dividends received from associates		**547**	691
– contributions paid for defined benefit plans		**(835)**	(913)
– tax paid		**(126,674)**	(156,678)
Net cash (used in)/generated from operating activities		**(1,038,061)**	222,334
Cash flows from investing activities			
Purchase of financial investments		**(10,089,443)**	(11,347,170)
Proceeds from the sale and maturity of financial investments		**10,147,875**	8,927,863
Purchase of property, plant and equipment		**(18,381)**	(30,793)
Proceeds from the sale of property, plant and equipment		**1,248**	30,440
Purchase of intangible assets		**(4,438)**	(6,155)
Proceeds from the sale of intangible assets		**100**	-
Net cash inflow from acquisition of subsidiaries and businesses		**–**	887,112
Net cash generated from/(used in) investing activities		**36,961**	(1,538,703)
Cash flows from financing activities			
Non equity preference share capital redeemed		**(100,000)**	(100,000)
Dividends paid to shareholders of the parent company		**(165,000)**	(135,000)
Dividends paid to non-controlling interests		**(2,545)**	(2,505)
Net cash used in financing activities		**(267,545)**	(237,505)
Net decrease in cash and cash equivalents		**(1,268,645)**	(1,553,874)
Cash and cash equivalents at 1 January		**9,160,192**	10,698,851
Effect of exchange rate changes on cash and cash equivalents		**(2,819)**	15,215
Cash and cash equivalents at 31 December	*32*	**7,888,728**	9,160,192

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

The accompanying notes on pages 12 to 109 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2013

	2013									
			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	Other reserves US$000	Merger reserve US$000	Total share-holders' equity US$000	Non-controlling interests US$000	Total equity US$000
At 1 January	**931,055**	**3,664,579**	**62,596**	**6,688**	**(17,576)**	**633**	**(15,352)**	**4,632,623**	**387,664**	**5,020,287**
Profit for the year	**–**	**837,036**	**–**	**–**	**–**	**–**	**–**	**837,036**	**15,207**	**852,243**
Other comprehensive income (net of tax)	**–**	**(3,853)**	**10,797**	**(1,934)**	**(4,545)**	**–**	**–**	**465**	**4,292**	**4,757**
Available-for-sale investments	**–**	**–**	**10,802**	**–**	**–**	**–**	**–**	**10,802**	**4,373**	**15,175**
Cash flow hedges	**–**	**–**	**–**	**(1,934)**	**–**	**–**	**–**	**(1,934)**	**–**	**(1,934)**
Remeasurement of defined asset/liability	**–**	**(3,925)**	**–**	**–**	**–**	**–**	**–**	**(3,925)**	**–**	**(3,925)**
Exchange differences and other	**–**	**72**	**(5)**	**–**	**(4,545)**	**–**	**–**	**(4,478)**	**(81)**	**(4,559)**
Total comprehensive income for the year	**–**	**833,183**	**10,797**	**(1,934)**	**(4,545)**	**–**	**–**	**837,501**	**19,499**	**857,000**
Dividends to shareholders	**–**	**(165,000)**	**–**	**–**	**–**	**–**	**–**	**(165,000)**	**(4,614)**	**(169,614)**
Cost of share-based payment arrangements	**–**	**547**	**–**	**–**	**–**	**–**	**–**	**547**	**–**	**547**
Acquisition of subsidiaries	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Changes in ownership interests in subsidiaries	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Other movements	**–**	**(13,430)**	**1,404**	**(125)**	**–**	**912**	**–**	**(11,239)**	**1,130**	**(10,109)**
At 31 December	**931,055**	**4,319,879**	**74,797**	**4,629**	**(22,121)**	**1,545**	**(15,352)**	**5,294,432**	**403,679**	**5,698,111**

The accompanying notes on pages 12 to 109 form an integral part of these financial statements.

	2012									
			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	Other reserves US$000	Merger reserve US$000	Total share-holders' equity US$000	Non-controlling interests US$000	Total equity US$000
At 1 January	931,055	3,187,258	56,325	5,229	(9,429)	–	(15,352)	4,155,086	375,387	4,530,473
Profit for the year	–	598,545	–	–	–	–	–	598,545	38,200	636,745
Other comprehensive income (net of tax)	–	(4,867)	7,257	1,459	(8,147)	–	–	(4,298)	1,555	(2,743)
Available-for-sale investments	–	–	7,247	–	–	–	–	7,247	1,564	8,811
Cash flow hedges	–	–	–	1,459	–	–	–	1,459	–	1,459
Remeasurement of defined asset/liability	–	(4,483)	–	–	–	–	–	(4,483)	–	(4,483)
Exchange differences and other	–	(384)	10	–	(8,147)	–	–	(8,521)	(9)	(8,530)
Total comprehensive income for the year	–	593,678	7,257	1,459	(8,147)	–	–	594,247	39,755	634,002
Dividends to shareholders	–	(135,000)	–	–	–	–	–	(135,000)	(2,505)	(137,505)
Cost of share-based payment arrangements	–	3,580	–	–	–	–	–	3,580	–	3,580
Acquisition of subsidiaries	–	–	–	–	–	–	–	–	377,071	377,071
Changes in ownership interests in subsidiaries	–	–	–	–	–	–	–	–	(402,348)	(402,348)
Other movements	–	15,063	(986)	–	–	633	–	14,710	304	15,014
At 31 December	931,055	3,664,579	62,596	6,688	(17,576)	633	(15,352)	4,632,623	387,664	5,020,287

The accompanying notes on pages 12 to 109 form an integral part of these financial statements.

Notes on the Financial Statements (continued)

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The consolidated financial statements of the group have been prepared in accordance with International Financial Reporting Standards (‘IFRSs’) as issued by the International Accounting Standards Board (‘IASB’) and as endorsed by the European Union (‘EU’). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU.

At 31 December 2013, there were no unendorsed standards effective for the year ended 31 December 2013 affecting these consolidated financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to the group. Accordingly, the group’s financial statements for the year ended 31 December 2013 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the IFRS Interpretations Committee (‘IFRIC’) and its predecessor body.

Standards adopted during the year ended 31 December 2013

On 1 January 2013, the group adopted the following significant new standards and amendments to standards. The financial effect of these new standards and amendments is insignificant to these consolidated financial statements:

- IFRS 10 ‘Consolidated Financial Statements’, IFRS 11 ‘Joint Arrangements’, IFRS 12 ‘Disclosure of Interests in Other Entities’ and amendments to IFRS 10, IFRS 11 and IFRS 12 ‘Transition Guidance’. IFRSs 10 and 11 are required to be applied retrospectively.
- Under IFRS 10, there is one approach for determining consolidation for all entities, based on the concepts of power, variability of returns and their linkage. This replaces the approach which applied to previous financial statements which emphasised legal control or exposure to risks and rewards, depending on the nature of the entity. The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns by exercising its power over the entity.

  In accordance with the transitional provisions of IFRS 10, the group has reviewed the population of investments in entities as at 1 January 2013 to determine whether entities previously consolidated or unconsolidated in accordance with IAS 27 'Consolidated and Separate Financial Statements' and SIC 12 'Consolidation - Special Purpose Entities' changed their consolidation status as a result of applying IFRS 10. The result of this review was that the effect of applying the requirements of IFRS 10 did not have a material effect on these consolidated financial statements. Therefore no restatements are necessary on application of IFRS 10.
- IFRS 11 places more focus on the investors’ rights and obligations than on the structure of the arrangement when determining the type of joint arrangement with which the group is involved, unlike the previous approach, and introduces the concept of a joint operation.
- The application of IFRS 11 ‘Joint Arrangements’ did not have a material effect on these consolidated financial statements.
- IFRS 12 is a comprehensive standard on disclosure requirements for all forms of interests in other entities, including for unconsolidated structured entities. The disclosure requirements of IFRS 12 do not require comparative information to be provided for periods prior to initial application.
- IFRS 13 ‘Fair Value Measurement’ establishes a single framework for measuring fair value and introduces new requirements for disclosure of fair value measurements. IFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of IFRS 13 do not require comparative information to be provided for periods prior to initial application.
- Amendments to IFRS 7 ‘Disclosures – Offsetting Financial Assets and Financial Liabilities’ requires disclosure of the effect or potential effects of netting arrangements on an entity’s financial position. The amendments require disclosure of recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement. The amendments have been applied retrospectively.

Notes on the Financial Statements (continued)

- The amendments to IAS 19 'Employee Benefits' ('IAS 19 revised') are required to be applied retrospectively. The main effect of IAS 19 revised for the group is that it replaces the interest cost on the plan liability and expected return on plan assets with a finance cost comprising the net interest on the net defined benefit liability or asset. This finance cost is determined by applying to the net defined benefit liability or asset the same discount rate used to measure the defined benefit obligation. The difference between the actual return on plan assets and the return included in the finance cost component reflected in the income statement is presented in other comprehensive income. The effect of this change is to increase or decrease the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

During 2013, the group adopted a number of interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group.

(b) Presentation of information

Capital disclosures under IAS 1 'Presentation of Financial Statements' have been included in Note 33.

The functional currency of the bank is US dollars, which is also the presentation currency of the consolidated financial statements of the group.

(c) Use of estimates and assumptions

The preparation of financial information requires the use of estimates and assumptions about future conditions. The use of available information and the application of judgement are inherent in the formation of estimates; actual results in the future may differ from estimates upon which financial information is prepared. Management believes that the group's critical accounting policies where judgement is necessarily applied are those which relate to impairment of loans and advances, the valuation of financial instruments, impairment of available for sale assets, and valuation of intangible assets recognised in business combinations.

Further information about key assumptions concerning the future, and other key sources of estimation uncertainty, are set out in the Notes on the Financial Statements.

(d) Consolidation

The consolidated financial statements of the group comprise the financial statements of HSBC Bank Middle East Limited and its subsidiaries made up to 31 December.

The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The group is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities. For the group to have power over an entity, it must have the practical ability to exercise those rights. In the rare situations where potential voting rights exist, these are taken into account if the group has the practical ability to exercise those rights.

Where voting rights are not relevant in deciding whether the group has power over an entity, the assessment of control is based on all facts and circumstances. Where it is not immediately clear where control rests, an analysis of the purpose and design of the entity, including determining which party has power over the activities which most affect its returns and whether there are any additional rights held that may confer such power, is undertaken.

When assessing whether to consolidate investment funds, the group reviews all facts and circumstances to determine whether the group, as fund manager, is acting as agent or principal. The group may be deemed to be a principal, and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or a guarantee, and is able to influence the returns of the funds by exercising its power.

The acquisition method of accounting is used when subsidiaries are acquired by the group. The cost of an acquisition is measured at the fair value of the consideration, including contingent consideration, given at the date of exchange. Acquisition-related costs are recognised as an expense in the income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are generally measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the group's previously held equity interest, if any, over the net of the amounts of the identifiable assets acquired and the liabilities assumed. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. In a business combination achieved in stages, the previously held equity interest is remeasured at the acquisition-date fair value with the resulting gain or loss recognised in the income statement. In the event that the amounts of net assets acquired is in excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the group's previously held equity interest, the difference is recognised immediately in the income statement.

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

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

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

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

All intra-group transactions are eliminated on consolidation.

The 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.

Disclosures of interests in unconsolidated structured entities provide information on involvement in these entities which exposes the group to variability of returns from the performance of the other entity. Involvement is considered on a case by case basis, taking into account the nature of the entity's activity. This could include holding debt and equity instruments, or the provision of structured derivatives, but excludes involvement that exists only because of typical customer supplier relationships, such as market making transactions to facilitate secondary trading or senior lending in the normal course of business.

(e) Future accounting developments

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

Amendments issued by the IASB and endorsed by the EU

In December 2011 the IASB issued amendments to IAS 32 'Offsetting Financial Assets and Financial Liabilities' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in IAS 32 'Financial Instruments: Presentation'. The amendments are effective for annual periods beginning on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively.

The group does not expect the amendments to IAS 32 to have a material effect on the group's financial statements.

Amendments issued by the IASB but not endorsed by the EU

During 2012 and 2013, the IASB issued various amendments to IFRS that are effective from 1 January 2014 and which are expected to have an insignificant effect on the consolidated financial statements of the group.

In November 2009, the IASB issued IFRS 9 'Financial Instruments' which introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued an amendment to IFRS 9 incorporating requirements for financial liabilities. Together, these changes represent the first phase in the

IASB's planned replacement of IAS 39 'Financial Instruments: Recognition and Measurement.' IFRS 9 classification and measurement requirements are to be applied retrospectively but prior periods need not be restated.

In November 2012, the IASB issued proposed amendments to IFRS9 in respect of classification and measurement. Since the final requirements for classification and measurement are uncertain, it remains impracticable to quantify the effect of IFRS 9 as at the date of the publication of these financial statements.

The second phase in the IASB's project to replace IAS 39 will address the impairment of financial assets. It is proposed to replace the 'incurred loss' approach to the impairment of financial assets carried at amortised cost in IAS 39 with an expected credit loss approach, and require that the expected credit loss approach be applied to other categories of financial instrument, including loan commitments and financial guarantees. The final requirements for impairment of financial assets are expected to be published in 2014.

The third phase of the project addresses general hedge accounting. Macro hedging is not included in the IFRS 9 project and will be considered separately. In November 2013, the IASB issued amendments to IFRS 9 in respect of the general hedge accounting requirements, transition and effective date. As a result of these amendments, it is confirmed that all phases of IFRS 9 (except for changes to the presentation of gains and losses for certain liabilities measured at fair value) must be applied from the same effective date. This effective date has not yet been set by the IASB but is not expected to be earlier than 1 January 2017. The revised hedge accounting requirements are applied prospectively and the group is currently assessing the impact they may have on the financial statements.

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held for trading or designated at fair value (except for debt securities issued by the group and derivatives managed in conjunction with those debt securities) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest 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 excluding future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

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

(b) Non interest income

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

– income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
– income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
– income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income'.

Notes on the Financial Statements (continued)

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

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

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

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

(c) Operating segments

The group's operating segments are organised into geographical regions comprising UAE, Qatar, Oman and Rest of Middle East. The Rest of Middle East covers Algeria, Bahrain, Jordan, Kuwait, Lebanon, Pakistan and the Palestine Autonomous Area. Due to the nature of the group, the Board (chief operating decision maker) regularly reviews operating activity on a number of bases, including by geographical region and by global business. Although the Board reviews information on a number of bases, capital resources are allocated and performance assessed primarily by geographical region and the segmental analysis is presented on that basis. In addition, the economic conditions of each geographical region are highly influential in determining performance across the different types of business activity carried out in each region. Therefore, provision of segment information on a geographical basis provides the most meaningful information with which to understand the performance of the business.

Information provided to the Board to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with IFRSs. Due to the nature of the HSBC Group's structure, the analysis of profits shown in Note 10 includes intra-group items between geographical regions with the elimination shown in a separate column. Such transactions are conducted on an arm's length basis. Shared costs are included in segments on the basis of the actual recharges made.

(d) Cash and cash equivalents

For the purpose of the statement of cash flows, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition. Cash and cash equivalents 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.

(e) Valuation of financial instruments

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

Notes on the Financial Statements (continued)

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

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the group's valuation methodologies which are described in Note 13.

(f) Reclassification of financial assets

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

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

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

(g) 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 classified as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to a borrower. They are derecognised when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less any reduction for impairment or uncollectibility. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment relating only to the hedged risk.

Loans and advances are reclassified to 'Assets held for sale' when their carrying amounts are to be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable; however, such loans and advances continue to be measured in accordance with the policy described above.

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

Notes on the Financial Statements (continued)

(h) Impairment of loans and advances

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

Individually assessed loans and advances

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

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

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

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

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

- known cash flow difficulties experienced by the borrower;
- contractual payments of either principal or interest being past due for more than 90 days;
- the probability that the borrower will enter bankruptcy or other financial realisation;
- a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in forgiveness or postponement of principal, interest or fees, where the concession is not insignificant; and
- there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful.

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

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service 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 denominated in local currency; and
- when available, the secondary market price of the debt.

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

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

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

– to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and

– for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

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

The collective impairment allowance is determined after taking into account:

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

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

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

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

Homogeneous groups of loans and advances

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

– When appropriate empirical information is available, the group utilises roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency, and ultimately prove irrecoverable. In addition to the delinquency groupings, loans are segmented according to their credit characteristics as described above. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring and its discovery, for example through a missed payment (known as the emergence period) and the period of time

Notes on the Financial Statements (continued)

between discovery and write-off (known as the outcome period). Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio.

– When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience, or a discounted cash flow model.

The inherent loss within each portfolio is assessed on the basis of statistical models using historical data observations, which are updated periodically to reflect recent portfolio and economic trends. When the most recent trends arising from changes in economic, regulatory or behavioural conditions are not fully reflected in the statistical models, they are taken into account by adjusting the impairment allowances derived solely from the statistical models to reflect these changes as at the balance sheet date.

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

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

Write-off of loans and advances

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

Reversals of impairment

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

Assets acquired in exchange for loans

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

Renegotiated loans

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

Notes on the Financial Statements (continued)

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

(i) Trading assets and trading liabilities

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

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

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

(k) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the 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 financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income in 'Available-for-sale investments – fair value gains/ (losses)' until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

Notes on the Financial Statements (continued)

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

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

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

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

– **Available-for-sale debt securities:** When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer.

  These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

– **Available-for-sale equity securities:** Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

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

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

– for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in fair value of the financial asset is recognised in other comprehensive income. If the fair value of the debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement. If there is no longer objective evidence that the debt security is impaired, the impairment loss is also reversed through the income statement;

– for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses

Notes on the Financial Statements (continued)

recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the 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.

(l) 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’ or ‘Trading assets’ as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement for loans and advances to banks and customers, and as net trading income for trading assets.

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

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

(m) 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 derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

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

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

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the 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) a hedge 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 hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or 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, in which case it is released to the income statement immediately.

Cash flow hedge

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

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

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

Net investment hedge

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

Hedge effectiveness testing

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

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

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

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

Derivatives that do not qualify for hedge accounting

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

Notes on the Financial Statements (continued)

managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

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

(n) Derecognition of financial assets and liabilities

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

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

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

(o) 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.

(p) Subsidiaries and associates

The group classifies investments in entities which it controls as subsidiaries. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates.

The group's investments in subsidiaries are stated at cost less any impairment losses. Impairment losses recognised in prior periods are reversed through the income statement if, and only if, there has been a change in the estimates used to determine the recoverable amount of the investment in subsidiary since the last impairment loss was recognised.

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

Profits on transactions between the group and its associates and joint ventures are eliminated to the extent of the group's interest in the respective associates. 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.

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, for example when any voting rights relate to administrative tasks only, and key activities are directed by contractual agreement. Structured entities often have restricted activities and a narrow and well defined objective. Examples of structured entities include investment funds, securitisation vehicles and asset backed financings. Involvement with structured entities is disclosed in Note 36.

For the purposes of disclosure, the group would be considered to sponsor another entity if it has a key role in establishing that entity or in bringing together the relevant counterparties so that the transaction, which is the purpose of the entity, can occur. This may include instances where the group initially sets up an entity for a structured transaction, and acts as an underwriter or lead manager. The group would not be considered a sponsor once our initial involvement in setting up the structured entity had ceased even if the group was subsequently

Notes on the Financial Statements (continued)

involved with an entity to the extent of providing arm's length services in the normal course of business, for example through the provision of senior lending in the ordinary course of business.

(q) Goodwill and intangible assets

(i) Goodwill arises on the acquisition of subsidiaries, when the aggregate of the fair value of the consideration transferred, the amount of any non-controlling interest and the fair value of any previously held equity interest in the acquiree exceed the amount of the identifiable assets and liabilities acquired. If the amount of the identifiable assets and liabilities acquired is greater, the difference is recognised immediately in the income statement.

(ii) Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

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

Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable. Where intangible assets have a finite useful life, they are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life.

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

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

(r) 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 at the greater of 2% per annum on a straight-line basis or over their remaining useful lives; and
– leasehold land and buildings are depreciated over the shorter of their unexpired terms of the leases, or 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 is calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.

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

(s) 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. The finance income receivable is recognised in ‘Net interest income’ over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When the 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 in ‘Net interest income’ over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

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 assets 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.

(t) Income Tax

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

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. The group provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

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

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

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

(u) Pension and other post-employment benefits

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

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the scheme’s actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit liability and is

Notes on the Financial Statements (continued)

presented in operating expenses. Service costs comprise current service cost, past service cost and gains or loss on settlement.

The past service cost which is charged immediately to the income statement, is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or curtailment (a significant reduction by the entity in the number of employees covered by a plan). A settlement is a transaction that eliminates all further legal and constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Remeasurements of the net defined benefit liability, which comprise actuarial gains and losses, return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income.

Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in other comprehensive income in the period in which they arise.

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

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

(v) Share-based payments

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

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

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

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

Where an award has been modified, as a minimum the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award of the extra equity instruments

Notes on the Financial Statements (continued)

is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

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

(w) 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 the group are presented in US dollars, which is also the group's functional 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 at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised in other comprehensive income if the gain or loss on the non-monetary item is recognised in other comprehensive income. Any exchange component of a gain or loss on a non-monetary item is recognised in the income statement if the gain or loss on the non-monetary item is recognised in the income statement.

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries and associates whose functional currency is not US dollars, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries and associates whose functional currency is not 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 recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In the consolidated financial statements these exchange differences are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in other comprehensive income are reclassified to the income statement as a reclassification adjustment when the gain or loss on disposal is recognised.

(x) Provisions

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

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

(y) Financial guarantee contracts

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

The bank may issue financial guarantees and similar contracts to other group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to

Notes on the Financial Statements (continued)

insurance contracts, the group may elect to account for guarantees as insurance contracts in the group's financial statements. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

(z) Debt securities issued, non-equity preference share capital and deposits by customers and banks

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

(aa) 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.

(ab) Assets held for sale

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Non-current assets and disposal groups (including both the assets and liabilities of the disposal groups) are classified as held for sale when their carrying amounts will be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable. Non-current assets held for sale and disposal groups are measured at the lower of their carrying amount and fair value less cost to sell, except for those assets and liabilities that are not within the scope of the measurement requirements of IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' such as deferred taxes, financial instruments, investment properties, insurance contracts and assets and liabilities arising from employee benefits. These are measured in accordance with the accounting policies described above. Immediately before the initial classification as held for sale, the carrying amounts of the asset (or assets and liabilities in the disposal group) are measured in accordance with applicable IFRSs. On subsequent remeasurement of a disposal group, the carrying amounts of the assets and liabilities noted above that are not within the scope of the measurement requirements of IFRS 5 are remeasured in accordance with applicable IFRSs before the fair value less costs to sell of the disposal group is determined.

3 Use of assumptions, estimates and judgement

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

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, and the high degree of judgement involved, including the use of assumptions and estimation, are disclosed below.

Impairment of loans and advances

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(h). Further information can be found in Note 33 'Risk Management'. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances.

The methods used to calculate collective allowances on homogeneous groups of loans and advances that are not considered individually significant are disclosed in Note 2(h). They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgement, to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

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

Where loans are individually assessed for impairment, management judgement is required in determining whether there is objective evidence that a loss event has occurred, and if so, the measurement of the impairment allowance. In determining whether there is objective evidence that a loss event has occurred, judgement is exercised in evaluating all relevant information on indicators of impairment, which is not restricted to the consideration of whether payments are contractually past-due but includes broader consideration of factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay. A higher level of judgement is required for loans to borrowers showing signs of financial difficulty in market sectors experiencing economic stress, particularly where the likelihood of repayment is affected by the prospects for refinancing or the sale of a specified asset. For those loans where objective evidence of impairment exists, management determine the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer’s business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations.

Under certain specified conditions, the group provides loan forbearance to borrowers experiencing financial difficulties by agreeing to modify the contractual payment terms of loans in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default or repossession. Where forbearance activities are significant, higher levels of judgement and estimation uncertainty are involved in determining their effects on loan impairment allowances. Forbearance activities take place in both retail and wholesale loan portfolios.

The exercise of judgement requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive. It is possible that the outcomes within the next financial year could differ from the assumptions used, and this could result in a material adjustment to the carrying amount of loans and advances.

Valuation of financial instruments

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

Notes on the Financial Statements (continued)

Valuation techniques used to calculate fair values are discussed in Note 13. The main assumptions and estimates which management considers when applying a model with valuation techniques are:

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

– selecting an appropriate discount rate for the instrument. The determination of this rate is based on an assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and

– judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

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

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

Impairment of available-for-sale financial assets

The group’s accounting policy for impairment on available-for-sale financial assets is described in Note 2(k).

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

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

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

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

Valuation of intangible assets recognised in business combinations

The group’s accounting policy for intangible assets is described in Note 2(q).

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

Notes on the Financial Statements (continued)

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

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

Pensions

The assumptions used are disclosed in Note 6 ‘Employee compensation and benefits’.

Share-based payments

The assumptions used are disclosed in Note 6 ‘Employee compensation and benefits’.

4 Net (expense)/income from financial instruments designated at fair value

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

- all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value; and
- interest income, interest expense and dividend income in respect of:
  - financial assets and liabilities designated at fair value; and
  - derivatives managed in conjunction with the above,

  except for interest arising from issued debt securities and derivatives managed in conjunction with those debt securities, which is recognised in ‘Interest expense’.

Net (expense)/income on long-term debt issued and related derivatives

	2013	2012
	US$000	US$000
- Changes in own credit spread on long-term debt	**(3,746)**	(11,951)
- Other changes in fair value	**1,406**	(541)
	(2,340)	(12,492)

Notes on the Financial Statements (continued)

5 Operating profit

Operating profit is stated after the following items of income, expense, gains and losses:

	2013 US$000	2012 US$000
Income		
Interest recognised on impaired financial assets	**28,430**	15,058
Fees earned 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	**464,745**	450,209
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**16,732**	13,434
Income from listed investments	**16,263**	15,469
Income from unlisted investments	**102,351**	108,169
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(230,733)**	(327,867)
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	**(30,329)**	(32,542)
Gains/(losses)		
Gain on disposal or settlement of loans and advances	**2,631**	–
Impairment of available-for-sale equity shares	**(196)**	(172)
Gain/(loss) on disposal of property, plant and equipment, intangible assets and non-financial investments	**329**	(947)
Loan impairment credit/(charge) and other credit risk provisions	**36,230**	(245,651)
Net impairment credit/(charge) on loans and advances	**38,906**	(215,365)
Net impairment of available-for-sale debt securities	**(50)**	(1,123)
Net impairment in respect of other credit risk provisions	**(2,626)**	(29,163)

6 Employee compensation and benefits

	2013 US$000	2012 US$000
Wages and salaries	**517,941**	529,300
Social security costs	**7,744**	6,471
Post-employment benefits	**21,785**	13,936
	547,470	549,707

Average number of persons employed during the year

	2013	2012
UAE	**2,860**	2,767
Oman	**1,254**	1,066
Qatar	**353**	358
Rest of Middle East	**1,286**	1,371
Total	**5,753**	5,562

Notes on the Financial Statements (continued)

Included in 'Wages and salaries' above are share-based payment arrangements, as follows:

Share-based payments income statement charge

	2013 US$000	2012 US$000
Restricted and performance share awards[1]	**18,419**	29,802
Savings-related and other share options plans	**347**	968
	18,766	30,770
Equity-settled share-based payments	**18,766**	30,770

[1] Restricted share awards include awards granted under the HSBC Group Performance Share Plan ('GPSP').

The share based payments income statement charge above includes US$16.9 million (2012: US$24.2 million) relating to deferred share awards. These awards are generally granted to employees early in the year following the year to which the award relates. The charge for these awards is recognised from the start of the period to which the service relates to the end of the vesting period. The vesting period is the period over which the employee satisfies certain service conditions in order to become entitled to the award. Due to the staggered vesting profile of certain deferred share awards, the employee becomes entitled to a portion of the award at the end of each year during the vesting period. The income statement charge reflects this vesting profile.

In addition, wages and salaries also includes US$4.5 million (2012: US$5.9 million) in respect of deferred cash awards for current and prior performance years.

The following table identifies the charge recognised in the current year, or expected to be recognised in future years, in relation to deferred bonus awards from the current year and prior year bonus pools.

Income statement charge for current year and prior year bonus pools

	Current year Bonus pool[1] US$000	Prior year bonus pools US$000	Total US$000
2013			
Charge recognised in 2013	**7,618**	**13,800**	**21,418**
Deferred share awards	**4,833**	**12,086**	**16,919**
Deferred cash awards	**2,785**	**1,714**	**4,499**
Charge expected to be recognised in 2014 or later	**10,680**	**7,950**	**18,630**
Deferred share awards	**9,131**	**6,710**	**15,841**
Deferred cash awards	**1,549**	**1,240**	**2,789**
2012			
Charge recognised in 2012	6,620	23,548	30,168
Deferred share awards	4,146	20,096	24,242
Deferred cash awards	2,474	3,452	5,926
Charge expected to be recognised in 2013 or later	9,091	8,658	17,749
Deferred share awards	7,348	7,351	14,699
Deferred cash awards	1,743	1,307	3,050

[1] Current year bonus pool relates to the bonus pool declared for the reporting period (2013 for the current year, 2012 for the 2012 comparatives).

Notes on the Financial Statements (continued)

Share based payments

HSBC Share Awards

Award	Policy	Purpose
Restricted share awards (including GPSP awards	• Vesting of awards generally subject to continued employment with HSBC • Vesting often staggered over three years. GPSP awards vest after five years • Certain shares subject to a retention requirement postvesting. In the case of GPSP awards retention applies until cessation of employment • Awards generally not subject to performance conditions • Awards granted from 2010 onwards are subject to clawback provision prior to vesting	• Rewards employee performance and potential and retention of key employees • To defer variable pay

Movement on HSBC share awards

	Restricted share awards	
	2013	2012
	Number	Number
	(000's)	(000's)
Outstanding at 1 January	**3,537**	3,032
Additions during the year	**939**	1,243
Transferred in the year	**-**	4,879
Released and forfeited in the year	**(2,317)**	(5,617)
Outstanding at 31 December	**2,159**	3,537
Weighted average fair value of awards granted (£)	**7.35**	5.55

HSBC Share Option Plans

Main plans	Policy	Purpose
Savings-related share option plans	• Exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively • The exercise price is set at a 20% (2012: 20%) discount to the market value immediately preceding the date of invitation	• Eligible employees save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or euros), with the option to use the savings to acquire shares • To align the interests of all employees with the creation of shareholder value
HSBC Holdings Group share option plan	• Plan ceased in May 2005 • Exercisable between third and tenth anniversaries of the date of grant	• Long-term incentive plan between 2000 and 2005 during which certain HSBC employees were awarded share options

Calculation of fair values

The fair values of share options, measured at the date of grant of the option, are calculated using a Black-Scholes model.

The fair value of a share award is based on the share price at the date of the grant.

Notes on the Financial Statements (continued)

Significant weighted average assumptions used to estimate the fair value of the options granted:

2013	1-year Savings-Related Share Option Plans	3-year Savings-Related Share Option Plans	5-year Savings-Related Share Option Plans
Risk-free interest rate[1] (%)	**n/a**	**0.91**	**1.73**
Expected life (years)	**n/a**	**3**	**5**
Expected volatility[2] (%)	**n/a**	**20**	**20**
Share price at grant date (£)	**n/a**	**6.89**	**6.89**
2012			
Risk-free interest rate[1] (%)	0.4	0.6	1.2
Expected life (years)	1	3	5
Expected volatility[2] (%)	26	27	27
Share price at grant date (£)	5.46	5.46	5.46

1 *The risk-free rate was determined from the UK gilts yield curve.*
2 *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.*

The expected US dollar denominated dividend yield was determined to be 4.5% per annum in line with consensus analyst forecasts (2012: 5.0%).

Movement on HSBC share option plans

	Savings-related share option plans		HSBC Holdings Group Share option plan	
2013	**Number (000's)**	**Weighted average exercise price £**	**Number (000's)**	**Weighted average exercise price £**
Outstanding at 1 January	**926**	**3.87**	**754**	**6.82**
Granted during the year	**2**	**5.47**	**-**	**-**
Exercised during the year	**(154)**	**3.99**	**(159)**	**6.28**
Transferred during the year	**(2)**	**4.50**	**15**	**7.22**
Forfeited and expired in the year	**(89)**	**3.75**	**(132)**	**6.06**
Outstanding at 31 December	**683**	**3.79**	**478**	**7.22**
Weighted average fair value of options granted during the year (£)		**1.00**		**-**
Weighted average share price at the date the options were exercised (£)		**6.73**		**6.99**
At 31 December 2013				
Exercise price range (£):		**£3.03-£7.36**	**£6.00-£7.00**	**£7.01-£8.50**
Weighted average remaining contractual life (years)		**1.21**	**-**	**-**
Of which exercisable:				
number (000s)		**683**	**-**	**478**
weighted average exercise price		**5.92**	**-**	**7.22**

Notes on the Financial Statements (continued)

2012	Savings-related share option plans Number (000's)	Savings-related share option plans Weighted average exercise price £	HSBC Holdings Group Share option plan Number (000's)	HSBC Holdings Group Share option plan Weighted average exercise price £
Outstanding at 1 January	1,548	4.13	886	7.41
Granted during the year	335	3.67	-	-
Exercised during the year	(607)	3.35	(1)	6.02
Transferred during the year	(105)	4.15	124	7.10
Forfeited and expired in the year	(245)	5.14	(255)	7.26
Outstanding at 31 December	926	3.87	754	6.82
Weighted average fair value of options granted during the year (£)		1.01		-
Weighted average share price at the date the options were exercised (£)		5.55		5.78
At 31 December 2012				
Exercise price range (£):		£3.02-£7.49	£6.00-£7.00	£7.01-£8.50
Weighted average remaining contractual life (years)		3.59	-	-
Of which exercisable:				
number (000s)		926	249	505
weighted average exercise price		3.48	6.02	7.22

Post-employment benefit plans

Income statement charge

	2013 US$000	2012 US$000
Defined benefit pension plans	**16,679**	13,355
Defined contribution pension plans	**5,106**	581
	21,785	13,936

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

	2013 US$000	2012 US$000
Defined benefit pension plans	**95,473**	80,238

Cumulative actuarial gains/(losses) recognised in other comprehensive income

	2013 US$000	2012 US$000
Defined benefit pension plans	**(31,183)**	(27,258)

Defined benefit pension plans

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.

Notes on the Financial Statements (continued)

Net liability under defined benefit pension plans

	Fair value of plan assets	Present value of defined benefit obligations	Net defined benefit liability
	US$000	US$000	US$000
Net defined liability			
At 1 January 2013	**4,315**	**(84,553)**	**(80,238)**
Current service cost	**–**	**(15,289)**	**(15,289)**
Service cost	**–**	**(15,289)**	**(15,289)**
Net interest income/(cost) on the net defined benefit liability	**166**	**(1,556)**	**(1,390)**
Remeasurement effects recognised in other comprehensive income	**135**	**(4,713)**	**(4,578)**
- Return on plan assets (excluding interest income)	**135**	**–**	**135**
- Actuarial losses from changes in financial assumptions	**–**	**(4,713)**	**(4,713)**
Exchange differences and other movements	**1,676**	**(7,021)**	**(5,345)**
Contributions by the group	**835**	**–**	**835**
- Normal	**835**	**–**	**835**
- Special	**–**	**–**	**–**
Contributions by employees	**–**	**(28)**	**(28)**
Benefits paid	**(278)**	**10,838**	**10,560**
At 31 December 2013	**6,849**	**(102,322)**	**(95,473)**
Retirement benefit liabilities recognised on the balance sheet			**(95,473)**
Present value of defined benefit obligation relating to:		**(102,322)**	
- Actives		**(85,319)**	
- Deferreds		**(10,154)**	
- Pensioners		**(6,849)**	
Net defined liability			
At 1 January 2012	1,845	(77,635)	(75,790)
Current service cost	–	(11,353)	(11,353)
Service cost	–	(11,353)	(11,353)
Net interest income/(cost) on the net defined benefit liability	196	(2,198)	(2,002)
Remeasurement effects recognised in other comprehensive income	–	(4,131)	(4,131)
- Return on plan assets (excluding interest income)	–	–	–
- Actuarial losses from changes in financial assumptions	–	(4,131)	(4,131)
Exchange differences and other movements	1,584	(4,783)	(3,199)
Contributions by the group	913	–	913
- Normal	913	–	913
- Special	–	–	–
Contributions by employees	–	(7)	(7)
Benefits paid	(223)	15,554	15,331
At 31 December 2012	4,315	(84,553)	(80,238)
Retirement benefit liabilities recognised on the balance sheet			(80,238)

Notes on the Financial Statements (continued)

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

	2013 US$000	2012 US$000
Defined benefit pension plans		
Current service cost	**15,289**	11,353
Net interest income on the net defined benefit asset/liability	**1,390**	2,002
Total expense	**16,679**	13,355

Post-employment defined benefit plans' principal actuarial assumptions

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

Principal actuarial assumptions

	Discount rate %	Rate of pay increase %	Combined rate of resignation and employment termination %
At 31 December 2013			
United Arab Emirates	**2.65**	**5.00**	**12.00**
At 31 December 2012			
United Arab Emirates	2.24	4.00	15.00

The group determines discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of long term, high quality corporate bonds or Central Bank certificate of deposits or longer dated swap rates of approximately 7 years as a proxy for a government bond yield of suitable term and currency to the liabilities of the scheme, where appropriate.

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal defined benefit plan:

The effect of changes in key assumptions on the principal plan

	United Arab Emirates	
	2013 US$000	2012 US$000
Discount rate		
Change in scheme obligation at year end from a 25bps increase	**(1,412)**	(929)
Change in scheme obligation at year end from a 25bps decrease	**1,366**	956
Change in following year scheme cost from a 25bps increase	**(99)**	(41)
Change in following year scheme cost from a 25bps decrease	**97**	41
Rate of pay increase		
Change in scheme obligation at year end from a 25bps increase	**(1,463)**	1,007
Change in scheme obligation at year end from a 25bps decrease	**1,423**	(906)
Change in following year scheme cost from a 25bps increase	**(335)**	230
Change in following year scheme cost from a 25bps decrease	**326**	18

Notes on the Financial Statements (continued)

7 Auditors' remuneration

The following fees were payable by the group to the group's principal auditor, KPMG Channel Islands Limited and its associates (together 'KPMG'):

	2013	2012
	US$000	US$000
Audit fees for HSBC Bank Middle East Limited statutory audit:		
– fees relating to current year	**949**	1,019
– fees relating to prior year	**23**	4
	972	1,023
Fees payable to KPMG for other services provided to the group		
– other services pursuant to legislation	**839**	970
– tax services	**112**	76
– all other services	**319**	772
	1,270	1,818
Total fees payable	**2,242**	2,841

The following is a description of the type of services included within the categories listed above:

- Audit fees are in respect of fees payable to KPMG Channel Islands Limited and their associates for the statutory audit of the consolidated financial statements of the group.
- 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 reviews of financial models.

No fees were payable to KPMG in the current or prior year for the following types of services: internal audit services, services related to litigation, and services related to recruitment and remuneration.

8 Tax

Tax expense

	2013	2012
	US$000	US$000
Current tax		
Tax – on current year profit	**141,581**	132,585
Tax – adjustments in respect of prior years	**13,578**	(11,141)
	155,159	121,444
Deferred tax		
Origination and reversal of temporary differences	**7,124**	(19,177)
Adjustment in respect of prior years	**(13,560)**	(190)
	(6,436)	(19,367)
Tax expense	**148,723**	102,077

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

Notes on the Financial Statements (continued)

Tax reconciliation

The tax charged to the income statement differs to the tax charge that would apply if all profits had been taxed at the UAE corporation tax rate as follows:

	2013		2012	
		Percentage of profit before tax		Percentage of profit before tax
	US$000	**%**	US$000	%
Taxation at UAE corporate tax rate of 20% (2012: 20 %)	**200,193**	**20.0**	147,764	20.0
Effect of taxing overseas profit in principal locations at different rates	**(20,266)**	**(2.0)**	(12,637)	(1.7)
Adjustment in respect of prior period liabilities	**18**	**0.0**	(11,331)	(1.6)
Deferred tax temporary differences not recognised	**(307)**	**(0.0)**	259	0.0
Effect of profits in associates	**(5)**	**(0.0)**	768	0.1
Non taxable income and gains	**(45,497)**	**(4.6)**	(31,958)	(4.3)
Permanent disallowables	**10,517**	**1.1**	4,943	0.7
Local taxes and overseas withholding taxes	**1,900**	**0.2**	2,263	0.3
Other items	**2,170**	**0.2**	2,006	0.3
Overall tax expense[1]	**148,723**	**14.9**	102,077	13.8

1 *The Effective Tax Rate (ETR) for 2013 is higher than that of 2012 by 1.1% This primarily resulted from the release of prior years' tax provisions in 2012 due to the closure of tax assessments for prior years. This contributed to a decrease of 1.6% in the 2012 ETR.*

In addition to the amount charged to the income statement the aggregate amount of deferred taxation, relating to items that are taken directly to other comprehensive income and equity, was a US$0.9 million increase in equity (2012: US$1.3 million decrease 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.

Deferred taxation

The table on the following page shows the deferred tax assets and liabilities recognised in the balance sheet and the related movements recognised in the income statement, other comprehensive income and directly in equity:

Notes on the Financial Statements (continued)

Movement of net deferred tax assets before offsetting balances within countries

	Retirement benefits US$000	Loan impairment allowances US$000	Unused tax losses US$000	Accelerated capital allowances US$000	Available-for-sale investments US$000	Cash flow hedges US$000	Share-based payments US$000	Revaluation of property US$000	Relief for unused tax credits US$000	Other US$000	Total US$000
Assets	**5,899**	**160,242**	**-**	**-**	**(1,010)**	**(2,570)**	**-**	**-**	**-**	**36,161**	**198,722**
Liabilities	**-**	**-**	**-**	**-**	**(2,526)**	**-**	**(1,857)**	**(1,502)**	**(808)**	**(68)**	**(6,761)**
At 1 January 2013	**5,899**	**160,242**	**-**	**-**	**(3,536)**	**(2,570)**	**(1,857)**	**(1,502)**	**(808)**	**36,093**	**191,961**
Acquisition and disposals	**-**	**-**	**-**	**-**	**(2,824)**	**571**	**-**	**-**	**-**	**1,152**	**(1,101)**
Income statement	**169**	**5,803**	**-**	**(58)**	**1,252**	**263**	**84**	**18**	**-**	**(1,095)**	**6,436**
Other comprehensive income:											
- available-for-sale investment	**-**	**-**	**-**	**-**	**(700)**	**-**	**-**	**-**	**-**	**-**	**(700)**
- cash flow hedges	**-**	**-**	**-**	**-**	**-**	**834**	**-**	**-**	**-**	**-**	**834**
- actuarial losses	**788**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**788**
Equity:											
- share based payments	**-**	**-**	**-**	**-**	**-**	**-**	**11**	**-**	**-**	**-**	**11**
Foreign exchange and other adjustments	**(505)**	**14,593**	**-**	**203**	**63**	**(834)**	**1,866**	**(808)**	**808**	**(17,462)**	**(2,076)**
	6,351	**180,638**	**-**	**145**	**(5,745)**	**(1,736)**	**104**	**(2,292)**	**-**	**18,688**	**196,153**
Assets	**6,351**	**180,638**	**-**	**145**	**(687)**	**(1,736)**	**104**	**-**	**-**	**19,119**	**203,934**
Liabilities	**-**	**-**	**-**	**-**	**(5,058)**	**-**	**-**	**(2,292)**	**-**	**(431)**	**(7,781)**
At 31 December 2013	**6,351**	**180,638**	**-**	**145**	**(5,745)**	**(1,736)**	**104**	**(2,292)**	**-**	**18,688**	**196,153**
Assets	6,251	146,985	5,918	399	(1,026)	(1,307)	-	-	-	16,499	173,719
Liabilities	-	-	-	-	(1,701)	-	(2,162)	(1,874)	-	(236)	(5,973)
At 1 January 2012	6,251	146,985	5,918	399	(2,727)	(1,307)	(2,162)	(1,874)	-	16,263	167,746
Acquisition and disposals	-	-	-	-	90	-	-	-	(808)	-	(718)
Income statement	-	16,238	(5,918)	(1)	1	-	-	372	-	8,675	19,367
Other comprehensive income:											
- available-for-sale investment	-	-	-	-	282	-	-	-	-	-	282
- cash flow hedges	-	-	-	-	-	(1,263)	-	-	-	-	(1,263)
- actuarial losses	(352)	-	-	-	-	-	-	-	-	-	(352)
Equity:											
- share based payments	-	-	-	-	-	-	305	-	-	-	305
Foreign exchange and other adjustments	-	(2,981)	-	(398)	(1,182)	-	-	-	-	11,155	6,594
	5,899	160,242	-	-	(3,536)	(2,570)	(1,857)	(1,502)	(808)	36,093	191,961
Assets	5,899	160,242	-	-	(1,010)	(2,570)	-	-	-	36,161	198,722
Liabilities	-	-	-	-	(2,526)	-	(1,857)	(1,502)	(808)	(68)	(6,761)
At 31 December 2012	5,899	160,242	-	-	(3,536)	(2,570)	(1,857)	(1,502)	(808)	36,093	191,961

Notes on the Financial Statements (continued)

Analysis of deferred tax assets by country

	2013 US$000	2012 US$000
UAE	**187,893**	173,514
Oman	**10,288**	11,727
Qatar	**-**	-
Rest of Middle East	**5,753**	13,481
	203,934	198,722

Unrecognised deferred tax assets and liabilities

The amount of temporary differences, unused tax losses and tax credits for which no defined tax is recognised in the balance sheet was US$Nil (2012: USDNil).

9 Dividends

Dividends to shareholders of the parent company

	2013		2012	
	US$ per share	Total US$000	US$ per share	Total US$000
Dividends declared on ordinary shares	**0.1772**	**165,000**	0.1450	135,000

During the year, first and second interim dividends for 2013 of US$65 million and US$100 million (2012: US$135 million) were declared on 2 May 2013 and 31 October 2013 and paid on 15 May 2013 and 12 November 2013, respectively.

The Directors declared after the end of the year a third interim dividend of US$70 million in respect of the financial year ended 31 December 2013.

10 Segment analysis

The factors used to identify the group's reporting segments are discussed in the 'Summary of significant accounting policies' in Note 2(c).

Products and services

The group provides a comprehensive range of banking and related financial services to its customers in its geographical regions. The products and services offered to customers are organised by customer group and global business.

- Retail Banking and Wealth Management ('RBWM') offers a broad range of products and services to meet the personal banking need, consumer finance and wealth management needs of individual customers. Typically, customer offerings include personal banking products (current and savings accounts, mortgages and personal loans, credit cards, debit cards and local and international payment services) and wealth management services (insurance and investment products and financial planning services).
- Commercial Banking ('CMB') product offerings include the provision of receivables financing services, payments and cash management, international trade finance, treasury and capital markets, commercial cards, insurance, cash and derivatives in foreign exchange and rates, and online and direct banking offerings
- Global Banking and Markets ('GB&M') provides tailored financial solutions to government, corporate and institutional clients. The client focused business lines deliver a full range of banking capabilities including financing, advisory and transaction services; a markets business that provides services in credit, rates, foreign exchange, money markets and securities services; and principle investment activities.
- Private Banking ('GPB') provides a range of services to high net worth individuals and families with complex and international needs.

Notes on the Financial Statements (continued)

Financial information

Profit/(loss) for the year

	UAE US$000	Oman US$000	Qatar US$000	Rest of Middle East US$000	Intra-group items US$000	Total US$000
2013						
Net interest income	**681,864**	**124,905**	**94,663**	**215,167**	**–**	**1,116,599**
Net fee income	**340,601**	**29,912**	**61,625**	**103,610**	**–**	**535,748**
Net trading income	**226,785**	**18,452**	**36,675**	**46,766**	**–**	**328,678**
Other operating income	**141,293**	**5,258**	**4,061**	**3,286**	**(79,083)**	**74,815**
Net operating income before loan impairment charges and other credit risk provisions	**1,390,543**	**178,527**	**197,024**	**368,829**	**(79,083)**	**2,055,840**
Loan impairment (charges)/recoveries and other credit risk provisions	**(12,909)**	**6,611**	**(3,303)**	**45,831**	**–**	**36,230**
Net operating income	**1,377,634**	**185,138**	**193,721**	**414,660**	**(79,083)**	**2,092,070**
Total operating expenses	**(754,934)**	**(151,661)**	**(84,630)**	**(179,521)**	**79,083**	**(1,091,663)**
Operating profit	**622,700**	**33,477**	**109,091**	**235,139**	**–**	**1,000,407**
Share of profit in associates	**559**	**–**	**–**	**–**	**–**	**559**
Profit before tax	**623,259**	**33,477**	**109,091**	**235,139**	**–**	**1,000,966**
By global business:						
Retail Banking and Wealth Management	**141,751**	**(7,190)**	**10,330**	**(141)**	**–**	**144,750**
Commercial Banking	**290,241**	**21,722**	**36,809**	**110,919**	**–**	**459,691**
Global Banking and Markets	**266,261**	**18,945**	**61,952**	**124,340**	**–**	**471,498**
Global Private Banking	**972**	**–**	**–**	**–**	**–**	**972**
Other[1]	**(75,966)**	**–**	**–**	**21**	**–**	**(75,945)**
2012						
Net interest income	684,980	104,069	101,610	212,044	–	1,102,703
Net fee income	309,103	26,054	64,366	104,549	–	504,072
Net trading income	182,926	23,415	43,689	61,785	–	311,815
Other operating income	124,216	3,676	4,967	3,405	(65,929)	70,335
Net operating income before loan impairment charges and other credit risk provisions	1,301,225	157,214	214,632	381,783	(65,929)	1,988,925
Loan impairment (charges)/recoveries and other credit risk provisions	(175,593)	1,049	490	(71,597)	–	(245,651)
Net operating income	1,125,632	158,263	215,122	310,186	(65,929)	1,743,274
Total operating expenses	(670,411)	(123,634)	(86,197)	(186,273)	65,929	(1,000,586)
Operating profit	455,221	34,629	128,925	123,913	–	742,688
Share of profit in associates	(3,866)	-	–	-	–	(3,866)
Profit before tax	451,355	34,629	128,925	123,913	–	738,822
By global business:						
Retail Banking and Wealth Management	143,190	(9,598)	9,392	14,452	–	157,436
Commercial Banking	234,855	21,247	36,366	85,722	–	378,190
Global Banking and Markets	128,864	20,929	83,167	23,739	–	256,699
Global Private Banking	994	-	–	-	–	994
Other[1]	(56,548)	2,051	–	-	–	(54,497)

[1] *The main items reported in the 'Other' category are Head Office operations costs and movements in fair value of own debt.*

Notes on the Financial Statements (continued)

Performance ratios

	UAE	Oman	Qatar	Rest of Middle East	Total
	%	%	%	%	%
Year ended 31 December 2013					
Share of the group's profit before tax	**62.3**	**3.3**	**10.9**	**23.5**	**100.0**
Cost efficiency ratio	**54.3**	**85.0**	**43.0**	**48.7**	**53.1**
Year ended 31 December 2012					
Share of the group's profit before tax	61.0	4.7	17.5	16.8	100.0
Cost efficiency ratio	51.5	78.6	40.2	48.8	50.3

Balance sheet information

	UAE	Oman	Qatar	Rest of Middle East	Intra-group items	Total
	US$000	US$000	US$000	US$000	US$000	US$000
Year ended 31 December 2013						
Loans and advances to customers (net)	**15,876,105**	**2,553,124**	**1,779,065**	**3,421,424**	**–**	**23,629,718**
Interest in associates	**30,642**	**–**	**–**	**–**	**–**	**30,642**
Total assets	**31,335,868**	**5,852,729**	**4,815,929**	**9,092,281**	**(2,669,135)**	**48,427,672**
Customer accounts	**18,486,377**	**4,638,588**	**2,860,983**	**5,329,734**	**–**	**31,315,682**
Total liabilities	**26,471,826**	**5,036,254**	**4,804,938**	**9,085,678**	**(2,669,135)**	**42,729,561**
Year ended 31 December 2012						
Loans and advances to customers (net)	15,410,868	3,097,838	1,844,129	3,662,431	–	24,015,266
Investment in associates	30,632	–	–	–	–	30,632
Total assets	32,786,820	6,363,278	4,819,494	9,539,520	(3,052,190)	50,456,922
Customer accounts	18,472,470	4,786,180	2,703,974	6,075,552	–	32,038,176
Total liabilities	28,571,526	5,575,215	4,802,532	9,539,552	(3,052,190)	45,436,635

Other financial information

Net operating income by global business

	RBWM	CMB	GB&M	GPB	Other[2]	Inter Segment	Total
	US$000	US$000	US$000	US$000	US$000	US$000	US$000
Year ended 31 December 2013							
Net operating income[1]	**690,544**	**735,812**	**641,515**	**1,163**	**65,889**	**(79,083)**	**2,055,840**
External	**590,224**	**780,647**	**735,094**	**421**	**(50,546)**	–	**2,055,840**
Inter-segment	**100,320**	**(44,835)**	**(93,579)**	**742**	**116,435**	**(79,083)**	–
Year ended 31 December 2012							
Net operating income[1]	668,000	750,204	585,678	9,260	41,713	(65,930)	1,988,925
External	553,087	854,584	663,359	3,466	(85,571)	–	1,988,925
Inter-segment	114,913	(104,380)	(77,681)	5,794	127,284	(65,930)	–

1 *Net operating income before loan impairment charges and other credit risk provisions, also referred to as revenue.*
2 *The main items reported in the 'Other' category are certain property activities, unallocated investment activities, centrally held investment companies movements in fair value of own debt and the head office company and financing operations.*

Notes on the Financial Statements (continued)

Information by country

	31 December 2013		31 December 2012	
	External net operating income[1]	**Non-current assets[2]**	External net operating income[1]	Non-current assets[2]
	US$000	**US$000**	US$000	US$000
UAE	**1,317,110**	**88,875**	1,236,432	101,339
Oman	**178,527**	**112,847**	157,213	116,161
Qatar	**196,869**	**8,836**	214,395	10,051
Rest of Middle East	**363,334**	**29,416**	380,885	35,072
TOTAL	**2,055,840**	**239,974**	1,988,925	262,623

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

11 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies in Note 2 describes 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 carrying amounts of the financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading.

	At 31 December 2013					
	Held for trading US$000	**Designated at fair value US$000**	**Available-for-sale securities US$000**	**Financial assets and liabilities at amortised cost US$000**	**Derivatives designated as cash flow hedging instruments US$000**	**Total US$000**
Financial assets						
Cash and balances at central banks	–	–	–	**1,573,701**	–	**1,573,701**
Items in the course of collection from other banks	–	–	–	**67,483**	–	**67,483**
Trading assets	**515,374**	–	–	–	–	**515,374**
Derivatives	**1,109,055**	–	–	–	**26,297**	**1,135,352**
Loans and advances to banks	–	–	–	**7,616,777**	–	**7,616,777**
Loans and advances to customers	–	–	–	**23,629,718**	–	**23,629,718**
Financial investments	–	–	**11,267,242**	–	–	**11,267,242**
Assets held for sale	**785**	–	**256,586**	**625,010**	–	**882,381**
Other assets	–	–	–	**1,132,033**	–	**1,132,033**
Accrued income	–	–	–	**106,816**	–	**106,816**
Total financial assets	**1,625,214**	–	**11,523,828**	**34,751,538**	**26,297**	**47,926,877**
Total non-financial assets						**500,795**
Total assets						**48,427,672**
Financial liabilities						
Deposits by banks	–	–	–	**1,379,473**	–	**1,379,473**
Customer accounts	–	–	–	**31,315,682**	–	**31,315,682**
Items in the course of transmission to other banks	–	–	–	**561,153**	–	**561,153**
Trading liabilities	**1,235,000**	–	–	–	–	**1,235,000**
Financial liabilities designated at fair value	–	**503,448**	–	–	–	**503,448**
Derivatives	**1,132,836**	–	–	–	–	**1,132,836**
Debt securities in issue	–	–	–	**3,206,249**	–	**3,206,249**
Liabilities of disposal groups held for sale	**616**	–	–	**984,352**	–	**984,968**
Other liabilities	–	–	–	**1,899,096**	–	**1,899,096**
Accruals	–	–	–	**67,013**	–	**67,013**
Total financial liabilities	**2,368,452**	**503,448**	–	**39,413,018**	–	**42,284,918**
Total non-financial liabilities						**444,643**
Total liabilities						**42,729,561**

Notes on the Financial Statements (continued)

	At 31 December 2012					
	Held for trading US$000	Designated at fair value US$000	Available-for-sale securities US$000	Financial assets and liabilities at amortised cost US$000	Derivatives designated as cash flow hedging instruments US$000	Total US$000
Financial assets						
Cash and balances at central banks	–	–	–	892,603	–	892,603
Items in the course of collection from other banks	–	–	–	116,083	–	116,083
Trading assets	580,613	–	–	–	–	580,613
Derivatives	1,414,896	–	–	–	21,346	1,436,242
Loans and advances to banks	–	–	–	9,537,777	–	9,537,777
Loans and advances to customers	–	–	–	24,015,266	–	24,015,266
Financial investments	–	–	11,206,230	–	–	11,206,230
Assets held for sale	108	–	138,200	391,350	–	529,658
Other assets	–	–	–	938,959	–	938,959
Accrued income	–	–	–	196,665	–	196,665
Total financial assets	1,995,617	–	11,344,430	36,088,703	21,346	49,450,096
Total non-financial assets						1,006,826
Total assets						50,456,922
Financial liabilities						
Deposits by banks	–	–	–	1,803,014	–	1,803,014
Customer accounts	–	–	–	32,038,176	–	32,038,176
Items in the course of transmission to other banks	–	–	–	569,835	–	569,835
Trading liabilities	1,090,962	–	–	–	–	1,090,962
Financial liabilities designated at fair value	–	508,989	–	–	–	508,989
Derivatives	1,418,636	–	–	–	–	1,418,636
Debt securities in issue	–	–	–	4,876,509	–	4,876,509
Liabilities of disposal groups held for sale	230	–	–	454,642	–	454,872
Other liabilities	–	–	–	2,221,707	–	2,221,707
Accruals	–	–	–	90,139	–	90,139
Total financial liabilities	2,509,828	508,989	–	42,054,022	–	45,072,839
Total non-financial liabilities						363,796
Total liabilities						45,436,635

12 Trading assets

	2013 US$000	2012 US$000
Trading assets:		
– not subject to repledge or resale by counterparties	**515,374**	580,613
Treasury and other eligible bills	**109,046**	–
Debt securities	**303,121**	463,050
Trading securities at fair value	**412,167**	463,050
Loans and advances to banks	**87,049**	84,639
Loans and advances to customers	**16,158**	32,924
	515,374	580,613

Notes on the Financial Statements (continued)

13 Fair value of financial instruments carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described in Notes 2 and 3. The fair value of financial instruments is generally measured on the basis of the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the IFRS offsetting criteria.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following table sets out the financial instruments carried at fair value.

Financial instruments carried at fair value and bases of valuation

		Valuation techniques		
	Quoted market price Level 1 US$000	Using observable inputs Level 2 US$000	With significant non-observable inputs Level 3 US$000	Total US$000
Recurring fair value measurements				
At 31 December 2013				
Assets				
Trading assets	**–**	**515,374**	**–**	**515,374**
Derivatives	**–**	**1,133,958**	**1,394**	**1,135,352**
Financial investments: available for sale	**10**	**11,107,870**	**159,362**	**11,267,242**
Liabilities				
Trading liabilities	**–**	**1,235,000**	**–**	**1,235,000**
Financial liabilities designated at fair value	**503,448**	**–**	**–**	**503,448**
Derivatives	**–**	**1,130,156**	**2,680**	**1,132,836**
Non-recurring fair value measurements				
Assets of disposal groups held for sale				
Derivatives	**–**	**178**	**–**	**178**
Financial investments: available for sale	**–**	**256,586**	**–**	**256,586**
Liabilities of disposal groups held for sale				
Derivatives	**–**	**47**	**–**	**47**
Recurring fair value measurements				
At 31 December 2012				
Assets				
Trading assets	–	495,308	85,305	580,613
Derivatives	–	1,432,634	3,608	1,436,242
Financial investments: available for sale	5,467	10,646,600	554,163	11,206,230
Liabilities				
Trading liabilities	–	1,090,962	–	1,090,962
Financial liabilities designated at fair value	508,989	–	–	508,989
Derivatives	–	1,418,235	401	1,418,636
Non-recurring fair value measurements				
Assets of disposal groups held for sale				
Derivatives	–	16	–	16
Financial investments: available for sale	138,200	–	–	138,200
Liabilities of disposal groups held for sale				
Derivatives	–	230	–	230

There were no material transfers between Level 1 and Level 2 in the period. Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

Notes on the Financial Statements (continued)

Control framework

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

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

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

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

Determination of fair value

Fair values are determined according to the following hierarchy:

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

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. In the event that the market for a financial instrument is not active, a valuation technique is used.

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

Valuation techniques

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations. A range of valuation techniques is employed, dependent upon the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analysis, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to consideration of credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. Projection utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent upon more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may impact the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, the group uses a discounting curve that reflects the overnight interest rate ('OIS discounting').

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit ('day 1 gain or loss') or greater than 5% of the instrument's carrying value is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

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

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

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

Changes in fair value are generally subject to a profit and loss analysis process. This process disaggregates changes in fair value into three high level categories; (i) portfolio changes, such as new transactions or maturing transactions, (ii) market movements, such as changes in foreign exchange rates or equity prices, and (iii) other, such as changes in fair value adjustments, discussed below.

Fair value adjustments

Fair value adjustments are adopted when the group considers that there are additional factors that would be considered by a market participant that are not incorporated within the valuation model. The group classifies fair value adjustments as either 'risk-related' or 'model-related'. The majority of these adjustments relate to Global Banking and Markets. Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.

Notes on the Financial Statements (continued)

Risk-related adjustments

Bid-offer

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

Uncertainty

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

Credit valuation adjustment

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

Debit valuation adjustment

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

Model-related adjustments

Model limitation

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

Inception profit (Day 1 P&L reserves)

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

Credit valuation adjustment/debit valuation adjustment methodology

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

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

Valuation of uncollateralised derivatives

The group values uncollateralised derivatives by discounting expected future cash flows at a benchmark interest rate, typically Libor or its equivalent. This approach has historically been adopted across the industry, and has therefore been an appropriate basis for fair value. The HSBC Group, and other industry participants, are currently considering whether this approach appropriately reflects the manner in which the derivatives are funded, which may occur at rates

Notes on the Financial Statements (continued)

other than interbank offer rates. No consensus has yet emerged on how such funding should be reflected in the fair value measurement for uncollateralised derivatives.

Fair value valuation bases

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

	Assets			Liabilities
	Available-for-sale US$000	Held for Trading US$000	Derivatives US$000	Derivatives US$000
At 31 December 2013				
Private equity including strategic investments	**138,722**	–	–	–
Other derivatives	–	–	**1,394**	**2,680**
Other portfolios	**20,640**	–	–	–
	159,362	–	**1,394**	**2,680**
At 31 December 2012				
Private equity including strategic investments	139,390	–	–	–
Other derivatives	–	–	3,608	401
Other portfolios	414,773	85,305	–	–
	554,163	85,305	3,608	401

Private equity and strategic investments

The group's private equity positions are generally classified as available-for-sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Derivatives

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

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

Other portfolios

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

Notes on the Financial Statements (continued)

Movement in Level 3 financial instruments

	Assets			Liabilities
	Available-for-sale US$000	Held for Trading US$000	Derivatives US$000	Derivatives US$000
At 1 January 2013	**554,163**	**85,305**	**3,608**	**401**
Total gains/(losses) recognised in profit or loss	**(525)**	**(2,559)**	**(2,180)**	**2,279**
Total gains/(losses) recognised in other comprehensive income	**14,081**	**-**	**-**	**-**
Purchases	**180,502**	**-**	**-**	**-**
Sales	**(498)**	**-**	**-**	**-**
Transfers out	**(741,585)**	**(82,746)**	**(380)**	**-**
Transfers in	**153,224**	**-**	**346**	**-**
At 31 December 2013	**159,362**	**-**	**1,394**	**2,680**
Total gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2013	**(525)**	**-**	**1,394**	**(2,274)**
At 1 January 2012	556,738	207,711	4,759	2,631
Total gains/(losses) recognised in profit or loss	-	(1,023)	1,520	(2,230)
Total gains/(losses) recognised in other comprehensive income	(2,669)	-	-	-
Purchases	566	-	-	-
Sales	(472)	(136,809)	-	-
Transfers out	-	-	(2,705)	-
Transfers in	-	15,426	34	-
At 31 December 2012	554,163	85,305	3,608	401
Total gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2012	-	(1,023)	3,091	(2,230)

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

Effects of changes in significant unobservable assumptions to reasonably possible alternatives:

The fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and that are not based on observable market data. The following table shows the sensitivity of these fair values to reasonably possible alternative assumptions:

Sensitivity of fair values to reasonable possible alternative assumptions

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes US$000	Unfavourable changes US$000	Favourable changes US$000	Unfavourable changes US$000
At 31 December 2013				
Derivatives, trading assets and trading liabilities[1]	**–**	**–**	**–**	**–**
Financial investments: available for sale	**–**	**–**	**5,548**	**(18,553)**
At 31 December 2012				
Derivatives, trading assets and trading liabilities[1]	8,532	(8,532)	–	–
Financial investments: available for sale	–	–	55,514	(55,514)

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

Notes on the Financial Statements (continued)

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

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes US$000	**Unfavourable changes US$000**	**Favourable changes US$000**	**Unfavourable changes US$000**
At 31 December 2013				
Private equity including strategic investments .	-	-	**3,484**	**(16,469)**
Other derivatives	-	-	-	-
Other portfolios	-	-	**2,064**	**(2,064)**
At 31 December 2012				
Private equity including strategic investments ...	-	-	13,937	(13,937)
Other derivatives	3	(3)	-	-
Other portfolios	8,529	(8,529)	41,477	(41,477)

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters using statistical techniques. The statistical techniques aim to apply a 90% confidence interval. When parameters are not amenable to statistical analysis, the quantification of uncertainty is judgemental, but is also guided by the 90% confidence interval.

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

Key unobservable inputs to Level 3 financial instruments

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

Private equity including strategic investments

The group's private equity and strategic investments are generally classified as available for sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. Given the bespoke nature of the analysis in respect of each holding, it is not practical to quote a range of key unobservable inputs.

Prepayment rates

Prepayment rates are a measure of the anticipated future speed at which a loan portfolio will be repaid in advance of the due date. A modelled price may be used where insufficient observable market prices exist to enable a market price to be determined directly. Prepayment rates are also an important input into the valuation of derivatives linked to securitisations. Prepayment rates vary according to the nature of the loan portfolio, and expectations of future market conditions. For example, prepayment rates will generally be anticipated to increase as interest rates rise. Prepayment rates may be estimated using a variety of evidence, such as prepayment rates implied from proxy observable security prices, current or historic prepayment rates, macro-economic modelling.

Market proxy

Market proxy pricing may be used for an instrument for which specific market pricing is not available, but evidence is available in respect of instruments that have some characteristics in common. In some cases it might be possible to identify a specific proxy, but more generally evidence across a wider range of instruments will be used to understand the factors that influence current market pricing and the manner of that influence. For example, in the collateralized loan obligation market it may be possible to establish that A-rated securities exhibit prices in a range, and to isolate key factors that influence position within the range. Application of this to a specific A-rated security within the group's portfolio allows assignment of a price.

The range of prices used as inputs into a market proxy pricing methodology may therefore be wide. This range is not indicative of the uncertainty associated with the price derived for an individual security.

Notes on the Financial Statements (continued)

Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that the group may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of the group's long option positions (i.e. the positions in which the group has purchased options), while the group's short option positions (i.e. the positions in which the group has sold options) will suffer losses.

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels. For example, while it is generally the case that foreign exchange volatilities are lower than equity volatilities, there may be examples in particular currency pairs or for particular equities where this is not the case.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data. For example, longer-dated volatilities may be extrapolated from shorter-dated volatilities.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference market price. For example, foreign exchange volatilities for a pegged currency may be very low, whereas for non-managed currencies the foreign exchange volatility may be higher. As a further example, volatilities for deep-in-the money or deep-out-of-the-money equity options may be significantly higher than at-the-money options. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. For example, an equity basket option has a payout that is dependent upon the performance of a basket of single stocks, and the correlation between the price movements of those stocks will be an input to the valuation. This is referred to as equity-equity correlation. There are a wide range of instruments for which correlation is an input, and consequently a wide range of both same-asset correlations (e.g. equity-equity correlation) and cross-asset correlations (e.g. foreign exchange rate-interest rate correlation) used. In general, the range of same-asset correlations will be narrower than the range of cross-asset correlations.

Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, group trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

Credit spread

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

Notes on the Financial Statements (continued)

Inter-relationships between key unobservable inputs

Key unobservable inputs to Level 3 financial instruments may not be independent of each other. As described above, market variables may be correlated. This correlation typically reflects the manner in which different markets tend to react to macro-economic or other events. For example, improving economic conditions may lead to a 'risk on' market, in which prices of risky assets such as equities and high yield bonds will rise, while 'safe haven' assets such as gold decline. Furthermore, the impact of changing market variables upon the group portfolio will depend upon the group's net risk position in respect of each variable. For example, increasing high-yield bond prices will benefit long high-yield bond positions, but the value of any credit derivative protection held against those bonds will fall.

14 Fair values of financial instruments not carried at fair value

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2.

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

	At 31 December 2013					At 31 December 2012	
		Fair value					
		Valuation techniques					
	Carrying amount US$000	**Quoted market price Level 1 US$000**	**Using observable inputs Level 2 US$000**	**With significant unobservable inputs Level 3 US$000**	**Total US$000**	Carrying amount US$000	Fair value US$000
Assets and liabilities not held for sale							
Assets							
Loans and advances to banks	**7,616,777**	**–**	**7,626,394**	**–**	**7,626,394**	9,537,777	9,543,668
Loans and advances to customers	**23,629,718**	**–**	**–**	**23,650,833**	**23,650,833**	24,015,266	24,034,974
Liabilities							
Deposits by banks	**1,379,473**	**–**	**1,387,371**	**–**	**1,387,371**	1,803,014	1,816,433
Customer accounts	**31,315,682**	**–**	**31,391,798**	**–**	**31,391,798**	32,038,176	32,036,993
Debt securities in issue	**3,206,249**	**–**	**3,182,000**	**–**	**3,182,000**	4,876,509	4,781,786

Fair values are determined according to the hierarchy set out in Note 13.

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

Assets

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

Liabilities

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

Valuation

The fair value measurement is the group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected

Notes on the Financial Statements (continued)

future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available.

Fair values of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

Loans and advances to banks and customers

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

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

Valuation techniques are calibrated on a regular basis and tested for validity using prices from observable current market transactions in the same instrument, without modification or repackaging, or are based on any available observable market data.

The fair value of a loan reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans, and the fair value impact of repricing between origination and the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

Deposits by banks and customer accounts

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

Debt securities in issue

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

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

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15 Derivatives

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

	Assets			Liabilities		
At 31 December 2013	**Trading US$000**	**Hedging US$000**	**Total US$000**	**Trading US$000**	**Hedging US$000**	**Total US$000**
Foreign exchange	**372,196**	**16,463**	**388,659**	**392,688**	**–**	**392,688**
Interest rate	**561,078**	**9,834**	**570,912**	**566,815**	**–**	**566,815**
Equity	**3,465**	**–**	**3,465**	**3,465**	**–**	**3,465**
Credit	**167,869**	**–**	**167,869**	**165,425**	**–**	**165,425**
Commodity and other	**4,447**	**–**	**4,447**	**4,443**	**–**	**4,443**
Gross total fair values	**1,109,055**	**26,297**	**1,135,352**	**1,132,836**	**–**	**1,132,836**
Netting			**–**			**–**
Total			**1,135,352**			**1,132,836**

	Assets			Liabilities		
At 31 December 2012	Trading US$000	Hedging US$000	Total US$000	Trading US$000	Hedging US$000	Total US$000
Foreign exchange	361,139	7,421	368,560	354,865	–	354,865
Interest rate	901,802	13,925	915,727	910,395	–	910,395
Equity	2,819	–	2,819	2,819	–	2,819
Credit	147,371	–	147,371	148,755	–	148,755
Commodity and other	1,765	–	1,765	1,802	–	1,802
Gross total fair values	1,414,896	21,346	1,436,242	1,418,636	–	1,418,636
Netting			–			–
Total			1,436,242			1,418,636

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

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. A description of how the fair value of derivatives is derived is set out in Note 13. Derivative assets and liabilities on different transactions are only set off (netted) if the transactions are with the same counterparty, a legal right of set off exists and the cash flows are intended to be settled on a net basis.

Use of derivatives

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

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

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin and for the risk management of exposure arising from customer activities.

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

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

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

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

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

	2013	2012
	US$000	US$000
Foreign exchange	**42,587,684**	44,593,864
Interest rate	**43,499,966**	44,481,066
Equity	**228,516**	310,948
Credit	**7,230,351**	6,001,504
Commodity and other	**57,061**	115,393
	93,603,578	95,502,775

Credit derivatives

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

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

Derivatives valued using models with unobservable inputs

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

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Unamortised balance of derivatives valued using models with unobservable inputs

	2013 US$000	2012 US$000
Unamortised balance at 1 January	–	2,298
Deferral on new transactions	**1,136**	183
Recognised in the income statement during the period:		
- subsequent to unobservable inputs becoming observable	**(346)**	(629)
- maturity or termination, or offsetting derivatives	**–**	(183)
Risk hedged	**(790)**	(1,669)
Unamortised balance at 31 December	**–**	–

Hedge accounting derivatives

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, cash flow hedges, or hedges in net investment of foreign operations. These are described under the relevant headings below. As at 31 December 2013 and 31 December 2012 the group did not hold any derivatives for hedging purposes under fair value hedging relationships.

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

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

	At 31 December 2013 Cash flow hedge US$000	At 31 December 2012 Cash flow hedge US$000
Foreign exchange	**361,266**	353,664
Interest rate	**499,952**	499,939
	861,218	853,603

Cash flow hedges

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

Fair value of derivatives designated as cash flow hedges

	At 31 December 2013		At 31 December 2012	
	Assets US$000	Liabilities US$000	Assets US$000	Liabilities US$000
Foreign exchange	**16,463**	**–**	7,421	–
Interest rate	**9,834**	**–**	13,925	–
	26,297	**–**	21,346	–

Notes on the Financial Statements (continued)

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

	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
At 31 December 2013				
Assets	**861,218**	**861,218**	**861,218**	**–**
Liabilities	**–**	**–**	**–**	**–**
Net cash inflow exposure	**861,218**	**861,218**	**861,218**	**–**
At 31 December 2012				
Assets	853,603	853,603	853,603	–
Liabilities	–	–	–	–
Net cash inflow exposure	853,603	853,603	853,603	–

This table reflects the interest rate re-pricing profile of the underlying hedged items.

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the years ended 31 December 2013 and 31 December 2012, no gains or losses were recognised due to hedge ineffectiveness.

16 Financial investments

	2013 US$000	2012 US$000
Financial investments:		
- not subject to repledge or resale by counterparties	**11,267,242**	11,206,230

Carrying amount and fair value of financial investments

	At 31 December 2013		At 31 December 2012	
	Carrying amount US$000	Fair value US$000	Carrying amount US$000	Fair value US$000
Treasury and other eligible bills				
- available for sale	**1,612,736**	**1,612,736**	1,658,007	1,658,007
Debt securities				
- available for sale	**9,435,527**	**9,435,527**	9,354,781	9,354,781
Equity securities				
- available-for-sale	**218,979**	**218,979**	193,442	193,442
Total financial investments	**11,267,242**	**11,267,242**	11,206,230	11,206,230

Notes on the Financial Statements (continued)

17 Interests in associates

Associates

Associates of the group

	At 31 December 2013			
	Country of incorporation	Principal activity	The group's interest in equity capital	Issued equity capital
Arabian Real Estate Investment Trust Management Limited	Cayman Islands	Real Estate	42.23%	US$4.4 million fully 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$0.99 million fully paid
MENA Holdings Limited	Cayman Islands	Petrochemical by-product	33.33%	US$ 5.4 million fully paid
Rewards Management Middle East Free Zone Limited Liability Company	Dubai, UAE	Multi-participant loyalty programmes	40.00%	AED 0.5 million

None of the above associates are considered significant to the group.

The group's share of associates' contingent liabilities amounted to US$ nil at 31 December 2013 (2012: nil).

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.

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

MENA Holdings Limited operates in Cayman Islands.

HSBC Middle East Leasing Partnership is treated as an associate reflecting the significant influence over the company established as a result of representation on the Board of Directors.

Summarised financial information in respect of associates not individually significant

	2013 US$000	2012 US$000
Carrying value		
The group's share of:		
- assets	**52,100**	45,157
- liabilities	**21,458**	14,525
- profit or loss from continuing operations	**559**	(3,866)
- total comprehensive income	**559**	(3,866)

Movement in investment in associates

	2013 US$000	2012 US$000
At 1 January	**30,632**	35,189
Share of results	**559**	(3,866)
Dividends	**(547)**	(691)
Other movements and foreign exchange	**(2)**	-
At 31 December	**30,642**	30,632

Notes on the Financial Statements (continued)

18 Intangible assets

Movement of intangible assets

	Internally generated software US$000	Purchased software US$000	Customer relationship US$000	Core deposit Intangibles US$000	Preferential lease intangibles US$000	Total US$000
Cost						
At 1 January 2013	**33,588**	**15,471**	**13,153**	**43,342**	**1,447**	**107,001**
Additions[1]	**2,299**	**2,139**	**–**	**–**	**–**	**4,438**
Disposals	**(2,307)**	**(97)**	**–**	**–**	**–**	**(2,404)**
Amounts written off	**(229)**	**–**	**–**	**–**	**–**	**(229)**
Other changes	**–**	**(1,205)**	**(1)**	**1**	**–**	**(1,205)**
At 31 December 2013	**33,351**	**16,308**	**13,152**	**43,343**	**1,447**	**107,601**
Accumulated amortisation						
At 1 January 2013	**(25,571)**	**(11,747)**	**(885)**	**(2,944)**	**(30)**	**(41,177)**
Charge for the year[2]	**(3,073)**	**(1,349)**	**(1,878)**	**(6,184)**	**(181)**	**(12,665)**
Impairment[2]	**(169)**	**–**	**–**	**–**	**–**	**(169)**
Disposals	**2,304**	**–**	**–**	**–**	**–**	**2,304**
Amounts written off	**229**	**–**	**–**	**–**	**–**	**229**
Other changes	**169**	**(8)**	**–**	**–**	**–**	**161**
At 31 December 2013	**(26,111)**	**(13,104)**	**(2,763)**	**(9,128)**	**(211)**	**(51,317)**
Net carrying amount at 31 December 2013	**7,240**	**3,204**	**10,389**	**34,215**	**1,236**	**56,284**
Cost						
At 1 January 2012	31,417	12,889	–	–	–	44,306
Additions[1]	4,022	2,133	–	–	–	6,155
Acquisition of subsidiaries and businesses	–	–	13,154	43,346	1,447	57,947
Disposals	(994)	(115)	–	–	–	(1,109)
Exchange differences	–	(2)	(1)	(4)	–	(7)
Other changes	(857)	566	–	–	–	(291)
At 31 December 2012	33,588	15,471	13,153	43,342	1,447	107,001
Accumulated amortisation				–		
At 1 January 2012	(21,506)	(10,425)	–	–	–	(31,931)
Charge for the year[2]	(4,481)	(1,374)	(885)	(2,944)	(30)	(9,714)
Impairment[2]	(750)	–	–	–	–	(750)
Disposals	416	–	–	–	–	416
Other changes	750	52	–	–	–	802
At 31 December 2012	(25,571)	(11,747)	(885)	(2,944)	(30)	(41,177)
Net carrying amount at 31 December 2012	8,017	3,724	12,268	40,398	1,417	65,824

1 *At 31 December 2013, the group did not have any contractual commitments to acquire intangible assets (2012: nil).*
2 *The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.*

Notes on the Financial Statements (continued)

19 Property, plant and equipment

	Freehold and leasehold land and buildings US$000	Equipment, fixtures and fittings US$000	Total US$000
Cost or fair value			
At 1 January 2013	**200,860**	**135,534**	**336,394**
Additions at cost	**8,477**	**9,904**	**18,381**
Acquisition of subsidiaries and businesses	**–**	**–**	**–**
Disposals	**(1,778)**	**(4,837)**	**(6,615)**
Other changes	**(15,181)**	**(6,346)**	**(21,527)**
Reclassified as held for sale	**(7,722)**	**(8,738)**	**(16,460)**
At 31 December 2013	**184,656**	**125,517**	**310,173**
Accumulated depreciation and impairment			
At 1 January 2013	**(70,443)**	**(99,783)**	**(170,226)**
Depreciation and impairment	**(10,132)**	**(16,568)**	**(26,700)**
Disposals	**1,371**	**2,787**	**4,158**
Other changes	**20,273**	**5,337**	**25,610**
Reclassified as held for sale	**2,405**	**7,628**	**10,033**
At 31 December 2013	**(56,526)**	**(100,599)**	**(157,125)**
Net carrying amount at 31 December 2013	**128,130**	**24,918**	**153,048**
Cost or fair value			
At 1 January 2012	120,231	128,041	248,272
Additions at cost	19,651	11,142	30,793
Acquisition of subsidiaries and businesses	64,508	18,284	82,792
Disposals	(3,345)	(14,876)	(18,221)
Other changes	(185)	(877)	(1,062)
Reclassified as held for sale	–	(6,180)	(6,180)
At 31 December 2012	200,860	135,534	336,394
Accumulated depreciation and impairment			
At 1 January 2012	(43,717)	(99,552)	(143,269)
Depreciation and impairment	(20,035)	(12,192)	(32,227)
Disposals	1,395	6,959	8,354
Other changes	(8,086)	226	(7,860)
Reclassified as held for sale	–	4,776	4,776
At 31 December 2012	(70,443)	(99,783)	(170,226)
Net carrying amount at 31 December 2012	130,417	35,751	166,168

Notes on the Financial Statements (continued)

20 Investments in subsidiaries

Subsidiary undertakings of the bank

	Country of incorporation or registration	Bank's interest in equity capital
		%
HSBC Bank Oman S.A.O.G.	Oman	51%
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%
HSBC Insurance Services (Lebanon) S.A.L.	Lebanon	100%

All the above prepare their financial statements up to 31 December.

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

The countries of operation are the same as the countries of incorporation.

HSBC Bank Oman S.A.O.G. is listed on the Muscat Securities Market. The remaining subsidiary undertakings are unlisted.

In order to comply with local legal requirements, the ownership of the investment in HSBC Middle East Securities LLC is held 49.00% in the name of the bank and 51.00% in the personal name of Mr Abdul Wahid Al Ulama, as nominee. Under a Memorandum of Understanding, the nominee has transferred his legal and/or beneficial interest in HSBC Middle East Securities LLC to the bank. The total book value of the assets of HSBC Middle East Securities LLC amount to US$3.2 million (2012: US$3.9 million).

On 9 December 2013, HSBC Insurance Services (Lebanon) SAL, a wholly owned subsidiary of the bank went into formal liquidation.

Structured entities consolidated by the group are discussed as part of the structured entities note (Note 36).

	2013	2012
HSBC Bank Oman S.A.O.G.		
Proportion of ownership interests and voting rights held by non-controlling interests	**49%**	49%
Place of business	**Oman**	Oman
	US$000	US$000
Profit attributable to non-controlling interests	**13,519**	4,738
Dividends paid to non-controlling interests	**2,545**	–
Summarised financial information		
- assets	**5,810,336**	6,319,268
- liabilities	**4,993,861**	5,529,599
- operating income	**178,527**	119,411
- profit after tax	**27,591**	12,509
- total comprehensive income	**36,357**	15,033

2012 acquisition of Oman International Bank S.A.O.G.

On 3 June 2012, the group merged the operations of HSBC Bank Middle East Limited Oman branch with Oman International Bank ('OIB'), an Omani joint stock company listed on the Muscat Securities Market and operating as a commercial bank in the Sultanate of Oman. Following the merger, the group acquired 51% of the combined entity for a total consideration of US$201.2 million.

Negative goodwill of US$3.2 million arose in 2012 from this acquisition.

The group elected to measure the non-controlling interest in the acquiree at the present ownership instruments' proportionate share in the recognised amounts of the fair value of the acquiree's identifiable net assets.

Notes on the Financial Statements (continued)

The following table summarises the consideration transferred to acquire OIB:

	Acquisition date US$000
Consideration	
Net assets of HSBC Bank Middle East Limited – Oman branch	201,249
Total consideration transferred	201,249

The consideration transferred is 49% of the fair value of HBME Oman branch. Effectively, 49% of the branch is disposed to non-controlling interests at fair value in exchange for shares in OIB. This gain arose from a transaction with owners in the capacity of owners and is recognised directly into equity.

The fair values of identifiable assets acquired and the liabilities assumed as at the acquisition date were as follows:

	Fair value recognised on acquisition US$000	Carrying value immediately prior to acquisition US$000
Assets		
Cash and balances at central banks	281,413	281,413
Derivatives	5,060	5,060
Loans and advances to banks	452,441	452,441
Loans and advances to customers	1,780,178	1,825,816
Financial investments	451,888	451,888
Other assets	313,270	313,566
Prepayments and accrued income	2,909	2,909
Intangible assets – core deposit intangible	31,964	-
Intangible assets – customer relationships	9,587	-
Property, plant and equipment	81,572	96,203
Deferred tax assets	10,047	2,468
Liabilities		
Deposits by banks	(55,275)	(55,275)
Customer accounts	(2,634,945)	(2,637,803)
Items in the course of transmission to other banks	(11,738)	(11,738)
Derivatives	(6,084)	(629)
Other liabilities	(301,504)	(301,504)
Current tax liabilities	(1,462)	(1,462)
Accruals and deferred income	(11,501)	(11,501)
Total identifiable net assets	397,820	
Non-controlling interest	(193,357)	
Negative goodwill arising on acquisition	(3,214)	
Total consideration transferred	201,249	

On the acquisition date, the fair value of the loans and advances to customers amounts to US$1,780 million. The gross amount of loans and advances to customers is US$2,061 million, of which US$235 million is expected to be uncollectable.

Transaction costs of US$3.3 million were expensed in 2012 and are included in general and administrative expenses.

Estimated total operating income and loss before tax from date of acquisition to 31 December 2012 included in the consolidated income statement are US$50 million and US$10 million respectively.

2012 acquisition of the onshore UAE retail and commercial banking business of Lloyds Banking Group in the United Arab Emirates

On 25 October 2012, HSBC Bank Middle East Limited (‘HBME’) acquired the onshore retail and commercial banking business of Lloyds Banking Group in the United Arab Emirates.

Negative goodwill of US$17.6 million arose in 2012 from this acquisition.

Notes on the Financial Statements (continued)

The following table summarises the consideration transferred to acquire the onshore retail and commercial banking business of Lloyds Banking Group:

	Acquisition date US$000
Consideration	
Cash	148,557
Total consideration transferred	148,557

The fair values of identifiable assets acquired and the liabilities assumed as at the acquisition date were as follows:

	Fair value recognised on acquisition US$000	Carrying value immediately prior to acquisition US$000
Assets		
Cash and balances at central banks	353,555	353,555
Derivatives		
Loans and advances to banks	18,101	18,101
Loans and advances to customers	412,703	408,070
Financial investments	33,356	33,356
Other assets	20,214	20,214
Prepayments and accrued income	2,330	2,330
Intangible assets – core deposit intangible	11,382	-
Intangible assets – customer relationships	3,567	-
Intangible assets – preferential lease	1,447	-
Property, plant and equipment	1,220	1,220
Liabilities		
Deposits by banks	(3,566)	(3,566)
Customer accounts	(663,961)	(663,961)
Items in the course of transmission to other banks		
Derivatives	(45)	(45)
Other liabilities	(21,652)	(21,652)
Deferred tax liabilities	(927)	-
Accruals and deferred income	(1,565)	(1,565)
Total identifiable net assets	166,159	
Negative goodwill arising on acquisition	(17,602)	
Total consideration transferred	148,557	

On the acquisition date, the fair value of the loans and advances to customers amounts to US$413 million. The gross amount of loans and advances to customers is US$459 million, of which US$51 million is expected to be uncollectable.

Transaction costs of US$1.0 million were expensed in 2012 and are included in general and administrative expenses.

Estimated total operating income and profit before tax from date of acquisition to 31 December 2012 included in the consolidated income statement are US$7 million and US$5 million respectively.

21 Assets held for sale and other assets

Assets held for sale

	2013 US$000	2012 US$000
Disposal group	**901,032**	541,736
Total assets held for sale	**901,032**	541,736

Notes on the Financial Statements (continued)

Disposal group

At 31 December 2013, the disposal group related to the group's sale of its banking operations in Jordan. The transaction is expected to be completed in 2014. Associated liabilities of US$1,005 million are included in 'Liabilities of disposal groups held for sale'.

At 31 December 2012, the disposal group related to the disposal of the Pakistan operations. The transaction was expected to be completed in the first half of 2013. However due to State Bank of Pakistan regulatory approval not having been received the disposal of the Pakistan operations was removed from the disposal group in 2013.

Other assets

	2013	2012
	US$000	US$000
Endorsements and acceptances	**1,041,222**	1,307,717
Other accounts	**92,000**	164,644
	1,133,222	1,472,361

22 Trading liabilities

	2013	2012
	US$000	US$000
Deposits by banks	**5,158**	10,833
Customer accounts	**541**	649
Debt securities in issue	**1,165,892**	1,011,551
Other liabilities – net short positions	**63,409**	67,929
	1,235,000	1,090,962

23 Financial liabilities designated at fair value

	2013	2012
	US$000	US$000
Debt securities in issue	**503,448**	508,989

At 31 December 2013, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of US$2.0 million (2012: US$1.7 million gain).

24 Debt securities in issue

	2013		2012	
	Carrying amount	**Fair value**	Carrying amount	Fair value
	US$000	**US$000**	US$000	US$000
Medium term notes	**3,925,589**	**3,925,925**	5,347,049	5,351,345
Non-equity preference shares	**950,000**	**925,415**	1,050,000	950,981
	4,875,589	**4,851,340**	6,397,049	6,302,326
Of which debt securities in issue reported as				
- trading liabilities (see Note 22)	**(1,165,892)**	**(1,165,892)**	(1,011,551)	(1,011,551)
- financial liabilities designated at fair value (see Note 23)	**(503,448)**	**(503,448)**	(508,989)	(508,989)
	3,206,249	**3,182,000**	4,876,509	4,781,786

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

Notes on the Financial Statements (continued)

Non-equity preference share capital

Authorised

The authorised non-equity preference share capital of the bank at 31 December 2013 was 1,350,000 (2012: 1,350,000) cumulative redeemable preference shares of US$1.00 each and 1,150,000 (2012: 1,150,000) non-cumulative redeemable preference shares of US$1.00 each.

Issued

Perpetual cumulative redeemable preference shares

Issue number	Issue Date	Perpetual cumulative redeemable preference shares	Cumulative redeemable preference dividends	Redeemable at the option of the bank on any date after
		Number	%	Date
1	29 October 1997	50,000	12 month US dollar LIBOR + 0.35	31 October 2002
2	01 April 1998	25,000	12 month US dollar LIBOR + 0.70	02 April 2003
6	14 March 2006	150,000	12 month US dollar LIBOR + 0.65	15 March 2011

1 *The perpetual cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*

2 *Cumulative redeemable preference dividends are payable annually on the issue price of each perpetual share.*

3 *The perpetual cumulative redeemable preference shares bear no mandatory redemption date. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*

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

5 *In the event of a winding up, the 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*

Dated cumulative redeemable preference shares:

Issue number	Issue date	Dated cumulative redeemable preference shares	Cumulative redeemable preference dividends	Redeemable at the option of the bank on any date after	Earliest redemption date (other than at the bank's option)
		Number	%	Date	Date
8	28 April 2008	200,000	12 month US dollar LIBOR + 2.34	28 April 2013	28 April 2018
9	31 July 2008	300,000	6.70 fixed rate	31 July 2013	31 July 2018

On 20 June 2013 the bank redeemed one tranche of 100,000 cumulative redeemable preference shares of US$1.00 each (the "Seventh Issue") issued at a premium of US$999.00 per share.

1 *The dated cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*

2 *Cumulative redeemable preference dividends are payable annually on the issue price of each dated share.*

3 *Redemption of the dated cumulative redeemable preference shares, other than at the option of the bank, will be subject to the approval of the ordinary shareholders of the bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the Bank without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*

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

5 *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)

Dated non-cumulative redeemable preference shares:

Issue number	Issue date	Dated cumulative redeemable preference shares	Cumulative redeemable preference dividends	Redeemable at the option of the bank on any date after	Earliest redemption date (other than at the bank's option)
		Number	%	Date	Date
10	30 December 2009	225,000	12 month US dollar LIBOR + 6.80	30 December 2014	30 December 2019

1 *The dated non-cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*

2 *Non-cumulative redeemable preference dividends are payable annually on the issue price of each dated share.*

3 *Redemption of the dated cumulative redeemable preference shares, other than at the option of the bank, will be subject to the approval of the ordinary shareholders of the bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the bank without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*

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

5 *As regards dividends and on a winding up of the company as regards capital, the non-cumulative preference shares shall rank after the undated and dated cumulative preference shares already in issue and ahead of the ordinary shares.*

25 Liabilities of disposal groups held for sale and other liabilities

	2013 US$000	2012 US$000
Liabilities of disposal group held for sale (refer to Note 21)	**1,004,983**	457,400
	1,004,983	457,400

Other liabilities	2013 US$000	2012 US$000
Share based payments liability to HSBC Holdings plc	**34,711**	35,018
Endorsements and acceptances	**1,041,222**	1,307,718
Other liabilities	**857,897**	918,604
Obligations under finance leases	**2,678**	-
	1,936,508	2,261,340

26 Provisions

	2013 US$000	2012 US$000
At 1 January	**42,893**	19,877
Additional provisions/increase in provisions	**29,764**	31,799
Provisions utilised	**(12,069)**	(13,737)
Amounts reversed	**(8,477)**	(1,990)
Exchange differences and other movements	**11,897**	6,944
At 31 December	**64,008**	42,893

Provisions include US$8.1 million (2012: US$8.2 million) relating to legal proceedings, investigations and regulatory matters, US$1.0 million (2012: US$0.7 million) relating to costs arising from contingent liabilities and contractual commitments, US$22.1 million (2012: US$11.8 million) relating to restructuring provisions; and US$25.6m (2012: US$Nil) relating to customer remediation provisions.

Notes on the Financial Statements (continued)

27 Maturity analysis of assets and liabilities

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

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

Maturity analysis of assets and liabilities

	At 31 December 2013			At 31 December 2012		
	Due within one year	**Due after more than one year**	**Total**	Due within one year	Due after more than one year	Total
	US$000	**US$000**	**US$000**	US$000	US$000	US$000
Assets						
Loans and advances to banks	**7,211,139**	**405,638**	**7,616,777**	9,104,128	433,649	9,537,777
Loans and advances to customers	**13,596,210**	**10,033,508**	**23,629,718**	16,600,731	7,414,535	24,015,266
Financial investments	**10,115,640**	**1,151,602**	**11,267,242**	9,827,606	1,378,624	11,206,230
Other financial assets	**1,127,870**	**4,163**	**1,132,033**	1,383,252	85,365	1,468,617
	32,050,859	**11,594,911**	**43,645,770**	36,915,717	9,312,173	46,227,890
Liabilities						
Deposits by banks	**1,379,346**	**127**	**1,379,473**	1,803,014	–	1,803,014
Customer accounts	**31,240,928**	**74,754**	**31,315,682**	31,887,117	151,059	32,038,176
Financial liabilities designated at fair value	**–**	**503,448**	**503,448**	–	508,989	508,989
Debt securities in issue	**310,846**	**2,895,403**	**3,206,249**	1,587,376	3,289,133	4,876,509
Other financial liabilities	**1,842,700**	**56,396**	**1,899,096**	2,174,218	46,067	2,220,285
	34,773,820	**3,530,128**	**38,303,948**	37,451,725	3,995,248	41,446,973

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

	On demand	**Due within 3 months**	**Due between 3 and 12 months**	**Due between 1 and 5 years**	**Due after 5 years**
	US$000	**US$000**	**US$000**	**US$000**	**US$000**
At 31 December 2013					
Deposits by banks	**872,552**	**476,082**	**31,110**	**128**	**–**
Customer accounts	**26,051,938**	**3,758,748**	**1,440,809**	**75,168**	**925**
Trading liabilities	**1,235,000**	**–**	**–**	**–**	**–**
Financial liabilities designated at fair value	**–**	**–**	**–**	**503,448**	**–**
Derivatives	**1,132,617**	**–**	**219**	**–**	**–**
Debt securities in issue	**225,000**	**232,324**	**85,966**	**2,470,813**	**225,000**
Other financial liabilities	**1,059,607**	**1,274,978**	**188,683**	**7,099**	**–**
	30,576,714	**5,742,132**	**1,746,787**	**3,056,656**	**225,925**
Loan and other credit-related commitments	**2,997,190**	**6,272,507**	**8,245,653**	**1,633,333**	**316,416**
Financial guarantees and similar contracts	**1,068,945**	**1,497,138**	**1,730,730**	**1,974,637**	**21**
	34,642,849	**13,511,777**	**11,723,170**	**6,664,626**	**542,362**
At 31 December 2012					
Deposits by banks	864,925	945,772	10,022	115	–
Customer accounts	24,832,957	4,875,625	2,193,296	165,268	–
Trading liabilities	1,090,962	–	–	–	–
Financial liabilities designated at fair value	–	–	17,253	525,728	–
Derivatives	1,418,636	–	2,034	–	–
Debt securities in issue	325,000	64,821	2,099,397	2,574,842	–
Other financial liabilities	293,486	1,564,409	174,801	1,324	–
	28,825,966	7,450,627	4,496,803	3,267,277	–
Loan and other credit-related commitments	3,792,524	3,809,351	7,968,537	4,109,924	326,643
Financial guarantees and similar contracts	1,533,669	1,700,724	1,813,450	3,634,451	16,083
	34,152,159	12,960,702	14,278,790	11,011,652	342,726

Notes on the Financial Statements (continued)

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

Further discussion of the group's liquidity and funding management can be found in Note 33 'Risk management'.

28 Offsetting of financial assets and financial liabilities

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

				Amounts not set off in the balance sheet		
	Gross amounts of recognised financial assets US$000	Gross amounts offset in the balance sheet US$000	Amounts presented in the balance sheet US$000	Financial instruments US$000	Cash collateral received US$000	Net amount US$000
At 31 December 2013						
Derivatives (note 15)	**1,135,352**	**–**	**1,135,352**	**–**	**–**	**1,135,352**
Reverse repurchase, securities borrowing and similar agreements	**24,455**	**–**	**24,455**	**–**	**–**	**24,455**
Classified as:						
- loans and advances to banks at amortised cost	**24,455**	–	**24,455**	–	–	**24,455**
Loans and advances to customers excluding reverse repos at amortised cost	**1,150,844**	**–**	**1,150,844**	**–**	**(316,954)**	**833,890**
	2,310,651	**–**	**2,310,651**	**–**	**(316,954)**	**1,993,697**
At 31 December 2012						
Derivatives (note 15)	1,436,242	–	1,436,242	–	–	1,436,242
Reverse repurchase, securities borrowing and similar agreements	499,897	–	499,897	–	–	499,897
Classified as:						
- loans and advances to banks at amortised cost	499,897	–	499,897	–	–	499,897
Loans and advances to customers excluding reverse repos at amortised cost	1,459,234	–	1,459,234	–	(449,772)	1,009,462
	3,395,373	–	3,395,373	–	(449,772)	2,945,601

Notes on the Financial Statements (continued)

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

	Gross amounts of recognised financial liabilities US$000	Gross amounts offset in the balance sheet US$000	Amounts presented in the balance sheet US$000	Amounts not set off in the balance sheet: Financial instruments US$000	Amounts not set off in the balance sheet: Cash collateral pledged US$000	Net amount US$000
At 31 December 2013						
Derivatives (note 15)	**1,132,836**	**–**	**1,132,836**	**–**	**–**	**1,132,836**
At 31 December 2012						
Derivatives (note 15)	1,418,636	–	1,418,636	–	–	1,418,636

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

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

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

29 Foreign exchange exposures

Structural foreign exchange exposures:

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

The group's management of structural foreign currency exposures is discussed in Note 33 'Risk management'.

Notes on the Financial Statements (continued)

Net structural foreign currency exposures

Currency of structural exposure

	2013 US$000	2012 US$000
Algerian dinar	**245,136**	210,262
Bahraini dinar	**219,644**	189,123
Jordanian dinar	**75,161**	164,594
Kuwaiti dinar	**151,376**	128,199
Lebanese pound	**82,120**	84,567
Omani riyal	**416,384**	403,475
Pakistani rupee	**5,460**	20,619
Qatari riyal	**623,893**	599,011
UAE dirham	**3,073,721**	2,811,813
Total	**4,892,895**	4,611,663

30 Assets charged as security for liabilities and collateral accepted as security for assets

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is US$Nil (2012: US$600 million). The fair value of any such collateral that have been sold or repledged is US$Nil (2012: US$Nil). The group is obliged to return these assets.

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

31 Called up share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2013 was 1,500,000,000 (2012: 1,500,000,000) ordinary shares[1] of US$1.00 each.

Issued and fully paid

	Number	US$000
At 1 January 2013 and 31 December 2013	**931,055,000**	**931,055**
At 1 January 2012 and 31 December 2012	931,055,000	931,055

[1] *All ordinary shares in issue confer identical rights in respect of capital, dividends and otherwise.*

Notes on the Financial Statements (continued)

32 Notes on the cash flow statement

Non-cash items included in profit before tax

	2013 US$000	2012 US$000
Depreciation, amortisation and impairment	**39,534**	42,691
Share-based payment expense	**18,766**	30,770
Loan impairment (releases)/losses gross of recoveries	**(36,230)**	291,661
Provisions	**21,287**	18,010
Impairment of financial investments	**247**	1,119
Charge for defined benefit plans	**16,679**	13,355
Accretion of discounts and amortisation of premiums	**696**	(4,306)
	60,979	393,300

Change in operating assets

	2013 US$000	2012 US$000
Change in prepayments and accrued income	**59,091**	(18,662)
Change in net trading securities and net derivatives	**224,367**	609,938
Change in loans and advances to banks	**(103,146)**	(2,137,817)
Change in loans and advances to customers	**404,308**	(2,803,153)
Change in other assets	**(20,157)**	(322,618)
	564,463	(4,672,312)

Change in operating liabilities

	2013 US$000	2012 US$000
Change in accruals and deferred income	**(15,767)**	(25,221)
Change in deposits by banks	**(423,541)**	(277,178)
Change in customer accounts	**(722,494)**	3,211,844
Change in debt securities in issue	**(1,570,260)**	578,346
Change in financial liabilities designated at fair value	**(5,541)**	1,159
Change in other liabilities	**210,682**	482,501
	(2,526,921)	3,971,451

Cash and cash equivalents

	2013 US$000	2012 US$000
Cash and balances at central banks	**1,573,701**	892,603
Items in the course of collection from other banks	**67,483**	116,083
Loans and advances to banks of one month or less	**4,831,240**	6,856,380
Treasury bills, other bills and certificates of deposit less than three months	**1,977,457**	1,864,961
Less: items in the course of transmission to other banks	**(561,153)**	(569,835)
Total cash and cash equivalents	**7,888,728**	9,160,192

Total interest paid by the group during the year was US$253 million (2012: US$266 million). Total interest received by the group during the year was US$1,438 million (2012: US$1,393 million). Total dividends received by the group during the year were US$9 million (2012: US$15 million).

Notes on the Financial Statements (continued)

33 Risk management

All the group’s activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks. The most important categories of risk that the group is exposed to are credit risk (including cross-border country risk), market risk, operational risks in various forms, liquidity risk, pension risk, residual value risk, reputational risk, legal risk and sustainability (environmental and social) risks. Market risk includes foreign exchange, interest rate and equity price risks.

Risk governance and ownership

An established risk governance and ownership structure ensures oversight of, and accountability for, the effective management of risk at group, regional, country and global business level. The risk management framework fosters the continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. Integral to the group’s risk management framework are risk appetite, stress testing and identification, assessment and management of top current and emerging risks.

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

In its oversight and stewardship of risk management at group level, RMC is supported by a dedicated Risk function headed by the Chief Risk Officer (‘CRO’), who is a member of RMC and reports to the Chief Executive Officer and to the Global CRO.

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

During the period, the group continued to implement the operating model for the global risk function. The model integrates Compliance (both Financial Crime Compliance and Regulatory Compliance) within Global Risk with established risk roles for GBM, CMB and RBWM in alignment with the global businesses, and broadens the responsibility of Security and Fraud Risk. The model is designed to enable the end-to-end management of risk in a consistent manner.

Risk culture

It is the responsibility of all staff to identify, assess and manage risk within the scope of their assigned responsibilities. HSBC global standards are central to the group’s approach of balancing risk and reward. Personal accountability is reinforced by the group’s values, with staff expected to be:

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

Risk appetite

Risk appetite, which is a key component of the group's risk management framework, is approved by the Board, and describes the types and levels of risk that the group is prepared to accept in executing the group’s strategy. The group's risk appetite is set out in the group’s Risk Appetite Statement and is central to the annual operating planning process. Global businesses, as well as regions and countries, are required to articulate and embed their risk appetite statements which are aligned with the group strategy, providing a risk profile for each global business, region and country.

Notes on the Financial Statements (continued)

Quantitative and qualitative metrics are assigned to six key categories: earnings, capital, liquidity and funding, impairments provisions and expected losses, risk categories and diversification, and balance sheet. Measurement against the metrics serves to:

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

Credit risk

Credit risk management:

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

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

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

Within the group, the Credit Risk function is headed by the Chief Risk Officer and reports to the Chief Executive Officer, with a functional reporting line to the HSBC Group Chief Risk Officer. Its responsibilities include:

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

Notes on the Financial Statements (continued)

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

Credit quality

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

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

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

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

Impairment Assessment

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

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

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

Write-off of loans and advances

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

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

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

Cross-border exposures

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

- performing, trade-related and of less than one year's maturity;
- mitigated by acceptable security cover which is, other than in exceptional cases, held outside the country concerned;
- in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily; and

Notes on the Financial Statements (continued)

- performing facilities with a principal (excluding security) of US$1 million or below and/or with maturity dates shorter than three months.

Credit exposure

Maximum exposure to credit risk

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

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

Maximum exposure to credit risk

	At 31 December 2013			At 31 December 2012		
	Maximum exposure	**Offset**	**Exposure to credit risk (net)**	Maximum exposure	Offset	Exposure to credit risk (net)
	US$000	**US$000**	**US$000**	US$000	US$000	US$000
Cash and balances at central banks	**1,573,701**	**–**	**1,573,701**	892,603	–	892,603
Items in the course of collection from other banks	**67,483**	**–**	**67,483**	116,083	–	116,083
Trading assets	**515,374**	**–**	**515,374**	580,613	–	580,613
treasury and other eligible bills	**109,046**	**–**	**109,046**	–	–	–
debt securities	**303,121**	**–**	**303,121**	463,050	–	463,050
loans and advances to banks	**87,049**	**–**	**87,049**	84,639	–	84,639
loans and advances to customers	**16,158**	**–**	**16,158**	32,924	–	32,924
Derivatives	**1,135,352**	**–**	**1,135,352**	1,436,242	–	1,436,242
Loans and advances to customers held at amortised cost	**23,629,718**	**(314,632)**	**23,315,086**	24,015,266	(415,359)	23,599,907
- personal	**5,717,292**	**(13,337)**	**5,703,955**	5,432,421	–	5,432,421
- corporate and commercial	**15,524,485**	**(300,944)**	**15,223,541**	17,615,361	(415,359)	17,200,002
- financial (non-bank institutions)	**2,387,941**	**(351)**	**2,387,590**	967,484	–	967,484
Loans and advances to banks held at amortised cost	**7,616,777**	**–**	**7,616,777**	9,537,777	–	9,537,777
Financial investments	**11,048,263**	**–**	**11,048,263**	11,012,788	–	11,012,788
Treasury and other similar bills	**1,612,736**	**–**	**1,612,736**	1,658,007	–	1,658,007
Debt securities	**9,435,527**	**–**	**9,435,527**	9,354,781	–	9,354,781
Assets held for sale – disposal groups	**901,032**	**–**	**901,032**	541,736	–	541,736
Other assets	**1,238,849**	**–**	**1,238,849**	1,636,759	–	1,636,759
Endorsements and acceptances	**1,041,222**	**–**	**1,041,222**	1,307,717	–	1,307,717
Other	**197,627**	**–**	**197,627**	329,042	–	329,042
Financial guarantees and similar contracts	**5,550,435**	**–**	**5,550,435**	8,066,141	–	8,066,141
Loan commitments and other credit-related commitments	**19,465,099**	**–**	**19,465,099**	20,006,979	–	20,006,979
	72,742,083	**(314,632)**	**72,427,451**	77,842,987	(415,359)	77,427,628

Notes on the Financial Statements (continued)

Collateral and other credit enhancements held

Loans and advances held at amortised cost

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

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

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

Personal lending – Residential mortgages by level of collateral:

	2013	2012
	US$000	US$000
Uncollateralised	**45,203**	33,557
Fully collateralised	**2,233,802**	2,105,654
- Less than 25% loan to value ('LTV')	**148,864**	125,458
- 25% to 50% LTV	**598,929**	623,039
- 51% to 75% LTV	**1,094,352**	1,000,662
- 76% to 90% LTV	**348,242**	188,610
- 91% to 100% LTV	**43,415**	167,885
Partially collateralised		
- greater than 100% LTV	**42,096**	85,293
- collateral value	**36,658**	76,189
Total residential mortgages	**2,321,101**	2,224,504

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

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

Other personal lending

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

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

Collateral held is analysed separately below for commercial real estate and for other corporate, commercial and financial (non-bank) lending. This reflects the difference in collateral held on the portfolios. In each case, the analysis includes off balance sheet loan commitments, primarily undrawn credit lines.

Notes on the Financial Statements (continued)

Commercial real estate loans and advances including loan commitments by level of collateral

	2013 US$000	2012 US$000
Rated CRR/EL 1 to 7		
Not collateralised	**86,480**	447,008
Fully collateralised	**21,225**	90,383
Partially collateralised	**138,662**	33,457
- collateral value	**24,378**	29,235
	246,367	570,848
Rated CRR/EL 8 to 10		
Not collateralised	**7,291**	14,037
Fully collateralised	**102,648**	6,822
LTV ratio:		
- Less than 25%	**–**	–
- 25% to 50% LTV	**6,823**	6,822
- 51% to 75% LTV	**79,137**	–
- 76% to 90% LTV	**16,684**	–
- 91% to 100% LTV	**4**	–
Partially collateralised	**180,847**	204,446
- collateral value	**88,614**	111,304
	290,786	225,305
Total commercial real estate loans and advances	**537,153**	796,153

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

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

Other corporate, commercial and financial (non-bank) loans and advances including loan commitments by level of collateral rated CRR/EL 8 to 10 only

	2013 US$000	2012 US$000
Rated CRR/EL 8 to 10		
Not collateralised	**1,037,015**	1,186,223
Fully collateralised	**49,723**	132,488
LTV ratio:		
- Less than 25%	**2,208**	412
- 25% to 50% LTV	**558**	6,449
- 51% to 75% LTV	**46,607**	32,875
- 76% to 90% LTV	**–**	18,178
- 91% to 100% LTV	**350**	74,574
Partially collateralised	**1,298,048**	827,663
- Collateral value	**499,966**	124,071
	2,384,786	2,146,374

Notes on the Financial Statements (continued)

Loans and advances to banks

The following table shows loans and advances to banks, including off-balance sheet loan commitments by level of collateral.

	2013
	US$000
Rated CRR/EL 1 to 8	
Not collateralised	**7,591,038**
Fully collateralised	**23,648**
Total	**7,614,686**
Rated CRR/EL 9 to 10	
Not collateralised	**312,481**
Total	**312,481**

	2012
	US$000
Rated CRR/EL 1 to 10	
Not collateralised	9,555,159
Total	9,555,159

The collateral used in the assessment of the above lending relates primarily to cash and marketable securities. Loans and advances to banks are typically unsecured. Certain products such as reverse repos are effectively collateralised and have been included in the above.

Derivatives

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

Other credit risk exposures

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

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

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

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

Collateral and other credit enhancements obtained

The group obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements, as follows:

	At 31 December	
Nature of assets	**2013**	2012
	US$000	US$000
Residential property and motor vehicles	**–**	-

Notes on the Financial Statements (continued)

Repossessed properties and motor vehicles are made available for sale in orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available they are used either for other secured lenders with lower priority or are returned to the customer. The group does not generally occupy the repossessed properties for its business use.

Concentration of exposure

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

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

- the majority of the group’s exposure to credit risk is concentrated in the Middle East. Within the Middle East, the group’s credit risk is diversified over a wide range of industrial and economic groupings; and
- the group’s position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2013 and 31 December 2012 was concentrated in the Middle East.

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

Cross-border exposures

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

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

Debt securities, treasury bills and bonds

At US$11,048 million, total financial investments excluding equity securities were 0.3% higher at 31 December 2013 than at 31 December 2012. Debt securities, at US$9,436 million, represented the largest concentration of financial investments at 85% of the total, compared with US$9,355 million (85%) at 31 December 2012. The group’s holdings of government, corporate debt, and other securities were spread across a wide range of issuers and geographical regions.

Investments in securities of governments and government agencies of US$10,956 million were 99% of overall financial investments excluding equity shares (2012 - US$10,765 million (97%)).

Derivatives

Derivatives asset exposures at 31 December 2013 were US$1,135 million, a decrease of 21% from 31 December 2012, with decreases across all interest rate and credit derivatives. Lower volatility within the financial markets, flattening yield curves in major currencies and narrowing credit spreads led to a decrease in the fair value of

Notes on the Financial Statements (continued)

outstanding derivative contracts. Derivatives exposure is shown gross under IFRSs. Derivative liabilities increased for the same reasons.

Loans and advances

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

Gross loans and advances to customers by industry sector

	Gross loans and advances to customers	
At 31 December 2013	**Total US$000**	**As a % of total gross loans %**
Personal		
Residential mortgages	**2,449,671**	**9.78%**
Other personal	**3,555,414**	**14.19%**
	6,005,085	**23.97%**
Corporate and commercial		
Commercial, industrial and international trade	**9,869,036**	**39.41%**
Commercial real estate	**533,333**	**2.13%**
Other property-related	**1,293,203**	**5.16%**
Government	**1,288,546**	**5.14%**
Other commercial	**3,622,074**	**14.46%**
	16,606,192	**66.30%**
Financial		
Non-bank financial institutions	**2,437,047**	**9.73%**
Total gross loans and advances to customers	**25,048,324**	**100.00%**
Impaired loans		
- as a percentage of gross loans and advances to customers	**7.95%**	
Total impairment allowances		
- as a percentage of gross loans and advances to customers	**5.66%**	
At 31 December 2012		
Personal		
Residential mortgages	2,142,332	8.35%
Other personal	3,609,565	14.07%
	5,751,897	22.42%
Corporate and commercial		
Commercial, industrial and international trade	10,444,654	40.72%
Commercial real estate	781,628	3.05%
Other property-related	2,063,536	8.05%
Government	1,482,153	5.78%
Other commercial	4,048,470	15.79%
	18,820,441	73.39%
Financial		
Non-bank financial institutions	1,075,142	4.19%
Total gross loans and advances to customers	25,647,480	100.00%
Impaired loans		
- as a percentage of gross loans and advances to customers	8.99%	
Total impairment allowances		
- as a percentage of gross loans and advances to customers	6.36%	

Notes on the Financial Statements (continued)

Areas of special interest

Middle East and North Africa ('MENA')

Although significant unrest and political changes continued to be witnessed in the Middle East and North Africa in 2013, the majority of the HSBC Group's exposures in the region were concentrated in the HSBC Group's associate investment in Saudi Arabia and in the UAE, where the respective political landscapes remained stable and economic growth continued to recover. In the remaining countries in which the group has a presence and there was unrest or political change (or which exhibited similar socio-economic, political and demographic profiles to countries experiencing unrest), the group continued to carefully monitor and respond to developments while assisting customers in managing their own risks in the volatile environment.

Wholesale lending

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions and corporate entities. The group's wholesale portfolios are well diversified across industry sectors throughout the region, with exposure subject to portfolio controls. The rise in business confidence in 2013 improved the liquidity of certain assets enabling solutions to be reached in the case of a number of problem accounts.

During 2013, the group continued to maintain tight control over its counterparty exposures in MENA countries most at risk from the uncertain political environment.

Commercial real estate

Commercial real estate lending to customers for the purpose of property investment at 31 December 2013 represented 2.12% (2012: 3.05%) of total gross loans and advances to customers. In 2013 there remained a risk of stress in certain markets. Accordingly, across the group's portfolios, credit risk is mitigated by long-standing and conservative policies on asset origination which focus on relationships with long-term customers and limited initial leverage. HSBC Group Risk, in conjunction with major subsidiaries, designates real estate as a Controlled Sector and, accordingly, implements enhanced exposure approval, monitoring and reporting procedures. For example, the group monitors risk appetite limits for the sector at regional level to detect and prevent higher risk concentrations.

Sovereign counterparties

The overall quality of the group's sovereign portfolio remained strong during the period with the large majority of both in-country and cross-border limits extended to countries with strong internal credit risk ratings. The group regularly updates its assessment of higher risk countries and adjusts its risk appetite to reflect such changes.

Personal lending

The group provides a broad range of secured and unsecured personal lending products to meet customer needs. Given the diverse nature of the markets in which the group operates, the range is not standardised across all countries but is tailored to meet the demands of individual markets while using appropriate distribution channels and, wherever possible, common global IT platforms.

Personal lending includes advances to customers for asset purchase, such as residential property and motor vehicles, where the loans are typically secured on the assets being acquired. The group also offers loans secured on existing assets and unsecured lending products such as overdrafts, credit cards and payroll loans.

During 2013, the growth strategy continued to focus on higher quality accounts, particularly employees of companies that have remained strong through the recent history. At a portfolio level, loan impairment charges reduced from prior year levels as the economic situation stabilised and collateral value improved. The portfolio primarily consists of seasoned accounts, that have managed to maintain payments throughout the downturn, and recent originations that passed minimum credit risk criterion.

Credit quality of financial instruments

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

Notes on the Financial Statements (continued)

The group's risk rating system facilitates the Internal Ratings Based ('IRB') approach under Basel II adopted by the HSBC Group to support calculation of our minimum credit regulatory capital requirement. For further details see definitions of our credit quality classifications below.

Special attention is paid to problem exposures in order to accelerate remedial action. When appropriate, our operating companies use specialist units to provide customers with support to help them avoid default wherever possible.

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

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

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

Credit quality classification

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

[1] *The group observes the disclosure convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired (see 'Past due but not impaired gross financial instruments').*

Quality classification definitions

- 'Strong' exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.
- 'Good' exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.
- 'Satisfactory' exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.
- 'Sub-standard' exposures require varying degrees of special attention and default risk is of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.
- 'Impaired' exposures have been assessed as impaired. Wholesale exposures where the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse by the bank to the actions such as realising security if held, or the customer is past due more than 90 days on any material credit obligation. Retail loans and advances greater than 90 days past due unless individually they have been assessed as not impaired. Renegotiated loans that have met the requirements to be disclosed as impaired and have not yet met the criteria to be returned to the unimpaired portfolio.

Notes on the Financial Statements (continued)

Risk rating scales

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

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

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

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

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

Distribution of financial instruments by credit quality

	31 December 2013							
	Neither past due nor impaired							
	Strong US$000	Good US$000	Satisfactory US$000	Sub-Standard US$000	Past due not impaired US$000	Impaired US$000	Impairment allowances US$000	Total US$000
Cash and balances at central banks	**1,436,301**	**105,058**	**–**	**32,342**	**–**	**–**	**–**	**1,573,701**
Items in the course of collection from other banks	**2,374**	**–**	**65,109**	**–**	**–**	**–**	**–**	**67,483**
Trading assets	**413,509**	**28,896**	**68,436**	**4,533**	**–**	**–**	**–**	**515,374**
treasury and other eligible bills	**109,046**	**–**	**–**	**–**	**–**	**–**	**–**	**109,046**
debt securities	**202,648**	**28,896**	**67,044**	**4,533**	**–**	**–**	**–**	**303,121**
loans and advances to banks	**87,049**	**–**	**–**	**–**	**–**	**–**	**–**	**87,049**
loans and advances to customers	**14,766**	**–**	**1,392**	**–**	**–**	**–**	**–**	**16,158**
Derivatives	**82,822**	**83,978**	**864,881**	**103,671**	**–**	**–**	**–**	**1,135,352**
Loans and advances held at amortised cost	**15,553,270**	**7,712,661**	**5,299,628**	**1,377,567**	**729,318**	**2,010,976**	**(1,436,925)**	**31,246,495**
loans and advances to banks	**5,944,289**	**1,319,034**	**189,440**	**161,926**	**–**	**20,405**	**(18,317)**	**7,616,777**
loans and advances to customers	**9,608,981**	**6,393,627**	**5,110,188**	**1,215,641**	**729,318**	**1,990,571**	**(1,418,608)**	**23,629,718**
Financial investments	**4,310,424**	**531,679**	**6,030,592**	**175,568**	**–**	**–**	**–**	**11,048,263**
treasury and other eligible bills	**1,195,713**	**368,402**	**–**	**48,621**	**–**	**–**	**–**	**1,612,736**
debt securities	**3,114,711**	**163,277**	**6,030,592**	**126,947**	**–**	**–**	**–**	**9,435,527**
Other assets	**203,208**	**192,410**	**787,049**	**36,709**	**19,473**	**–**	**–**	**1,238,849**
endorsements and acceptances	**200,053**	**191,967**	**596,571**	**36,709**	**15,922**	**–**	**–**	**1,041,222**
accrued income and other	**3,155**	**443**	**190,478**	**–**	**3,551**	**–**	**–**	**197,627**
Total financial instruments	**22,001,908**	**8,654,682**	**13,115,695**	**1,730,390**	**748,791**	**2,010,976**	**(1,436,925)**	**46,825,517**

Notes on the Financial Statements (continued)

	31 December 2012							
	Neither past due nor impaired							
	Strong US$000	Good US$000	Satisfactory US$000	Sub-Standard US$000	Past due not impaired US$000	Impaired US$000	Impairment allowances US$000	Total US$000
Cash and balances at central banks	686,399	145,299	60,905	–	–	–	–	892,603
Items in the course of collection from other banks	–	28,908	87,175	–	–	–	–	116,083
Trading assets	339,750	69,017	169,527	2,319	–	–	–	580,613
treasury and other eligible bills	–	–	–	–	–	–	–	–
debt securities	238,198	69,017	153,516	2,319	–	–	–	463,050
loans and advances to banks	84,639	–	–	–	–	–	–	84,639
loans and advances to customers	16,913	–	16,011	–	–	–	–	32,924
Derivatives	97,467	166,484	1,050,681	121,610	–	–	–	1,436,242
Loans and advances held at amortised cost	16,324,543	7,506,799	6,620,989	1,469,153	949,991	2,331,169	(1,649,601)	33,553,043
loans and advances to banks	8,150,928	622,299	590,438	165,325	–	26,175	(17,388)	9,537,777
loans and advances to customers	8,173,615	6,884,500	6,030,551	1,303,828	949,991	2,304,994	(1,632,213)	24,015,266
Financial investments	3,660,570	611,182	6,548,644	192,392	–	–	–	11,012,788
treasury and other eligible bills	1,090,209	459,845	3,597	104,356	–	–	–	1,658,007
debt securities	2,570,361	151,337	6,545,047	88,036	–	–	–	9,354,781
Other assets	111,778	173,259	1,263,516	81,222	6,360	624	–	1,636,759
endorsements and acceptances	100,928	173,259	945,324	81,222	6,360	624	–	1,307,717
accrued income and other	10,850	–	318,192	–	–	–	–	329,042
Total financial instruments	21,220,507	8,700,948	15,801,437	1,866,696	956,351	2,331,793	(1,649,601)	49,228,131

Past due but not impaired gross financial instruments

Past due but not impaired loans are those in respect of which the customer is in the early stages of delinquency and has failed to make a payment or a partial payment in accordance with the contractual terms of the loan agreement. This is typically when a loan is less than 90 days past due and there are no other indicators of impairment.

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

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

Notes on the Financial Statements (continued)

	Up to 29 days US$000	30-59 days US$000	60-89 days US$000	90-179 Days US$000	Over 180 days US$000	Total US$000
At 31 December 2013						
Loans and advances to customers held at amortised cost	**490,871**	**120,949**	**61,799**	**32,573**	**23,126**	**729,318**
- personal	**83,462**	**25,219**	**28,587**	**8,854**	**178**	**146,300**
- corporate and commercial	**405,330**	**95,730**	**32,093**	**23,719**	**22,935**	**579,807**
- Financial (non-bank institutions)	**2,079**	**–**	**1,119**	**–**	**13**	**3,211**
Loans and advances to banks held at amortised cost	–	–	–	–	–	–
Other assets	**13,887**	**2,712**	**410**	**559**	**1,905**	**19,473**
Endorsements and acceptances	**10,788**	**2,698**	**410**	**521**	**1,505**	**15,922**
Other	**3,099**	**14**	**–**	**38**	**400**	**3,551**
	504,758	**123,661**	**62,209**	**33,132**	**25,031**	**748,791**
At 31 December 2012						
Loans and advances to customers held at amortised cost	649,705	119,221	73,023	105,639	2,403	949,991
- personal	141,603	45,865	22,726	12,417	–	222,611
- corporate and commercial	506,755	73,332	50,297	93,222	2,388	725,994
- Financial (non-bank institutions)	1,347	24	–	–	15	1,386
Loans and advances to banks held at amortised cost	–	–	–	–	–	–
Other assets	5,656	661	–	–	43	6,360
Endorsements and acceptances	5,656	661	–	–	43	6,360
Other	–	–	–	–	–	–
	655,361	119,882	73,023	105,639	2,446	956,351

Renegotiated loans and forbearance

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

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

For retail lending our credit risk management policy sets out restrictions on the number and frequency of renegotiations, the minimum period an account must have been opened before any renegotiation can be considered and the number of qualifying payments that must be received. The application of this policy varies according to the nature of the market, the product and the management of customer relationships through the occurrence of exceptional events.

The contractual terms of a loan may be modified for a number of reasons, including changes in market conditions, customer retention and other factors not related to the current or potential credit deterioration of a customer. 'Forbearance' describes concessions made on the contractual terms of a loan in response to an obligor's financial difficulties. The group classifies and reports concessions granted under conditions of credit distress as 'renegotiated loans' when their contractual payment terms have been modified because the group has significant concerns about the borrowers' ability to meet contractual payments when due. Loans where concessions are made to customers which do not affect the payment structure or basis of repayment, such as waivers of financial or security covenants, do not directly provide concessionary relief to a customer in terms of their ability to service obligations as they fall due and are therefore not included in this classification.

Identifying renegotiated loans

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

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

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

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

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

Credit quality classification of renegotiated loans

Under IFRSs, an entity is required to assess whether there is objective evidence that financial assets are impaired at the end of each reporting period. A loan is impaired, and an impairment allowance is recognised, when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated. When the group grants a concession to a customer that the group would not otherwise consider, as a result of their financial difficulty, this is objective evidence of impairment and impairment losses are measured accordingly.

A renegotiated loan is presented as impaired when:

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

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

Notes on the Financial Statements (continued)

For loans that are assessed for impairment on a collective basis, the evidence typically comprises a history of payment performance against the original or revised terms, as appropriate to the circumstances. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case by case basis.

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

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

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

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

Renegotiated loans and advances to customers

	At 31 December 2013			
	Neither past due nor impaired US$000	**Past Due but not impaired US$000**	**Impaired US$000**	**Total US$000**
Retail	**82,711**	**32,057**	**48,546**	**163,314**
- Residential Mortgages	**47,492**	**3,056**	**40,534**	**91,082**
- Other personal	**35,219**	**29,001**	**8,012**	**72,232**
Corporate and commercial	**391,243**	**112,242**	**623,529**	**1,127,014**
- Manufacturing and international trade services	**32,032**	**7,893**	**143,282**	**183,207**
- Commercial real estate	**269,031**	**25,645**	**355,529**	**650,205**
- Other commercial	**90,180**	**78,704**	**124,718**	**293,602**
Financial	**264,439**	**–**	**94,332**	**358,771**
Total renegotiated loans and advances to customers	**738,393**	**144,299**	**766,407**	**1,649,099**
Total impairment allowance on renegotiated loans				**412,374**

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	At 31 December 2012			
	Neither past due nor impaired US$000	Past Due but not impaired US$000	Impaired US$000	Total US$000
Retail	99,448	12,639	77,210	189,297
- Residential Mortgages	45,703	803	64,896	111,402
- Other personal	53,745	11,836	12,314	77,895
Corporate and commercial	638,894	154,855	750,836	1,544,585
- Manufacturing and international trade services	121,320	34,035	205,099	360,454
- Commercial real estate	448,535	2,862	434,144	885,541
- Other commercial	69,039	117,958	111,593	298,590
Financial	247,021	–	92,158	339,179
Total renegotiated loans and advances to customers	985,363	167,494	920,204	2,073,061
Total impairment allowance on renegotiated loans				546,796

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

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

Impaired loans

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

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

Notes on the Financial Statements (continued)

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

	Banks	Customers		
	Individually assessed US$000	Individually assessed US$000	Collectively assessed US$000	Total US$000
At 1 January 2013	**17,388**	**1,224,574**	**407,639**	**1,649,601**
Amounts written off	**–**	**(94,923)**	**(99,190)**	**(194,113)**
Recoveries of loans and advances written off in previous years	**–**	**46,625**	**40,011**	**86,636**
(Release)/charge to income statement	**(78)**	**(66,948)**	**28,121**	**(38,905)**
Exchange and other movements	**1,007**	**(55,816)**	**(11,485)**	**(66,294)**
At 31 December 2013	**18,317**	**1,053,512**	**365,096**	**1,436,925**
At 1 January 2012	17,004	1,102,244	407,627	1,526,875
Amounts written off	-	(115,814)	(110,592)	(226,406)
Recoveries of loans and advances written off in previous years	-	31,468	43,705	75,173
Charge to income statement	364	186,871	28,130	215,365
Exchange and other movements	20	19,805	38,769	58,594
At 31 December 2012	17,388	1,224,574	407,639	1,649,601

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

	At 31 December	
	2013 %	2012 %
Banks		
Individually assessed impairment allowances	**0.24%**	0.18%
Customers		
Individually assessed impairment allowances	**4.20%**	4.77%
Collectively assessed impairment allowances	**1.46%**	1.59%
	5.66%	6.36%

Liquidity and funding

Liquidity risk is the risk that the group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. The risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained on the expected terms and when required.

The objective of our liquidity framework is to allow us to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations.

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities in compliance with the group’s liquidity and funding risk management framework, and with practices and limits set by the GMB (Group Management Board) through the Risk Management Committee and approved by the Board. These limits vary according to the depth and the liquidity of the markets in which the entities operate. The group’s general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of the group’s Asset, Liability and Capital Management (‘ALCM’) structure, the group have established ALCO at group level and the operating entities. The terms of reference of all ALCO include the monitoring and control of liquidity and funding.

The primary responsibility for managing liquidity and funding within the group’s framework and risk appetite resides with the local operating entity ALCO. Our most significant operating entities are overseen by group ALCO, HSBC Group ALCO and the HSBC Group Risk Management Meeting. The remaining smaller operating entities are overseen by group ALCO, with appropriate escalation of significant issues to HSBC Group ALCO and the HSBC Group Risk Management Meeting.

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding.

Primary sources of funding

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

Of total liabilities of US$42,730 million at 31 December 2013, funding from customers amounted to US$31,316 million, of which US$31,241 million was contractually repayable within one year.

An analysis of cash flows payable by the group under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 27.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US$19,465 million), included cash, central bank balances, items in the course of collection and treasury and other bills (US$3,254 million); loans to banks (US$7,617 million, including US$7,211 million repayable within one year); and loans to customers (US$23,630 million, including US$13,596 million repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended.

The group also accesses wholesale funding markets by issuing senior secured and unsecured debt securities (publically and privately) and borrowing from the secured repo markets against high quality collateral, in order to obtain funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local wholesale markets.

Management of liquidity risk

Core deposits

A key assumption of the group's internal framework is the categorisation of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during liquidity stress. This characterisation takes into account the inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that the group uses to calculate our principal liquidity risk metrics.

The three filters considered in assessing whether a deposit in any operating entity is core are:

– price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core.

– size: depositors with total funds above certain monetary thresholds are excluded. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and

– line of business: the element of any deposit remaining after the application of the price and size filters is assessed on the basis of the line of business to which the deposit is associated. The proportion of any customer deposit that can be considered core under this filter is between 35% and 90%.

Repo transactions and bank deposits cannot be categorised as core deposits.

Advances to core funding ratio

Core deposits are an important source of funding to finance lending to customers, and mitigate against reliance on short-term wholesale funding. Limits are placed on operating entities to restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long-term debt funding with a residual maturity beyond one year; this measure is referred to as the 'advances to core funding' ratio.

Advances to core funding ratio limits are set by the HSBC Group Risk Management Meeting for the most significant operating entities, and by regional ALCOs for smaller operating entities, and are monitored by ALCM teams. The

Notes on the Financial Statements (continued)

ratio describes current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. In general, customer loans are assumed to be renewed and are included in the numerator of the advances to core funding ratio, irrespective of the contractual maturity date. Reverse repo arrangements are excluded from the advances to core funding ratio.

	Advances to core funding ratio during:		Stressed one month coverage ratio during:	
	2013	2012	**2013**	2012
	%	%	**%**	%
Year-end	**96.7**	96.1	**134.0**	137.0
Maximum	**99.7**	104.4	**149.0**	142.0
Minimum	**92.5**	92.6	**125.0**	126.0
Average	**95.8**	98.7	**135.6**	134.4

The distinction between core and non-core deposits generally means that our measure of advances to core funding is more restrictive than that which can be inferred from the published financial statements.

Stressed one month coverage ratio

The stressed one month coverage ratios tabulated above express the stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. HSBC Group entities are required to target a ratio of 100% or greater.

The stressed cash inflows include:

- inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and
- contractual cash inflows from maturing assets that are not already reflected as a utilisation of liquid assets.

In line with the approach adopted for the advances to core funding ratio, customer loans are, in general, assumed not to generate any cash inflows under stress scenarios and are therefore excluded from the numerator of the stressed coverage ratios, irrespective of the contractual maturity date.

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow under the stress scenario being monitored. Group operating entities are required to maintain a ratio of 100% or greater out to three months under the combined market-wide and HSBC-specific stress scenario defined by the inherent liquidity risk categorisation of the operating entity concerned.

Market risk management

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

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

Monitoring and limited market risk exposure

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

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

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

The management of market risk is principally undertaken in Global Markets, where 85% of the total value at risk of HSBC Holdings (excluding Insurance) and almost all trading VAR resides, using risk limits approved by the GMB. Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. HSBC Group Risk, an independent unit within group Head Office, is responsible for our market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by HSBC Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

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

Sensitivity analysis

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, the present value of a basis point movement in interest rates, for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk (‘VAR’)

VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence.

The VAR models used by the group are predominantly based on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates, such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models assess potential market movements with reference to data from the past two years and calculate VAR to a 99% confidence level and for a one-day holding period.

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

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

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or the risks offset in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market moves.

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Stress testing

In recognition of the limitations of VAR, the group augments VAR with stress testing to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables.

The process is governed by the Stress Testing Review Group forum which, in conjunction with the regional risk managers, determines the scenarios to be applied at portfolio and consolidated level, as follows:

- sensitivity scenarios consider the impact of any single risk factor or a set of factors that are unlikely to be captured within the VAR models such as the break of a currency peg;
- technical scenarios, consider the largest move in each risk factor, without consideration of any underlying market correlation;
- hypothetical scenarios, which consider potential macro economic events, for example, a global flu pandemic; and
- historical scenarios, which incorporate historical observations of market movements during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial impact such events would have on the group's profit.

Trading and non-trading portfolios

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

	Portfolio	
	Trading	**Non-trading**
Risk type		
Foreign exchange and commodity	VAR	VAR[1]
Interest rate	VAR	VAR
Credit spread	VAR	VAR

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

Value at risk of the trading and non-trading portfolios

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

Value at risk

	2013	2012
	US$000	US$000
At 31 December	**2,479**	2,572
Average	**2,813**	3,142
Minimum	**2,090**	1,788
Maximum	**4,484**	4,437

Trading portfolios

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

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Market-making and position-taking is undertaken within Global Markets. The VAR for such trading intent activity at 31 December 2013 was US$0.6 million (2012: US$1.0 million). This is analysed below by risk type:

VAR by risk type for the trading intent activities

	Foreign exchange US$000	Interest rate US$000	Credit US$000	Total[1] US$000
At 31 December 2013	**183**	**342**	**439**	**631**
At 31 December 2012	140	1,166	767	1,045
Average				
2013	**195**	**979**	**930**	**1,433**
2012	1,433	2,242	806	1,838
Minimum				
2013	**121**	**303**	**427**	**628**
2012	131	946	344	933
Maximum				
2013	**366**	**2,961**	**2,453**	**3,000**
2012	2,460	3,332	1,813	2,818

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

Gap risk

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

Given the characteristics, these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks for such transactions within the stress testing scenarios and monitor gap risk on an ongoing basis. The group incurred no material gap losses arising from movements in the underlying market price on such transactions in the 12 months ended 31 December 2013.

Non-trading portfolios

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

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

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

Equity securities classified as available-for-sale

Market risk arises on equity securities held as available-for-sale. The fair value of these securities at 31 December 2013 was US$219 million (2012: US$193 million).

Sensitivity of net interest income

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

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

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

Structural foreign exchange exposures

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

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

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

Defined benefit pension scheme

Market risk also arises within the group's defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. Pension scheme assets include equities and debt securities, the cash flows of which change as equity prices and interest rates vary. There is a risk that market movements in equity prices and interest rates could result in asset values which, taken together with regular ongoing contributions, are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess these risks using reports prepared by independent external actuaries and takes action and, where appropriate, adjust investment strategies and contribution levels accordingly.

Operational risk management

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

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

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

A centralised database is used to record the results of the operational risk management process. Operational risk and control assessments, control monitoring plans and incidents, are input and maintained by the business units. To ensure that operational risk losses are consistently reported and monitored at group level, all group companies are required to report individual losses when the net loss is expected to exceed US$10,000.

Legal risk

Each operating company is required to implement procedures to manage legal risk that conform to group standards. Legal risk falls within the definition of operational risk and includes contractual risk, dispute risk, legislative risk and non-contractual rights risk.

- Contractual risk is the risk that the rights and/or obligations of a group company within a contractual relationship are defective.
- Dispute risk is the risk that a group company is subject to when it is involved in or managing a potential or actual dispute.
- Legislative risk is the risk that a group company fails to adhere to the laws of the jurisdictions in which it operates.
- Non-contractual rights risk is the risk that a group company's assets are not properly owned or are infringed by others, or a group company infringes another party's rights.

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

Operating companies must notify the legal department immediately if any litigation is either threatened or commenced against the group or an employee. The legal department must be immediately advised (and must in turn immediately advise the HSBC Group Head Office legal department) of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect HSBC Group's reputation. Further, any claims which exceed US$1.5 million or equivalent must also be advised to the legal department and the legal department must immediately advise the HSBC Group Head Office if any such claim exceeds US$5 million. All such matters are then reported to the HSBC Group Risk Management Meeting of the HSBC Group Board in a monthly paper.

An exception report must be made to the local compliance function and escalated to the head of group compliance in respect of any breach which has given rise to a fine and/or costs levied by a court of law or regulatory body where the amount is US$1,500 or more, and material or significant issues are reported to RMM and/or the group Audit Committee.

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

Capital management

The Jersey Financial Services Commission ('JFSC') supervises the bank on a solo basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the bank 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 to maintain a ratio of total capital to risk-weighted assets taking into account both balance sheet assets and off-balance sheet transactions.

Notes on the Financial Statements (continued)

The bank's capital is divided into two tiers:

- Tier 1 capital comprises shareholders' funds less deductions for the book values of intangible assets and 50% of the investment in subsidiaries, associates and capital of other banks at cost, and 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 and reserves arising from the revaluation of properties less deductions for 50% of the investment in subsidiaries, associates and capital of other banks at cost.

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% 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.

Capital structure at 31 December (solo basis)

	2013	2012
	Basel II	Basel II
	US$000	US$000
Composition of regulatory capital		
Tier 1 capital	**4,891,124**	4,263,619
Tier 2 capital	**856,567**	986,703
Total regulatory capital	**5,747,691**	5,250,322
Risk weighted assets		
Credit and counterparty risk	**30,928,840**	31,320,357
Market risk	**2,641,250**	2,820,632
Operational risk	**3,659,932**	3,703,837
	37,230,022	37,844,826
Capital ratios	**%**	%
Capital adequacy ratio	**15.44**	13.87

34 Contingent liabilities, contractual commitments and guarantees

	2013	2012
	US$000	US$000
Guarantees and other contingent liabilities		
Guarantees	**11,787,834**	11,783,131
Commitments		
Documentary credits and short-term trade-related transactions	**1,385,937**	1,537,103
Undrawn formal standby facilities, credit lines and other commitments to lend:	**18,079,162**	18,469,876
	19,465,099	20,006,979

The table above discloses the nominal principal amounts of commitments, excluding capital commitments, which are separately disclosed below, guarantees and other contingent liabilities; mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Notes on the Financial Statements (continued)

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

	2013	2012
	US$000	US$000
Guarantees and assets pledged by the bank as collateral security	**1,421,900**	1,314,235
Documentary credits and short-term trade-related transactions	**156,303**	4,874
	1,578,203	1,319,109

Guarantees

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

	At 31 December 2013		At 31 December 2012	
	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]	**1,582,216**	**404,255**	6,118,270	218,001
Credit related guarantees[2]	**3,968,219**	**316,781**	1,947,873	414,233
Other guarantees[3]	**4,815,499**	**700,864**	2,402,753	682,001
Total	**10,365,934**	**1,421,900**	10,468,896	1,314,235

1 *Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. Intra-group financial guarantees include a guarantee of a capital nature issued by the group to a HSBC Group entity for inclusion as capital support by the latter's regulator.*

2 *Credit related guarantees are contracts that have similar features to financial guarantee contracts but fail to meet the strict definition of a financial guarantee contracts under IAS 39.*

3 *Other guarantee contracts accounted for as contingent liabilities under IAS 37 (as they do not meet criteria to be accounted for as financial instruments under IAS 39).*

The amounts disclosed in the above table are nominal principal amounts and reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

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

	2013	2012
	US$000	US$000
Other items	**1,034**	741
	1,034	741

Other commitments

In addition to the commitments disclosed above, at 31 December 2013 the group had US$ Nil (2012: US$ Nil) of capital commitments authorised but not contracted for.

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.

Notes on the Financial Statements (continued)

35 Lease commitments

Operating lease commitments

At 31 December 2013, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

	Land and buildings	
	2013	2012
	US$000	US$000
Future minimum lease payments under non-cancellable operating leases expiring:		
no later than one year	**39,811**	36,441
later than one year and no later than five years	**126,646**	132,054
later than five years	**18,854**	41,177
	185,311	209,672

In 2013, US$36.4 million (2012: US$34 million) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

Finance lease receivables

The group leases a variety of assets to third parties under finance leases. At the end of the lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn future income.

	Present value of finance lease commitments	
	2013[1]	2012
	US$000	US$000
Lease receivables:		
- no later than one year	**52,940**	201,297
- later than one year and no later than five years	**116,441**	443,332
- later than five years	**75,313**	122,161
	244,694	766,790

1 *Certain categories of finance leases have been recategorised within loans and advances.*

36 Structured entities

The group is involved with structured entities, mainly through securitisation of financial assets and investment funds. The group’s arrangements that involve structured entities are authorised centrally when they are established to ensure appropriate purpose and governance. The activities of structured entities administered by the group are closely monitored by senior management. The group has involvement with consolidated structured entities, which may be established by the group or by a third party, detailed below.

Consolidated structured entities

Structured entities are assessed for consolidation in accordance with the accounting policy set out in Note 1(e).

Total assets of the group’s consolidated structured entities, split by entity type

	Nature of structured entity	**2013** US$000	2012 US$000
HBME Sukuk Company Limited	Corporate debt issuer	**502,400**	590,000

Notes on the Financial Statements (continued)

Unconsolidated structured entities

The term unconsolidated structured entities' refers to all structured entities that are not controlled by the group. It includes interests in structured entities that are not consolidated. The group enters into transactions with unconsolidated structured entities in the normal course of business to facilitate customer transactions and for specific investment opportunities.

The table below shows the total assets of unconsolidated structured entities in which the group has an interest at the reporting date, and reflect the group's maximum exposure to loss in relation to those interests. The comprise units of third party managed funds in order to facilitate both business and customer needs.

Total assets of the group's interest in unconsolidated structured entities, split by entity type:

	2013	2012
	US$000	US$000
Non-group managed funds	**71,260**	58,293

37 Legal proceedings and regulatory matters

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

The bank is currently co-operating with the Jersey Financial Services Commission (the "Commission") in respect of its enquiry into the bank's adherence to Jersey anti-money laundering requirements and international sanctions legislation.

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

Anti-money laundering and sanctions-related

In October 2010, HSBC Bank USA entered into a consent cease and desist order with the OCC and the indirect parent of that company, HSBC North America Holdings Inc. ('HNAH'), entered into a consent cease and desist order with the Federal Reserve Board (the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including various issues relating to US Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. Steps continue to be taken to address the requirements of the Orders to ensure compliance, and that effective policies and procedures are maintained.

In addition, in December 2012, HSBC Holdings, HNAH and HSBC Bank USA entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA and AML and sanctions laws. Among those agreements, HSBC Holdings and HSBC Bank USA entered into a five-year deferred prosecution agreement with the DoJ, the US Attorney's Office for the Eastern District of New York, and the US Attorney's Office for the Northern District of West Virginia (the 'US DPA'), HSBC Holdings entered into a two-year deferred prosecution agreement with the New York County District Attorney (the 'DANY DPA'), and HSBC Holdings consented to a cease and desist order and HSBC Holdings and HNAH consented to a monetary penalty order with the Federal Reserve Board ('FRB'). In addition, HSBC Bank USA entered into a monetary penalty consent order with FinCEN and a separate monetary penalty order with the OCC. HSBC Holdings also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions and an undertaking with the UK Financial Services Authority, now a Financial Conduct Authority ('FCA') Direction, to comply with certain forward-looking AML and sanctions-related obligations.

Under these agreements, HSBC Holdings and HSBC Bank USA made payments totalling US$1,921m to US authorities and are continuing to comply with ongoing obligations. On 1 July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of the same. Under the agreements with the DoJ, FCA, and the FRB, an independent monitor (who is, for FCA purposes, a 'skilled person' under Section 166 of the Financial Services and Markets Act) will evaluate and regularly assess the effectiveness of HSBC's AML and sanctions compliance function and HSBC's progress in implementing its remedial obligations under the agreements. The monitorship, which began on 22 July 2013, is proceeding as anticipated and consistent with the timelines and requirements set forth in the relevant agreements.

Notes on the Financial Statements (continued)

If HSBC Holdings and HSBC Bank USA fulfil all of the requirements imposed by the US DPA, the DOJ's charges against those entities will be dismissed at the end of the five-year period of that agreement. Similarly, if HSBC Holdings fulfils all of the requirements imposed by the DANY DPA, DANY's charges against it will be dismissed at the end of the two-year period of that agreement. The DoJ may prosecute HSBC Holdings or HSBC Bank USA in relation to the matters which are the subject of the US DPA if HSBC Holdings or HSBC Bank USA breaches the terms of the US DPA, and DANY may prosecute HSBC Holdings in relation to the matters which are subject of the DANY DPA if HSBC Holdings violates the terms of the DANY DPA.

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

The settlement with US and UK authorities does not preclude private litigation relating to, among other things, HSBC's compliance with applicable AML, BSA and sanctions laws or other regulatory or law enforcement actions for AML/BSA or sanctions matters not covered by the various agreements.

38 Related party transactions

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

Copies of the HSBC Group financial statements may be obtained from the following address:
HSBC Holdings plc
8 Canada Square
London
E14 5HQ

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

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Bank Middle East Limited and the group and includes members of the Boards of Directors of HSBC Bank Middle East Limited. The emoluments of a number of the Key Management Personnel are paid by other HSBC Group companies who make no recharge to the group. The Directors are also Directors of a number of other HSBC Group companies and it is not possible to make a reasonable apportionment of their emoluments in respect of each of the companies. Accordingly, no emoluments in respect of the Directors paid by other HSBC Group companies and applicable to the group has been included in the following disclosure.

Transactions, arrangements and agreements including Key Management Personnel

Compensation of Key Management Personnel

	2013	2012
	US$000	US$000
Remuneration (wages and bonus)	**6,351**	4,930
Post-employment benefits	**208**	231
Share based payments – value of shares awarded	**3,209**	2,160
	9,768	7,321

Notes on the Financial Statements (continued)

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

	2013		2012	
	Highest balance during the year[1] US$000	**Balance at 31 December[1] US$000**	Highest balance during the year[1] US$000	Balance at 31 December[1] US$000
Key Management Personnel and connected persons and companies controlled by them				
Loans	**1,180**	**762**	4,853	948
Credit cards	**82**	**37**	83	33

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.*

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

Transactions with other related parties

Associates

	2013		2012	
	Highest balance during the year[1] US$000	**Balance at 31 December[1] US$000**	Highest balance during the year[1] US$000	Balance at 31 December[1] US$000
Amounts due from associates	**332**	**248**	316	264
Amounts due to associates	**16,437**	**13,121**	15,438	4,665

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.*

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

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

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

	2013		2012	
	Highest balance during the year[1] US$000	**Balance at 31 December[1] US$000**	Highest balance during the year[1] US$000	Balance at 31 December[1] US$000
Assets				
Loans and advances to customers	**738**	**198**	4,031	738
Liabilities				
Customer accounts	**25,408**	**20,060**	21,622	12,205
Subordinated amounts due	**300,000**	**300,000**	300,000	300,000

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.*

Notes on the Financial Statements (continued)

	For the year ended 31 December 2013 US$000	For the year ended 31 December 2012 US$000
Income Statement		
Interest expense	**20,100**	20,100
Fee expense	**5,361**	-
Other operating income	**(163)**	889
General and administrative expenses	**30,415**	31,601

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

	2013		2012	
	Highest balance during the year[1] US$000	**Balance at the year end[1] US$000**	Highest balance during the year[1] US$000	Balance at the year end[1] US$000
Assets				
Derivatives	**914,675**	**732,807**	971,775	913,994
Loans and advances to banks	**2,837,447**	**2,837,447**	2,336,603	2,272,834
Liabilities				
Deposits by banks	**238,748**	**238,748**	388,662	187,830
Derivatives	**1,375,372**	**1,023,545**	1,371,425	1,324,876
Subordinated amounts due	**750,000**	**650,000**	850,000	750,000
Guarantees	**404,255**	**404,255**	294,731	218,001

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.*

	For the year ended 31 December 2013 US$000	For the year ended 31 December 2012 US$000
Income Statement		
Interest income	**5,203**	4,421
Interest expense	**25,965**	27,530
Fee income	**62,964**	28,662
Fee expense	**25,795**	33,545
Other operating income	**40,698**	38,821
General and administrative expenses	**119,398**	94,958

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

Transactions between HSBC Bank Middle East Limited and its subsidiaries

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

	2013		2012	
	Highest balance during the year[1] US$000	**Balance at the year end[1] US$000**	Highest balance during the year[1] US$000	Balance at the year end[1] US$000
Assets				
Loans and advances to banks	**84,325**	**45,961**	29,105	25,781
Loans and advances to customers	**376,785**	**373,968**	430,343	353,005
Liabilities				
Deposits by banks	**141,769**	**141,769**	9,902	9,902
Customer accounts	**74,064**	**50,245**	166,268	74,064

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.*

Notes on the Financial Statements (continued)

39 Events after the balance sheet date

A third interim dividend for 2013 of US$70 million was declared by the Directors on 13 February 2014.

These accounts were approved by the Board of Directors on 13 February 2014 and authorised for issue.

HSBC Bank Middle East Limited and other HSBC Group Offices in the Region

HSBC Bank Middle East Limited
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Fax: (44–1534) 606149

Middle East Management Office
HSBC Building,
Emaar Square
P O Box 66
Dubai
United Arab Emirates
Tel: (971–4) 4235168
Fax: (971–4) 4267397

ALGERIA
El Mohammadia branch
Hydra branch
Oran branch

BAHRAIN
Seef – Main Branch
Adliya
Manama – Batelco Building
Sanad
1 Customer Service Unit

JORDAN
Amman (Western Amman Main Branch)
Amman (Jebel Hussein Branch)
Amman (Abdoun Branch)
Amman (Madinah Munawarah Branch)

KUWAIT
Kuwait City - Qibla Area

LEBANON
Beirut – Minet El-Hosn
Beirut – Ras–Beirut Branch Rbeiz Building
Greater Beirut – Dora Branch

PAKISTAN
Faisalabad– Jail Road
Islamabad– Sector F-7/2
Karachi– Shaheen Commercial Complex
Karachi–Clifton
Karachi–Defence
Karachi–Citi Tower
Lahore–Gulberg
Lahore–Model Town
Rawalpindi–Bank Road Saddar
Sialkot—Qayyum Trade Centre

PALESTINIAN AUTONOMOUS AREA
Ramallah – Jaffa St

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

UNITED ARAB EMIRATES
Abu Dhabi – Old Airport Road
Dubai – Deira Al Muraqqabat
Dubai – Bur Dubai
Dubai – Jumeirah
Dubai – DIFC branch
Jebel Ali – Free Trade Zone
Fujairah – Hamad Bin Abdulla St
Ras Al Khaimah – Corniche Rd
Sharjah – King Faisal Road
14 Customer Service Units and 2 Management Offices

HSBC Bank Middle East Limited - DIFC Branch
Dubai International Financial Centre
Dubai, UAE

PRINCIPAL SUBSIDIARY COMPANIES
HSBC Bank Oman S.A.O.G.
Muscat Head Office, 84 branches and 1 Customer Service Unit

HSBC Financial Services (Middle East) Limited
Dubai

HSBC Middle East Securities LLC
Dubai

HSBC Middle East Finance Company Limited
Abu Dhabi – Al Salam St
Al Ain – Al Kuwaitat St
Dubai – Sheikh Zayed Road
Ras Al Khaimah – Corniche Road

ASSOCIATED COMPANIES
Arabian Real Estate Investment Trust Management Limited
Cayman Islands

Rewards Management Middle East Free Zone Limited Liability Company
Dubai

MENA Infrastructure Fund (GP) Limited
Dubai

MENA Holdings Limited
Cayman Islands

HSBC Middle East Leasing Partnership
Dubai

SPECIAL CONNECTIONS WITH THESE MEMBERS OF THE HSBC GROUP
Dar Es Salaam Investment Bank
Iraq, Baghdad Head Office and 10 branches

HSBC Bank Egypt S.A.E.
Cairo, Head Office, 74 branches and
10 Corporate Implants

HSBC Bank International Limited

HSBC Insurance Brokers Limited

HSBC Securities (Egypt) S.A.E.

HSBC Electronic Data Service Delivery (Egypt) S.A.E

HSBC Saudi Arabia Limited

The Hongkong and Shanghai Banking Corporation Limited
Seef, Bahrain – Wholesale (Offshore)

The Saudi British Bank
Riyadh Head Office and 80 branches

SABB Insurance Services Limited

SABB Takaful Limited

HSBC Financial Services (Lebanon) s.a.l.

HSBC BANK MIDDLE EAST LIMITED
HSBC Bank Middle East Limited is incorporated in Jersey, Channel Islands - number 85600

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