

## SUPPLEMENTARY LISTING PARTICULARS



### HSBC Bank Middle East Limited

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

*as Issuer*

#### US\$7,000,000,000 DEBT ISSUANCE PROGRAMME

This supplement (the "**Supplement**") to the information memorandum dated 15 July 2014 relating to the US\$7,000,000,000 debt issuance programme (the "**Programme**") of HSBC Bank Middle East Limited (the "**Issuer**") and the supplements thereto dated 18 September 2014 and 18 December 2014 (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 2000 (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 Supplement.

This Supplement is supplemental to, and should be read in conjunction with, the Information Memorandum.

This Supplement has been approved by the Irish Stock Exchange for the purposes of Listing.

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

The purpose of this Supplement is to disclose that the Issuer has published its annual audited financial statements for the year ending 31 December 2014 (the "**2014 Annual Audited Financial Statements**"). The 2014 Annual Audited Financial Statements can be found in the Issuer's 2014 annual report and accounts dated 10 February 2015 (the "**Issuer's 2014 Annual Report and 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 Supplement and (b) any other statement in or incorporated by reference in the Information Memorandum prior to the date of this Supplement, the statement in this Supplement will prevail.

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

18 March 2015

**ANNEX**

**ISSUER'S 2014 ANNUAL REPORT AND ACCOUNTS**



## Annual Report and Accounts 2014

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### Presentation of Information

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This document comprises the *Annual Report and Accounts 2014* 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

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### Board of Directors

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D G Eldon, Chairman  
 M M Al Tuwaijri, Chief Executive Officer and Deputy Chairman  
 R E Al Gurg  
 A M Keir  
 C J M Keirle  
 A H M H B Mostafawi

Sir W C Patey  
 A M Sharaf  
 T L Slattery  
 C D Spooner  
 N G Winsor

### Changes in Directors

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- A M Keir was appointed as a Director on 4 February 2014;
- S N Cooper resigned as a Director on 13 February 2014;
- R B Gray resigned as a Director on 13 February 2014;
- R E Al Gurg was appointed as a Director on 19 February 2014;
- C D Spooner was appointed as a Director on 15 April 2014; and
- A R D Monro Davies resigned as a Director on 31 January 2015.

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

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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. Changes in the branch network during the year are outlined below.

On 19 June 2014, the bank completed the sale of its banking operations in Jordan to Arab Jordan Investment Bank.

On 17 October 2014, the bank completed the sale of its branches in Pakistan to Meezan Bank Limited.

### Attributable profit and dividends

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The profit attributable to the shareholders of the parent company amounted to US\$822 million (2013: US\$837 million) as set out in the consolidated income statement on page 6.

During the year, a third interim dividend for 2013 and first, second and third interim dividends for 2014 of US\$70 million, US\$150 million, US\$305 million and US\$200 million (2013: US\$165 million) were declared on 13 February 2014, 1 May 2014, 23 July 2014 and 20 October 2014 and were paid on 24 February 2014, 12 May 2014, 30 July 2014 and 28 October 2014, respectively.

A fourth interim dividend for 2014 of US\$135 million was declared by the Directors on 10 February 2015.

### Non-equity preference share capital

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On 16 December 2014 the bank redeemed 200,000 and 300,000 cumulative redeemable preference shares of USD1,000 each (the "Eighth and Ninth issues") at par value, and issued 500,000 cumulative redeemable preference shares of USD1,000 each (the "Eleventh issue") at par value; and

On 30 December 2014 the bank redeemed 225,000 non-cumulative redeemable preference shares of USD1,000 each (the "Tenth issue") at par value, and issued 225,000 cumulative redeemable preference shares of USD1,000 each (the "Twelfth issue") at par value.

## Report of the Directors (continued)

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### Registered office

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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

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The auditor is KPMG Channel Islands Limited. Following a tender process for the audit of HSBC Holdings plc and its subsidiaries in 2013, PricewaterhouseCoopers has been recommended to be appointed as auditors of the HSBC Group entities effective for periods ending on or after 1 January 2015. As a result KPMG Channel Islands Limited will not be seeking re-appointment as the Company's auditor for the financial year ending 31 December 2015 and PricewaterhouseCoopers CI LLP will seek appointment instead.

On behalf of the Board  
J A Tothill, *Secretary*  
10 February 2015

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

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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 ('the group') for the year ended 31 December 2014 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 2014 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)

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### 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

19 February 2015

### 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 19 February 2015. KPMG Channel Islands Limited has carried out no procedures of any nature subsequent to 19 February 2015 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 2014

	Notes	2014 US\$000	2013 US\$000
Interest income .....		1,300,929	1,356,533
Interest expense .....		(188,764)	(239,934)
Net interest income .....		1,112,165	1,116,599
Fee income .....		625,532	605,043
Fee expense .....		(66,757)	(69,295)
Net fee income .....		558,775	535,748
Trading income excluding net interest income .....		301,307	336,918
Net interest expense on trading activities .....		(16,556)	(8,240)
Net trading income .....		284,751	328,678
Net expense from financial instruments designated at fair value .....	2	(2,497)	(2,340)
Gains less losses from financial investments .....		19,545	3,918
Dividend income .....		13,684	9,233
Other operating income .....		41,039	64,004
<b>Net operating income before loan impairment recoveries and other credit risk provisions .....</b>		<b>2,027,462</b>	<b>2,055,840</b>
Loan impairment recoveries and other credit risk provisions .....	3	7,711	36,230
<b>Net operating income .....</b>		<b>2,035,173</b>	<b>2,092,070</b>
Employee compensation and benefits .....	4	(594,125)	(547,470)
General and administrative expenses .....		(433,897)	(504,659)
Depreciation and impairment of property, plant and equipment .....	21	(19,500)	(26,700)
Amortisation and impairment of intangible assets .....	19	(11,964)	(12,834)
<b>Total operating expenses .....</b>		<b>(1,059,486)</b>	<b>(1,091,663)</b>
<b>Operating profit .....</b>	3	<b>975,687</b>	<b>1,000,407</b>
Share of profit in associates .....	18	3,013	559
<b>Profit before tax .....</b>		<b>978,700</b>	<b>1,000,966</b>
Tax expense .....	7	(140,287)	(148,723)
<b>Profit for the year .....</b>		<b>838,413</b>	<b>852,243</b>
Profit attributable to shareholders of the parent company .....		821,514	837,036
Profit attributable to non-controlling interests .....		16,899	15,207

The accompanying notes on pages 12 to 106 form an integral part of these financial statements.

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

	2014 US\$000	2013 US\$000
Profit for the year.....	838,413	852,243
<b>Other comprehensive income/(expense)</b>		
<b>Items that will be reclassified subsequently to profit or loss when specific conditions are met:</b>		
Available-for-sale investments .....	(20,344)	15,175
– fair value (losses)/gains .....	(7,952)	5,870
– fair value (gains)/losses reclassified to the income statement on disposal.....	(13,790)	10,005
– income taxes .....	1,398	(700)
Cash flow hedges.....	(13,002)	(1,934)
– fair value losses.....	(13,679)	(2,768)
– income taxes .....	677	834
Exchange differences .....	(30,311)	(4,559)
<b>Items that will not be reclassified subsequently to profit or loss:</b>		
Remeasurement of defined benefit asset/liability .....	(20,486)	(3,925)
– before income taxes .....	(25,070)	(4,713)
– income taxes .....	4,584	788
Other comprehensive (expense)/income for the year, net of tax .....	(84,143)	4,757
Total comprehensive income for the year .....	<b>754,270</b>	<b>857,000</b>
Total comprehensive income for the year attributable to:		
– shareholders of the parent company .....	737,907	837,501
– non-controlling interests .....	16,363	19,499
	<b>754,270</b>	<b>857,000</b>

The accompanying notes on pages 12 to 106 form an integral part of these financial statements.

**Financial Statements** (continued)**Consolidated statement of financial position at 31 December 2014**

	Notes	2014 US\$000	2013 US\$000
<b>Assets</b>			
Cash and balances at central banks .....		952,640	1,573,701
Items in the course of collection from other banks .....		71,711	67,483
Trading assets .....	11	465,454	515,374
Derivatives .....	14	1,178,406	1,135,352
Loans and advances to banks .....	28	9,244,193	7,592,322
Loans and advances to customers .....	28	25,925,735	23,629,718
Reverse repurchase agreements – non-trading .....	15	18,533	24,455
Financial investments .....	16	10,397,639	11,267,242
Prepayments, accrued income and other assets .....	21	1,321,891	2,324,876
Current tax assets .....		1,127	6,289
Interests in associates .....	18	55,555	30,642
Intangible assets .....	19	47,449	56,284
Deferred tax assets .....	7	201,551	203,934
Total assets at 31 December .....		<b>49,881,884</b>	<b>48,427,672</b>
<b>Liabilities and equity</b>			
<b>Liabilities</b>			
Deposits by banks .....	28	2,483,030	1,379,473
Customer accounts .....	28	32,083,757	31,315,682
Items in the course of transmission to other banks .....		458,068	561,153
Trading liabilities .....	23	1,684,135	1,235,000
Financial liabilities designated at fair value .....	24	860,293	503,448
Derivatives .....	14	1,208,456	1,132,836
Debt securities in issue .....	25	3,174,957	3,206,249
Accruals, deferred income and other liabilities .....	26	2,025,672	3,172,456
Current tax liabilities .....		146,782	151,475
Provisions .....	27	27,961	64,008
Deferred tax liabilities .....	7	5,276	7,781
Total liabilities at 31 December .....		<b>44,158,387</b>	<b>42,729,561</b>
<b>Equity</b>			
Called up share capital .....	31	931,055	931,055
Other reserves .....		(9,110)	43,498
Retained earnings .....		4,393,142	4,319,879
Total equity attributable to shareholders of the parent company .....		<b>5,315,087</b>	<b>5,294,432</b>
Non-controlling interests .....		408,410	403,679
Total equity .....		<b>5,723,497</b>	<b>5,698,111</b>
Total equity and liabilities at 31 December .....		<b>49,881,884</b>	<b>48,427,672</b>

The accompanying notes on pages 12 to 106 form an integral part of these financial statements.

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

**Financial Statements** (continued)**Consolidated statement of cash flows for the year ended 31 December 2014**

	Notes	2014 US\$000	2013 US\$000
<b>Cash flows from operating activities</b>			
Profit before tax .....		978,700	1,000,966
Adjustments for:			
– net loss from investing activities .....		(25,864)	(4,443)
– share of profits in associates .....		(3,013)	(559)
– loss on disposal of businesses .....		26,985	-
– other non-cash items included in profit before tax .....	32	59,216	60,979
– change in operating assets .....	32	(120,046)	564,463
– change in operating liabilities .....	32	999,964	(2,526,921)
– elimination of exchange differences <sup>1</sup> .....		94,218	(5,584)
– dividends received from associates .....		-	547
– contributions paid for defined benefit plans .....		(696)	(835)
– tax paid .....		(143,950)	(126,674)
Net cash generated from/(used in) operating activities .....		<u>1,865,514</u>	<u>(1,038,061)</u>
<b>Cash flows from investing activities</b>			
Purchase of financial investments .....		(9,835,669)	(10,089,443)
Proceeds from the sale and maturity of financial investments .....		10,433,892	10,147,875
Purchase of property, plant and equipment .....		(18,427)	(18,381)
Proceeds from the sale of property, plant and equipment .....		11,770	1,248
Net purchase of intangible assets .....		(3,101)	(4,438)
Proceeds from the sale of intangible assets .....		15	100
Net cash outflow from increase in investment in associates.....		(21,900)	-
Net cash outflow from disposal of businesses .....		(14,586)	-
Net cash generated from investing activities .....		<u>551,994</u>	<u>36,961</u>
<b>Cash flows from financing activities</b>			
Redemption of non-equity preference shares .....		(725,000)	(100,000)
Issuance of non-equity preference shares .....		725,000	-
Dividends paid to shareholders of the parent company.....		(725,000)	(165,000)
Dividends paid to non-controlling interests .....		(11,365)	(2,545)
Net cash used in financing activities .....		<u>(736,365)</u>	<u>(267,545)</u>
<b>Net increase/(decrease) in cash and cash equivalents .....</b>		<b>1,681,143</b>	<b>(1,268,645)</b>
Cash and cash equivalents at 1 January .....		7,888,728	9,160,192
Exchange differences in respect of cash and cash equivalents .....		(125,406)	(2,819)
<b>Cash and cash equivalents at 31 December .....</b>	32	<b><u>9,444,465</u></b>	<b><u>7,888,728</u></b>

<sup>1</sup> 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 106 form an integral part of these financial statements.

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

	2014									
	Called up share capital US\$000	Retained earnings US\$000	Other reserves					Total share- holders' equity US\$000	Non- controlling interests US\$000	Total equity 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				
At 1 January .....	931,055	4,319,879	74,797	4,629	(22,121)	1,545	(15,352)	5,294,432	403,679	5,698,111
Profit for the year .....	-	821,514	-	-	-	-	-	821,514	16,899	838,413
Other comprehensive income (net of tax) .....	-	(20,431)	(19,732)	(13,002)	(30,388)	(54)	-	(83,607)	(536)	(84,143)
Available-for-sale investments .....	-	-	(19,714)	-	-	-	-	(19,714)	(630)	(20,344)
Cash flow hedges .....	-	-	-	(13,002)	-	-	-	(13,002)	-	(13,002)
Remeasurement of defined asset/liability .....	-	(20,693)	-	-	-	-	-	(20,693)	207	(20,486)
Exchange differences .....	-	262	(18)	-	(30,388)	(54)	-	(30,198)	(113)	(30,311)
Total comprehensive income for the year .....	-	801,083	(19,732)	(13,002)	(30,388)	(54)	-	737,907	16,363	754,270
Dividends to shareholders .....	-	(725,000)	-	-	-	-	-	(725,000)	(11,365)	(736,365)
Other movements .....	-	(2,820)	7,268	1,861	-	1,439	-	7,748	(267)	7,481
<b>At 31 December .....</b>	<b>931,055</b>	<b>4,393,142</b>	<b>62,333</b>	<b>(6,512)</b>	<b>(52,509)</b>	<b>2,930</b>	<b>(15,352)</b>	<b>5,315,087</b>	<b>408,410</b>	<b>5,723,497</b>

The accompanying notes on pages 12 to 106 form an integral part of these financial statements.

	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 .....	–	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
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 106 form an integral part of these financial statements.

## Notes on the Financial Statements

### 1 Basis of preparation and significant accounting policies

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

International Financial Reporting Standards ('IFRSs') comprise accounting standards issued or adopted by the International Accounting Standards Board ('IASB') as well as interpretations issued or adopted by the IFRS Interpretations Committee ('IFRS IC').

The consolidated financial statements of the group have been prepared in accordance with IFRSs as issued by the IASB and as endorsed by the EU. EU-endorsed IFRSs could differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs were not to be endorsed by the EU.

At 31 December 2014, there were no unendorsed standards effective for the year ended 31 December 2014 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 2014 are prepared in accordance with IFRSs as issued by the IASB.

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

There were no new standards applied during the year ended 31 December 2014.

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

During 2014, 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) Future accounting developments

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

#### **Standards and amendments issued by the IASB and endorsed by the EU but effective after 31 December 2014**

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

#### **Standards and amendments issued by the IASB but not endorsed by the EU**

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

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



## Notes on the Financial Statements (continued)

### *Classification and measurement*

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

### *Impairment*

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

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

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

### *Hedge accounting*

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

### *Transition*

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

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. The group intends to revise the presentation of fair value gains and losses relating to the entity's own credit risk on certain liabilities as soon as permitted by EU law. If this presentation was applied at 31 December 2014, the effect would be to increase or decrease profit before tax with the opposite effect on other comprehensive income based on the change in fair value attributable to changes in the

## Notes on the Financial Statements (continued)

group's credit risk for the year, with no effect on net assets. Further information on change in fair value attributable to changes in credit risk, including the group's credit risk, is disclosed in Note 33.

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

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

In order to make the financial statements and notes thereon easier to understand, the group has changed the location and the wording used to describe certain accounting policies within the notes, removed certain immaterial disclosures and changed the order of certain sections. In applying materiality to financial statement disclosures, we consider both the amount and nature of each item. The main changes to the presentation of the financial statements and notes thereon in 2014 are as follows:

- Consolidated statement of financial position and Consolidated statement of changes in equity: rationalised separate line item disclosure to focus on material information.
- Note 1 Summary of significant accounting policies: accounting policies have been placed, whenever possible, within the relevant Notes to the financial statements, and the changes in wording are intended to more clearly set out the accounting policies. These changes in wording do not represent changes in accounting policies.
- Critical accounting policies: replaced 'Critical accounting policies' with 'Critical accounting estimates and judgements' and placed them within the relevant Notes alongside the significant accounting policy to which they relate. The new approach meets the reporting requirements of IAS 1 'Presentation of Financial Statements'.
- Note 4 Employee compensation and benefits: rationalised to remove duplication and focus on material information. Disclosure on share based payments is now presented separately in Note 5.
- In 2013, the financial statements included Note 21 Assets held for sale and other assets, and Note 19 Property, plant and equipment. In 2014, separate notes for these areas have been removed and relevant information incorporated within Note 21 Prepayments, accrued income and other assets.

From 1 January 2014, the group has chosen to present non-trading reverse repos and repos separately on the face of the balance sheet. These items are classified for accounting purposes as loans and receivables or financial liabilities measured at amortised cost. Previously, they were presented on an aggregate basis together with other loans or deposits measured at amortised cost under the following headings in the consolidated balance sheet: 'Loans and advances to banks', 'Loans and advances to customers', 'Deposits by banks' and 'Customer accounts'. The separate presentation aligns disclosure of reverse repos and repos with market practice and provides more meaningful information in relation to loans and advances. Further explanation is provided in Note 15.

### (d) Presentation of information

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

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

### (e) Critical accounting estimates and judgements

The preparation of financial information requires the use of estimates and judgements about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items listed below, it is possible that the outcomes in the next financial

## Notes on the Financial Statements (continued)

year could differ from those on which management's estimates are based, resulting in material different conclusions from those reached by management for the purposes of the 2014 Financial Statements. Management's selection of the group's accounting policies which contain critical estimates and judgements is listed below; it reflects the materiality of the items to which the policies are applied, and the high degree of judgement and estimation uncertainty involved:

- Impairment of loans and advances: refer to Note 1(i);
- Valuation of financial instruments: refer to Note 12;
- Provisions: refer to Note 27;
- Valuation of intangible assets recognised in business combinations: refer to Note 19.

(f) Consolidation and related disclosures

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

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

Business combinations are accounted for using the acquisition method. The 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. For acquisitions 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.

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, based on financial statements made up to 31 December.

## Notes on the Financial Statements (continued)

### (g) Foreign currencies

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised either in other comprehensive income or in the income statement depending where the gain or loss on the underlying non-monetary item is recognised. In the consolidated financial statements, the assets and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not US dollars, are translated into the group's presentation currency at the rate of exchange at the balance sheet date, while their results are translated into US dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net assets, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate at the period end, are recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements and in other comprehensive income in consolidated accounts. On disposal of a foreign operation, exchange differences previously recognised in other comprehensive income are reclassified to the income statement as a reclassification adjustment.

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

These include loans and advances originated by the group, not classified as held for trading or designated at fair value. They are recognised when cash is advanced to a borrower and 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 impairment allowance.

Loans and advances are reclassified to 'Assets held for sale' when they meet the criteria presented in Note 21; however, their measurement continues to be in accordance with this policy.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. On drawdown, the loan is classified as held for trading. Where the group intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. On inception of the loan, the loan to be held is recorded at its fair value and subsequently measured at amortised cost. For certain transactions, such as leveraged finance and syndicated lending activities, the cash advanced may not be 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, the difference is charged to the income statement in other operating income. The write-down will be recovered over the life of the loan, through the recognition of interest income, unless the loan becomes impaired.

### (i) Impairment of loans and advances and available-for-sale financial assets

#### **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 or on groups of loans assessed collectively, are recorded as charges to the income statement and are recorded against the carrying amount of impaired loans on the balance sheet. Losses which may arise from future events are not recognised.

## Notes on the Financial Statements (continued)

### *Individually assessed loans and advances*

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio, 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 to make this assessment 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 costs of obtaining and selling collateral as part of foreclosure;
- 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.

### *Collectively assessed loans and advances*

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

## Notes on the Financial Statements (continued)

### *Incurred but not yet identified impairment*

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for a collective impairment assessment. These credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. This assessment captures 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. When information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed individually.

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 judgment 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 based on 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 may vary over time as these factors change.

### *Homogeneous groups of loans and advances*

Statistical methods are used to determine collective impairment losses for homogeneous groups of loans not considered individually significant. Losses in these groups of loans are recorded individually when individual loans are removed from the group and written off. The methods that are used to calculate collective allowances are:

- When appropriate empirical information is available, the group utilises roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date and which the group is not able to identify individually. Individual loans are grouped using ranges of past due days; statistical analysis is then used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics 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 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.
- 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. Where a basic formulaic approach is undertaken, the period between a loss event occurring and its identification is explicitly estimated by local management, and is typically between six and twelve months.

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 from the statistical models to reflect these changes as at the balance sheet date.

### *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

## Notes on the Financial Statements (continued)

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 those assets are classified as held for sale. 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. Impairments and reversal of previous impairments are recognised in the income statement, 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. They are segregated from other parts of the loan portfolio for the purposes of collective impairment assessment, to reflect their risk profile. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired. The carrying amounts of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument. Any new agreements arising due to a derecognition event will continue to be disclosed as renegotiated loans.

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

Available-for-sale financial assets are assessed at each balance sheet date for objective evidence of impairment. If such evidence exists 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 has an impact, which can be reliably measured, on the estimated future cash flows of the financial asset an impairment loss is recognised.

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

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

- *Available-for-sale debt securities.* In assessing objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. Financial difficulties of the issuer, as well as 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.

## Notes on the Financial Statements (continued)

- *Available-for-sale equity securities.* Objective evidence of impairment 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 equity 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 continuous 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, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the type of asset:

- 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 the fair value of the financial asset is recognised in other comprehensive income. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, or the instrument is no longer impaired, the impairment loss is reversed through the income statement;
- 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 in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred.

### (j) Operating income

#### **Interest income and expense**

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

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.

#### **Non-interest income and expense**

**Fee income** is earned from a diverse range of services provided by HSBC 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 the related interest income, expense and dividends.

**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.

The accounting policies for **net income/(expense) from financial instruments designated at fair value** are disclosed in Note 2.

**2 Net expense from financial instruments designated at fair value****Accounting policy**

Net expense from financial instruments designated at fair value includes:

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

Net expense on long-term debt issued and related derivatives

	2014 US\$000	2013 US\$000
Net expense arising on:		
- changes in own credit spread on long term debt .....	(6,133)	(3,746)
- other change in fair value.....	3,636	1,406
	<u>(2,497)</u>	<u>(2,340)</u>

**Notes on the Financial Statements** (continued)**3 Operating profit**

Other operating profit is stated after the following items of income, expense, gains and losses, and loan impairment charges and other credit risk provisions:

	2014 US\$000	2013 US\$000
<b>Income</b>		
Interest recognised on impaired financial assets .....	40,056	28,430
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 .....	476,661	464,745
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers .....	24,859	16,732
Income from listed investments .....	13,190	16,263
Income from unlisted investments .....	87,758	102,351
<b>Expense</b>		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value .....	(178,936)	(230,733)
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 .....	(30,662)	(30,329)
Fees payable relating to trust and other fiduciary activities where the group holds or invests assets on behalf of its customers .....	(19)	(30)
Payments under lease agreements .....	(32,424)	(36,387)
<b>Gains/(losses)</b>		
Impairment of available-for-sale equity securities .....	(23)	(196)
Losses recognised on assets held for sale .....	(26,985)	-
(Losses)/gains on disposal or settlement of loans and advances .....	(37)	2,631
Gains on disposal of property, plant and equipment, intangible assets and non-financial investments .....	6,296	329
<b>Loan impairment credit and other credit risk provisions</b>		
Net impairment credit on loans and advances .....	1,997	38,906
Impairment of available-for-sale debt securities .....	(15)	(50)
Release/(impairment) in respect of other credit risk provisions .....	5,729	(2,626)

**4 Employee compensation and benefits**

	2014 US\$000	2013 US\$000
Wages and salaries .....	561,379	517,941
Social security costs .....	8,871	7,744
Post-employment benefits .....	23,875	21,785
	<b>594,125</b>	<b>547,470</b>
<i>Average number of persons employed by the group during the year</i>		
	2014	2013
UAE .....	3,148	2,860
Oman .....	1,134	1,254
Qatar .....	323	353
Rest of Middle East .....	1,027	1,286
	<b>5,632</b>	<b>5,753</b>

## Notes on the Financial Statements (continued)

### Post employment benefit plans

#### Accounting policy

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 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.

#### Income statement charge

	2014 US\$000	2013 US\$000
Defined benefit pension plans .....	19,074	16,679
Defined contribution pension plans .....	4,801	5,106
	<b>23,875</b>	<b>21,785</b>

**Notes on the Financial Statements** (continued)*Income statement charge: deferred bonuses*

	Current year Bonus pool <sup>1</sup> US\$000	Prior year bonus pools US\$000	Total US\$000
<b>2014</b>			
Charge recognised in 2014 .....	6,469	10,149	16,618
Deferred share awards .....	3,506	8,711	12,217
Deferred cash awards .....	2,963	1,438	4,401
Charge expected to be recognised in 2015 or later .....	6,024	7,079	13,103
Deferred share awards .....	3,998	5,961	9,959
Deferred cash awards .....	2,026	1,118	3,144
<b>2013</b>			
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

<sup>1</sup> Current year bonus pool relates to the bonus pool declared for the reporting period (2014 for the current year, 2013 for the 2013 comparatives).

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

	2014 US\$000	2013 US\$000
Defined benefit pension plans .....	<u>121,152</u>	<u>95,473</u>

*Cumulative actuarial losses recognised in other comprehensive income*

	2014 US\$000	2013 US\$000
Defined benefit pension plans .....	<u>(56,689)</u>	<u>(31,183)</u>

**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)**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 %
<b>At 31 December 2014</b>			
United Arab Emirates .....	<b>2.19</b>	<b>5.00</b>	<b>12.00</b>
<b>At 31 December 2013</b>			
United Arab Emirates .....	2.65	5.00	12.00

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 charge/(credit) from 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	
	2014	2013
	US\$000	US\$000
<b>Discount rate</b>		
Change in scheme obligation at year end from a 25bps increase .....	<b>(1,844)</b>	(1,366)
Change in scheme obligation at year end from a 25bps decrease .....	<b>1,905</b>	1,412
Change in following year scheme cost from a 25bps increase .....	<b>(126)</b>	(97)
Change in following year scheme cost from a 25bps decrease .....	<b>127</b>	99
<b>Rate of pay increase</b>		
Change in scheme obligation at year end from a 25bps increase .....	<b>1,963</b>	1,463
Change in scheme obligation at year end from a 25bps decrease .....	<b>(1,911)</b>	(1,423)
Change in following year scheme cost from a 25bps increase .....	<b>435</b>	335
Change in following year scheme cost from a 25bps decrease .....	<b>(424)</b>	(326)

## Notes on the Financial Statements (continued)

## Net asset/(liability) under defined benefit pension plans

	Fair value of plan assets US\$000	Present value of defined benefit obligations US\$000	Net defined benefit liability US\$000
<b>Net defined liability</b>			
<b>At 1 January 2014</b>	6,849	(102,322)	(95,473)
Current service cost .....	-	(16,715)	(16,715)
Service cost .....	-	(16,715)	(16,715)
Net interest cost on the net defined benefit liability .....	-	(2,359)	(2,359)
Remeasurement effects recognised in other comprehensive income .	252	(25,322)	(25,070)
- Return on plan assets (excluding interest income) .....	252	-	252
- Actuarial losses from changes in financial assumptions .....	-	(25,322)	(25,322)
Exchange differences and other movements .....	(162)	10,702	10,540
Contributions by the group - Normal .....	696	-	696
Contributions by employees .....	-	(69)	(69)
Benefits paid .....	(405)	10,049	9,644
Disposals .....	(2,336)	(10)	(2,346)
<b>At 31 December 2014</b> .....	<b>4,894</b>	<b>(126,046)</b>	<b>(121,152)</b>
Retirement benefit liabilities recognised on the balance sheet .....			(121,152)
Present value of defined benefit obligation relating to: .....		(126,046)	
- Actives .....		(110,956)	
- Deferreds .....		(10,196)	
- Pensioners .....		(4,894)	
<b>Net defined liability</b>			
<b>At 1 January 2013</b>	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 - Normal .....	835	-	835
Contributions by employees .....	-	(28)	(28)
Benefits paid .....	(278)	10,838	10,560
<b>At 31 December 2013</b> .....	<b>6,849</b>	<b>(102,322)</b>	<b>(95,473)</b>
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)	

## Notes on the Financial Statements (continued)

### 5 Share based payments

#### Accounting policy

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 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.

'Wages and salaries' include the impact of share-based payments arrangements, of which US\$18.1 million are equity settled (2013: US\$18.8 million), as follows:

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Restricted and performance share awards .....	<b>17,916</b>	18,419
Savings-related and other share options plans .....	<b>201</b>	347
	<b>18,117</b>	18,766

The share based payments income statement charge above includes US\$12.2 million (2013: US\$16.9 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\$4.4 million (2013: US\$4.5 million) in respect of deferred cash awards for current and prior performance years.

## Notes on the Financial Statements (continued)

### Share based payments

#### HSBC Share Awards

Award	Policy	Purpose
Restricted share awards (including GPSP awards)	<ul style="list-style-type: none"> <li>Vesting of awards generally subject to continued employment with HSBC</li> <li>Vesting often staggered over three years. GPSP awards vest after five years</li> <li>Certain shares subject to a retention requirement postvesting. In the case of GPSP awards retention applies until cessation of employment</li> <li>Awards generally not subject to performance conditions</li> <li>Awards granted from 2010 onwards are subject to clawback provision prior to vesting</li> </ul>	<ul style="list-style-type: none"> <li>Rewards employee performance and potential and retention of key employees</li> <li>To defer variable pay</li> </ul>

#### Movement on HSBC share awards

	Restricted share awards	
	2014 Number (000's)	2013 Number (000's)
Outstanding at 1 January .....	2,159	3,537
Additions during the year .....	1,139	939
Released and forfeited in the year .....	(1,326)	(2,317)
Outstanding at 31 December .....	1,972	2,159
Weighted average fair value of awards granted (£)	6.16	7.35

### HSBC Share Option Plans

Main plans	Policy	Purpose
Savings-related share option plans	<ul style="list-style-type: none"> <li>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</li> <li>The exercise price is set at a 20% (2013: 20%) discount to the market value immediately preceding the date of invitation</li> </ul>	<ul style="list-style-type: none"> <li>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</li> <li>To align the interests of all employees with the creation of shareholder value</li> </ul>
HSBC Holdings Group share option plan	<ul style="list-style-type: none"> <li>Plan ceases in May 2005</li> <li>Exercisable between third and tenth anniversaries of the date of grant</li> </ul>	<ul style="list-style-type: none"> <li>Long-term incentive plan between 2000 and 2005 during which certain HSBC employees were awarded share options</li> </ul>

### 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)

## Movement on HSBC share option plans

	Savings-related share option plans		HSBC Holdings Group Share option plan	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
<b>2014</b>				
Outstanding at 1 January .....	683	3.79	478	7.22
Granted during the year .....	2	5.19	-	-
Exercised during the year .....	(294)	3.53	-	-
Transferred during the year .....	(44)	4.54	2	7.22
Forfeited and expired in the year .....	(39)	5.19	(480)	7.22
Outstanding at 31 December .....	<b>308</b>	<b>3.92</b>	-	-
Weighted average remaining contractual life (years) .....		<b>0.95</b>		-

	Savings-related share option plans		HSBC Holdings Group Share option plan	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
<b>2013</b>				
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 .....	<b>683</b>	<b>3.79</b>	<b>478</b>	<b>7.22</b>
Weighted average remaining contractual life (years) .....		1.21		-

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

	1-year Savings-Related Share Option Plans	3-year Savings-Related Share Option Plans	5-year Savings-Related Share Option Plans
<b>2014</b>			
Risk-free interest rate <sup>1</sup> (%) .....	n/a	1.38	1.89
Expected life (years) .....	n/a	3	5
Expected volatility <sup>2</sup> (%).....	n/a	20	20
Share price at grant date (£) .....	n/a	6.52	6.52
<b>2013</b>			
Risk-free interest rate <sup>1</sup> (%) .....	n/a	0.91	1.73
Expected life (years) .....	n/a	3	5
Expected volatility <sup>2</sup> (%) .....	n/a	20	20
Share price at grant date (£) .....	n/a	6.89	6.89

<sup>1</sup> The risk-free rate was determined from the UK gilts yield curve.

<sup>2</sup> 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 (2013: 4.5%).

**Notes on the Financial Statements** (continued)**6 Auditors' remuneration**

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Audit fees payable to KPMG.....	<b>980</b>	972
Audit fees payable to non-KPMG entities .....	<b>88</b>	68
Total auditor's remuneration for year ended 31 December .....	<b>1,068</b>	1,040

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

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Audit fees for HSBC Bank Middle East Limited statutory audit:		
– fees relating to current year .....	<b>949</b>	949
– fees relating to prior year .....	<b>31</b>	23
	<b>980</b>	972
Fees payable to KPMG for other services provided to the group		
– other services pursuant to legislation .....	<b>935</b>	839
– tax related services .....	<b>201</b>	112
– all other services .....	<b>182</b>	319
	<b>1,318</b>	1,270
Total fees payable for year ended 31 December .....	<b>2,298</b>	2,242

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.

**7 Tax****Accounting policy**

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.

**Notes on the Financial Statements** (continued)

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.

	2014 US\$000	2013 US\$000
<b>Current tax</b>		
Tax – on current year profit .....	153,954	141,581
Tax – adjustments in respect of prior years .....	<b>(22,804)</b>	13,578
	<b>131,150</b>	155,159
<b>Deferred tax</b>		
Origination and reversal of temporary differences .....	4,441	7,124
Adjustment in respect of prior years .....	<b>4,696</b>	(13,560)
	<b>9,137</b>	(6,436)
Tax expense .....	<b>140,287</b>	148,723

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

**Tax reconciliation**

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

	2014		2013	
	US\$000	Percentage of profit before tax %	US\$000	Percentage of profit before tax %
Taxation at UAE corporate tax rate of 20% (2013: 20 %) .....	195,740	20.0	200,193	20.0
Effect of taxing overseas profit in principal locations at different rates.....	<b>(12,203)</b>	<b>(1.2)</b>	(20,266)	(2.0)
Adjustment in respect of prior period liabilities .....	<b>(18,108)</b>	<b>(1.9)</b>	18	0.0
Deferred tax temporary differences not recognised .....	<b>(73)</b>	<b>(0.0)</b>	(307)	(0.0)
Effect of profits in associates	<b>(648)</b>	<b>(0.1)</b>	(5)	(0.0)
Non-taxable income and gains .....	<b>(37,749)</b>	<b>(3.9)</b>	(45,497)	(4.6)
Permanent disallowables .....	8,594	0.9	10,517	1.1
Local taxes and overseas withholding taxes	3,474	0.4	1,900	0.2
Other items .....	1,260	0.1	2,170	0.2
Overall tax expense <sup>1</sup> .....	<b>140,287</b>	<b>14.3</b>	148,723	14.9

<sup>1</sup> The Effective Tax Rate (ETR) for 2014 is lower than that of 2013 by 0.6%. This primarily resulted from the release of prior years' tax provisions in 2014 due to the closure of tax assessments for prior years (1.9% decrease) partly offset by increase in profits in higher tax areas (0.8% increase) and reduction in non taxable gains (0.7% increase).

**Notes on the Financial Statements** (continued)

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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\$6.7 million increase in equity (2013: US\$0.9 million increase in equity).

The group is subject to income taxes in many jurisdictions and significant judgement is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some future point in time. 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	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 .....	6,351	180,638	145	(687)	(1,736)	104	-	-	19,119	203,934
Liabilities .....	-	-	-	(5,058)	-	-	(2,292)	-	(431)	(7,781)
At 1 January 2014 .....	6,351	180,638	145	(5,745)	(1,736)	104	(2,292)	-	18,688	196,153
Acquisition and disposals .....	-	(70)	-	-	-	-	-	-	-	(70)
Income statement .....	332	(1,061)	-	(4,035)	-	(104)	959	-	(5,228)	(9,137)
Other comprehensive income: .....	-	-	-	-	-	-	-	-	-	-
- available-for-sale investment .....	-	-	-	1,398	-	-	-	-	-	1,398
- cash flow hedges .....	-	-	-	-	677	-	-	-	-	677
- actuarial losses .....	4,584	-	-	-	-	-	-	-	-	4,584
Equity: .....	-	-	-	-	-	-	-	-	-	-
- share based payments .....	-	-	-	-	-	-	-	-	-	-
Foreign exchange and other adjustments ...	3	(2,431)	(145)	4,429	1,059	-	10	-	(255)	2,670
	<b>11,270</b>	<b>177,076</b>	<b>-</b>	<b>(3,953)</b>	<b>-</b>	<b>-</b>	<b>(1,323)</b>	<b>-</b>	<b>13,205</b>	<b>196,275</b>
Assets .....	11,270	177,076	-	-	-	-	-	-	13,205	201,551
Liabilities .....	-	-	-	(3,953)	-	-	(1,323)	-	-	(5,276)
At 31 December 2014 .....	11,270	177,076	-	(3,953)	-	-	(1,323)	-	13,205	196,275
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: .....	-	-	-	-	-	11	-	-	-	11
- share based payments .....	-	-	-	-	-	11	-	-	-	11
Foreign exchange and other adjustments ...	(505)	14,593	203	63	(834)	1,866	(808)	808	(17,462)	(2,076)
	<b>6,351</b>	<b>180,638</b>	<b>145</b>	<b>(5,745)</b>	<b>(1,736)</b>	<b>104</b>	<b>(2,292)</b>	<b>-</b>	<b>18,688</b>	<b>196,153</b>
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

**Notes on the Financial Statements** (continued)*Analysis of deferred tax assets by country*

	2014 US\$000	2013 US\$000
UAE .....	189,970	187,893
Oman .....	7,786	10,288
Qatar .....	-	-
Rest of Middle East .....	3,795	5,753
	<b>201,551</b>	<b>203,934</b>

**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 (2013: US\$Nil).

**8 Dividends***Dividends to shareholders of the parent company*

	2014		2013	
	US\$ per share	Total US\$000	US\$ per share	Total US\$000
Dividends declared on ordinary shares.....	0.7787	725,000	0.1772	165,000

During the year a third interim dividend for 2013 of US\$70 million was declared on 13 February 2014 (paid 24 February 2014) and the first, second and third interim dividends for 2014 of US\$150 million, US\$305 million and US\$200m (2013: US\$165 million) were declared on 1 May 2014, 23 July 2014 and 20 October 2014 and were paid on 12 May 2014, 30 July 2014 and 28 October 2014, respectively.

On 10 February 2015 the Directors declared a fourth interim dividend of US\$135 million in respect of the financial year ended 31 December 2014.

**9 Segment analysis****Accounting Policy**

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, Kuwait, Lebanon, 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 group's structure, the analysis of profits shown below 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.

**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.

**Notes on the Financial Statements** (continued)

- 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.

## 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
<b>2014</b>						
Net interest income .....	707,631	126,914	92,991	184,629	-	1,112,165
Net fee income .....	363,243	32,629	71,700	91,203	-	558,775
Net trading income .....	202,727	18,770	34,146	29,108	-	284,751
Other income .....	130,322	8,131	4,468	4,261	(75,411)	71,771
Loan impairment (charges)/recoveries and other credit risk provisions .....	(19,837)	(6,989)	5,749	28,788	-	7,711
Net operating income .....	1,384,086	179,455	209,054	337,989	(75,411)	2,035,173
Total operating expenses .....	(735,143)	(145,622)	(93,845)	(160,287)	75,411	(1,059,486)
Operating profit .....	648,943	33,833	115,209	177,702	-	975,687
Share of profit in associates .....	3,013	-	-	-	-	3,013
Profit before tax .....	651,956	33,833	115,209	177,702	-	978,700
<b>By global business:</b>						
Retail Banking and Wealth Management .....	154,244	(1,446)	8,370	6,945	-	168,113
Commercial Banking .....	190,305	19,686	41,816	90,637	-	342,444
Global Banking and Markets .....	357,758	16,505	65,164	82,407	-	521,834
Global Private Banking .....	(241)	-	-	-	-	(241)
Other <sup>1</sup> .....	(50,110)	(912)	(141)	(2,287)	-	(53,450)

## Notes on the Financial Statements (continued)

	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 income .....	141,293	5,258	4,061	3,286	(79,083)	74,815
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 <sup>1</sup> .....	(75,966)	–	–	21	–	(75,945)

<sup>1</sup> The main items reported in the 'Other' category are Head Office operations costs and movements in fair value of own debt.

## Balance sheet information

	UAE US\$000	Oman US\$000	Qatar US\$000	Rest of Middle East US\$000	Intra- group items US\$000	Total US\$000
<b>Year ended 31 December 2014</b>						
Loans and advances to customers (net) .....	18,105,409	3,019,436	1,842,314	2,958,576	–	25,925,735
Interest in associates .....	55,555	–	–	–	–	55,555
Total assets .....	34,199,384	5,895,023	4,932,274	6,664,348	(1,809,145)	49,881,884
Customer accounts .....	19,779,987	4,792,644	3,070,940	4,440,186	–	32,083,757
Total liabilities .....	29,321,723	5,067,495	4,921,929	6,656,385	(1,809,145)	44,158,387
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
Investment 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

## Other financial information

## Net operating income by global business

	RBWM US\$000	CMB US\$000	GB&M US\$000	GPB US\$000	Other <sup>2</sup> US\$000	Inter Segment US\$000	Total US\$000
<b>Year ended 31 December 2014</b>							
Net operating income <sup>1</sup> .....	665,445	667,048	707,752	778	61,850	(75,411)	2,027,462
External .....	602,700	715,989	754,058	14	(45,299)	–	2,027,462
Internal .....	62,745	(48,941)	(46,306)	764	107,149	(75,411)	–
Year ended 31 December 2013							
Net operating income <sup>1</sup> .....	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
Internal .....	100,320	(44,835)	(93,579)	742	116,435	(79,083)	–

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

<sup>2</sup> 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 2014		31 December 2013	
	External net operating income <sup>1</sup> US\$000	Non-current assets <sup>2</sup> US\$000	External net operating income <sup>1</sup> US\$000	Non-current assets <sup>2</sup> US\$000
UAE .....	1,332,453	109,893	1,317,110	88,875
Oman .....	184,401	104,166	178,527	112,847
Qatar .....	203,067	7,598	196,869	8,836
Rest of Middle East .....	307,541	27,542	363,334	29,416
<b>Total .....</b>	<b>2,027,462</b>	<b>249,199</b>	<b>2,055,840</b>	<b>239,974</b>

<sup>1</sup> 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.

<sup>2</sup> 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.

*Performance ratios*

	UAE	Oman	Qatar	Rest of Middle East	Total
	%	%	%	%	%
<b>Year ended 31 December 2014</b>					
Share of the group's profit before tax .....	66.5	3.5	11.8	18.2	100.0
Cost efficiency ratio .....	52.4	78.1	46.2	51.8	52.3
<b>Year ended 31 December 2013</b>					
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

**10 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. Note 12 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 financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading.

## Notes on the Financial Statements (continued)

	At 31 December 2014					
	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 hedging instruments US\$000	Total US\$000
<b>Financial assets</b>						
Cash and balances at central banks .....	-	-	-	952,640	-	952,640
Items in the course of collection from other banks .....	-	-	-	71,711	-	71,711
Trading assets .....	465,454	-	-	-	-	465,454
Derivatives .....	1,170,501	-	-	-	7,905	1,178,406
Loans and advances to banks .....	-	-	-	9,244,193	-	9,244,193
Loans and advances to customers .....	-	-	-	25,925,735	-	25,925,735
Reverse repurchase agreements .....	-	-	-	18,533	-	18,533
Financial investments .....	-	-	10,397,639	-	-	10,397,639
Assets held for sale .....	-	-	-	-	-	-
Other assets .....	-	-	-	1,047,046	-	1,047,046
Accrued income .....	-	-	-	102,506	-	102,506
Total financial assets .....	1,635,955	-	10,397,639	37,362,364	7,905	49,403,863
Total non-financial assets .....	-	-	-	-	-	478,021
Total assets .....	-	-	-	-	-	49,881,884
<b>Financial liabilities</b>						
Deposits by banks .....	-	-	-	2,483,030	-	2,483,030
Customer accounts .....	-	-	-	32,083,757	-	32,083,757
Items in the course of transmission to other banks .....	-	-	-	458,068	-	458,068
Trading liabilities .....	1,684,135	-	-	-	-	1,684,135
Financial liabilities designated at fair value ..	-	860,293	-	-	-	860,293
Derivatives .....	1,170,742	-	-	-	37,714	1,208,456
Debt securities in issue .....	-	-	-	3,174,957	-	3,174,957
Liabilities of disposal groups held for sale ..	-	-	-	-	-	-
Other liabilities .....	-	-	-	1,719,423	-	1,719,423
Accruals .....	-	-	-	64,412	-	64,412
Total financial liabilities .....	2,854,877	860,293	-	39,983,647	37,714	43,736,531
Total non-financial liabilities .....	-	-	-	-	-	421,856
Total liabilities .....	-	-	-	-	-	44,158,387

## Notes on the Financial Statements (continued)

	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 hedging instruments US\$000	Total US\$000
<b>Financial assets</b>						
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 .....	<u>1,625,214</u>	<u>–</u>	<u>11,523,828</u>	<u>34,751,538</u>	<u>26,297</u>	<u>47,926,877</u>
Total non-financial assets .....						<u>500,795</u>
Total assets .....						<u>48,427,672</u>
<b>Financial liabilities</b>						
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 .....	<u>2,368,452</u>	<u>503,448</u>	<u>–</u>	<u>39,413,018</u>	<u>–</u>	<u>42,284,918</u>
Total non-financial liabilities .....						<u>444,643</u>
Total liabilities .....						<u>42,729,561</u>

## 11 Trading assets

## Accounting policy

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 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 sold. 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'.

**Notes on the Financial Statements** (continued)

For trading assets, the interest is shown in net trading income.

	2014 US\$000	2013 US\$000
Trading assets:		
– not subject to repledge or resale by counterparties .....	<b>465,454</b>	515,374
Treasury and other eligible bills .....	<b>175,141</b>	109,046
Debt securities .....	<b>216,074</b>	303,121
Equity securities .....	<b>33</b>	-
Trading securities at fair value .....	<b>391,248</b>	412,167
Loans and advances to banks .....	<b>72,663</b>	87,049
Loans and advances to customers .....	<b>1,543</b>	16,158
	<b>465,454</b>	515,374

**12 Fair value of financial instruments carried at fair value****Accounting policy***Valuation of financial instruments*

All financial instruments are recognised initially at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is 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.

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

**Critical accounting estimates and judgements***Valuation of financial instruments*

The best evidence of fair value is a quoted price in an actively traded principal 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. 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. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

## Notes on the Financial Statements (continued)

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate;
- 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.

A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering 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 on more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may affect 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 or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

### 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,

## Notes on the Financial Statements (continued)

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.

### Financial liabilities measured at fair value

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

Structured notes issued and certain other hybrid instrument liabilities are included within 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 HSBC 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 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.

**Notes on the Financial Statements** (continued)

The following table sets out the financial instruments by fair value hierarchy.

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

	Valuation techniques			Total US\$000
	Quoted market price Level 1 US\$000	Using observable inputs Level 2 US\$000	With significant non-observable inputs Level 3 US\$000	
<b>Recurring fair value measurements</b>				
<b>At 31 December 2014</b>				
Assets				
Trading assets .....	–	465,454	–	465,454
Derivatives .....	–	1,175,898	2,508	1,178,406
Financial investments: available for sale	–	10,281,291	116,348	10,397,639
Liabilities				
Trading liabilities .....	–	1,684,135	–	1,684,135
Financial liabilities designated at fair value .....	860,293	–	–	860,293
Derivatives .....	–	1,197,057	11,399	1,208,456
<b>Non-recurring fair value measurements</b>				
<b>Assets of disposal groups held for sale</b>				
Derivatives .....	–	–	–	–
Financial investments: available for sale	–	–	–	–
<b>Liabilities of disposal groups held for sale</b>				
Derivatives .....	–	–	–	–
Recurring fair value measurements				
<b>At 31 December 2013</b>				
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

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.

**Fair value adjustments**

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

#### *Debit valuation adjustment*

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

### Model-related adjustments

#### *Model limitation*

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

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

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

### Credit valuation adjustment/debit valuation adjustment methodology

The 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

Historically, the group has valued uncollateralised derivatives by discounting expected future cash flows at a benchmark interest rate, typically Libor or its equivalent. In line with evolving industry



**Notes on the Financial Statements** (continued)

practice, in the second half of 2014, the group revised its estimation methodology for valuing the uncollateralised derivative portfolios by introducing a funding fair value adjustment ('FFVA'). The FFVA adjustment reflects the estimated present value of the future market funding cost or benefit associated with funding uncollateralised derivative exposure. The impact of FFVA adoption in 2014 is a reduction in net trading income of US\$4.7 million. This is an area in which a full industry consensus has not yet emerged and the group will continue to monitor industry evolution and refine the calculation methodology as necessary .

## 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
<b>At 31 December 2014</b>				
Private equity including strategic investments .....	116,132	–	–	–
Other derivatives .....	–	–	2,508	11,399
Other portfolios .....	216	–	–	–
	<u>116,348</u>	<u>–</u>	<u>2,508</u>	<u>11,399</u>
<b>At 31 December 2013</b>				
Private equity including strategic investments .....	138,722	–	–	–
Other derivatives .....	–	–	1,394	2,680
Other portfolios .....	20,640	–	–	–
	<u>159,362</u>	<u>–</u>	<u>1,394</u>	<u>2,680</u>

**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 tranching CDS transactions.

**Notes on the Financial Statements** (continued)**Other portfolios**

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

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

The following table provides a reconciliation of the movements between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant observable inputs:

*Movement in Level 3 financial instruments*

	Assets			Liabilities
	Available-for-sale US\$000	Held for Trading US\$000	Derivatives US\$000	Derivatives US\$000
<b>At 1 January 2014</b> .....	<b>159,362</b>	-	<b>1,394</b>	<b>2,680</b>
Total gains recognised in profit or loss:				
- Gains less losses from financial investments .....	<b>7,261</b>	-	-	-
- Trading income excluding net interest income.....	-	-	<b>1,114</b>	<b>8,719</b>
Total losses recognised in other comprehensive income:				
- Available-for-sale investments: fair value losses .....	<b>(8,488)</b>	-	-	-
- Exchange differences .....	<b>(17)</b>	-	-	-
Purchases.....	-	-	-	-
Sales.....	<b>(42,007)</b>	-	-	-
Transfers out.....	-	-	-	-
Transfers in.....	<b>237</b>	-	-	-
<b>At 31 December 2014</b> .....	<b>116,348</b>	-	<b>2,508</b>	<b>11,399</b>
Unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held at 31 December 2014				
- Trading income excluding net interest income.....	-	-	<b>2,508</b>	<b>(11,399)</b>
At 1 January 2013.....	554,163	85,305	3,608	401
Total losses recognised in profit or loss:				
- Gains less losses from financial investments .....	(525)	-	-	-
- Trading income excluding net interest income.....	-	(2,559)	(2,180)	2,279
Total gains recognised in other comprehensive income:				
- Available-for-sale investments: fair value gains.....	13,930	-	-	-
- Exchange differences .....	151	-	-	-
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
Unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held at 31 December 2013				
- Trading income excluding net interest income.....	-	-	1,394	(2,680)

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)

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

The following table shows the sensitivity of level 3 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
<b>At 31 December 2014</b>				
Derivatives, trading assets and trading liabilities <sup>1</sup> .....	–	–	–	–
Financial investments: available for sale ....	–	–	5,828	(11,636)
<b>At 31 December 2013</b>				
Derivatives, trading assets and trading liabilities <sup>1</sup> .....	–	–	–	–
Financial investments: available for sale ....	–	–	5,548	(18,553)

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

#### 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
<b>At 31 December 2014</b>				
Private equity including strategic investments .....	–	–	5,806	(11,624)
Other derivatives .....	–	–	–	–
Other portfolios .....	–	–	22	(22)
<b>At 31 December 2013</b>				
Private equity including strategic investments .....	–	–	3,484	(16,469)
Other derivatives .....	–	–	–	–
Other portfolios .....	–	–	2,064	(2,064)

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

## Notes on the Financial Statements (continued)

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.

### *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 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.

## Notes on the Financial Statements (continued)

### *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.

### *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.

**Notes on the Financial Statements** (continued)**13 Fair values of financial instruments not carried at fair value**

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

	Carrying amount US\$000	Fair value Valuation techniques			Total US\$000
		Quoted market price Level 1 US\$000	Using observable inputs Level 2 US\$000	With significant unobservable inputs Level 3 US\$000	
<b>At 31 December 2014</b>					
<b>Assets and liabilities not held for sale</b>					
<b>Assets</b>					
Loans and advances to banks .....	9,244,193	-	9,249,270	-	9,249,270
Loans and advances to customers .....	25,925,735	-	-	25,600,219	25,600,219
Reverse repurchase agreements .....	18,533	-	18,533	-	18,533
<b>Liabilities</b>					
Deposits by banks .....	2,483,030	-	2,478,606	-	2,478,606
Customer accounts .....	32,083,757	-	32,235,248	-	32,235,248
Debt securities in issue .....	3,174,957	-	3,115,157	-	3,115,157
<b>At 31 December 2013</b>					
<b>Assets and liabilities not held for sale</b>					
<b>Assets</b>					
Loans and advances to banks .....	7,592,322	-	7,601,939	-	7,601,939
Loans and advances to customers .....	23,629,718	-	-	23,650,833	23,650,833
Reverse repurchase agreements .....	24,455	-	24,455	-	24,455
<b>Liabilities</b>					
Deposits by banks .....	1,379,473	-	1,387,371	-	1,387,371
Customer accounts .....	31,315,682	-	31,391,798	-	31,391,798
Debt securities in issue .....	3,206,249	-	3,182,000	-	3,182,000

Fair values are determined according to the hierarchy set out in Note 12.

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

**Valuation**

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

Fair values of the following assets and liabilities are estimated for the purpose of disclosure as described below:

**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.

## Notes on the Financial Statements (continued)

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

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

### Financial investments

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

### Deposits by banks and customer accounts

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

### Debt securities in issue and subordinated liabilities

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

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

Fair values are estimated by using discounted cash flows, applying current rates. Fair values approximate carrying amounts as their balances are generally short dated.

## 14 Derivatives

### Accounting policy

#### Derivatives

Derivatives are initially recognised, and are subsequently remeasured, at fair value. Fair values of derivatives are obtained either from quoted market prices or by using valuation techniques. Derivative assets and liabilities arising from different transactions are only offset for accounting purposes if the offsetting criteria are met.

Embedded derivatives are treated as separate derivatives ('bifurcated') when their economic characteristics and risks are not clearly and closely related to those of the host non-derivative contract, their contractual terms would otherwise meet the definition of a stand-alone derivative and the combined contract is not held for trading or designated at fair value. The bifurcated 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 only offset if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

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

## Notes on the Financial Statements (continued)

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.

### Hedge accounting

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 a net investment in a foreign operation ('net investment hedges').

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and the hedged items, its risk management objective and its strategy for undertaking the hedge. The group requires documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items.

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

#### *Cash flow hedge*

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income; the ineffective portion of the change in fair value 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 affects profit or loss. In hedges of forecasted transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability.

When a hedging relationship is discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the income statement.

#### *Net investment hedge*

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; the residual change in fair value 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 both prospectively and retrospectively, on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed and 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, with the effectiveness range being defined as 80% to 125%. Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.



**Notes on the Financial Statements** (continued)*Derivatives that do not qualify for hedge accounting*

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

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

	Assets			Liabilities		
	Trading US\$000	Hedging US\$000	Total US\$000	Trading US\$000	Hedging US\$000	Total US\$000
<b>At 31 December 2014</b>						
Foreign exchange .....	499,389	373	499,762	503,022	36,191	539,213
Interest rate .....	500,744	7,532	508,276	489,164	1,523	490,687
Equity .....	4,041	-	4,041	4,041	-	4,041
Credit .....	115,960	-	115,960	124,148	-	124,148
Commodity and other .....	50,367	-	50,367	50,367	-	50,367
Gross total fair values .....	<u>1,170,501</u>	<u>7,905</u>	<u>1,178,406</u>	<u>1,170,742</u>	<u>37,714</u>	<u>1,208,456</u>
Netting .....			-			-
Total .....			<u>1,178,406</u>			<u>1,208,456</u>

	Assets			Liabilities		
	Trading US\$000	Hedging US\$000	Total US\$000	Trading US\$000	Hedging US\$000	Total US\$000
<b>At 31 December 2013</b>						
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 .....	<u>1,109,055</u>	<u>26,297</u>	<u>1,135,352</u>	<u>1,132,836</u>	<u>-</u>	<u>1,132,836</u>
Netting .....			-			-
Total .....			<u>1,135,352</u>			<u>1,132,836</u>

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.

**Use of derivatives**

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

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

**Trading derivatives**

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

Other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness.

**Notes on the Financial Statements** (continued)

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*

	2014 US\$000	2013 US\$000
Foreign exchange .....	64,777,128	42,587,684
Interest rate .....	46,323,363	43,499,966
Equity .....	237,282	228,516
Credit .....	7,710,900	7,230,351
Commodity and other .....	129,574	57,061
	<b>119,178,247</b>	<b>93,603,578</b>

**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:

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

	2014 US\$000	2013 US\$000
Unamortised balance at 1 January .....	–	–
Deferral on new transactions.....	–	1,136
Recognised in the income statement during the period:		
- subsequent to unobservable inputs becoming observable .....	–	(346)
- maturity or termination, or offsetting derivatives .....	–	–
Risk hedged .....	–	(790)
Unamortised balance at 31 December .....	<b>–</b>	<b>–</b>

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

**Notes on the Financial Statements** (continued)*Notional contract amounts of derivatives held for hedge accounting purposes by product type*

	2014		2013	
	Fair value hedge	Cash flow hedge	Fair value hedge	Cash flow hedge
	US\$000	US\$000	US\$000	US\$000
Foreign exchange .....	-	1,587,485	-	361,266
Interest rate .....	172,538	1,129,431	-	499,952
	<b>172,538</b>	<b>2,716,916</b>	-	<b>861,218</b>

*Fair value hedges*

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

*Fair value of derivatives designated as fair value hedges*

	At 31 December 2014		At 31 December 2013	
	Assets	Liabilities	Assets	Liabilities
	US\$000	US\$000	US\$000	US\$000
Interest rate .....	697	1,367	-	-
	<b>697</b>	<b>1,367</b>	-	-

*Losses arising from fair value hedges*

	2014	2013
	US\$000	US\$000
Losses on the hedged items attributable to the hedged risk .....	<b>(131)</b>	-

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

*Cash flow hedges*

The group's cash flow hedges consist principally of interest rate swaps, futures 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.

*Fair value of derivatives designated as cash flow hedges*

	At 31 December 2014		At 31 December 2013	
	Assets	Liabilities	Assets	Liabilities
	US\$000	US\$000	US\$000	US\$000
Foreign exchange .....	373	36,191	16,463	-
Interest rate .....	6,835	156	9,834	-
	<b>7,208</b>	<b>36,347</b>	<b>26,297</b>	-

**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
<b>At 31 December 2014</b>				
Assets .....	2,716,916	2,716,916	2,648,800	29,596
Liabilities .....	-	-	-	-
Net cash inflow exposure .....	<b>2,716,916</b>	<b>2,716,916</b>	<b>2,648,800</b>	<b>29,596</b>
<b>At 31 December 2013</b>				
Assets .....	861,218	861,218	861,218	-
Liabilities .....	-	-	-	-
Net cash inflow exposure .....	<b>861,218</b>	<b>861,218</b>	<b>861,218</b>	-

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

**15 Non-trading reverse repurchase and repurchase agreements****Accounting policy**

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the balance sheet and an asset is recorded in respect of the initial consideration paid.

Non trading repos and reverse repos are measured at amortised cost. The difference between the sale and repurchase price or between the purchase and resale price is treated as interest and recognised in net interest income over the life of the agreement for loans and advances to banks and customers.

Non-trading repos and reverse repos are presented as separate lines in the balance sheet. This separate presentation was adopted with effect from 1 January 2014 and comparatives are re-presented accordingly. Previously, non-trading reverse repos were included within 'Loans and advances to banks' and 'Loans and advances to customers' and non-trading repos were included within 'Deposits by banks' and 'Customer accounts'.

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

	2014 US\$000	2013 US\$000
Banks.....	<b>18,533</b>	24,455

**16 Financial investments****Accounting policy**

Treasury bills, debt securities and equity securities 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. They are recognised on trade date when the group enters into contractual arrangements to purchase those instruments, and are normally derecognised when either the securities are sold or redeemed.

- (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 until they 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 over the debt asset's expected life. Premiums and/or discounts arising on the purchase of dated debt securities are included in the interest recognised. Dividends from equity assets are recognised in the income statement when the right to receive payment is established.

- (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 to maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost, less any impairment losses.

The accounting policy related to impairments of available-for-sale securities is present in Note 1(i).

*Financial investments*

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Financial investments:		
- not subject to repledge or resale by counterparties.....	<b>10,397,639</b>	11,127,001
- which may be repledged or resold by counterparties.....	-	140,241
At 31 December .....	<b>10,397,639</b>	11,267,242

*Carrying amount and fair value of financial investments*

	<u>At 31 December 2014</u>		<u>At 31 December 2013</u>	
	Carrying amount US\$000	Fair value US\$000	Carrying amount US\$000	Fair value US\$000
Treasury and other eligible bills .....				
- available for sale .....	<b>2,072,834</b>	<b>2,072,834</b>	1,612,736	1,612,736
Debt securities .....				
- available for sale .....	<b>8,151,468</b>	<b>8,151,468</b>	9,435,527	9,435,527
Equity securities .....				
- available-for-sale .....	<b>173,337</b>	<b>173,337</b>	218,979	218,979
Total financial investments .....	<b>10,397,639</b>	<b>10,397,639</b>	11,267,242	11,267,242

**17 Assets charged as security for liabilities, and collateral accepted as security for assets****Accounting policy****Derecognition of financial assets**

Financial assets are derecognised when the contractual rights 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.

**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 (2013: US\$Nil). The fair value of any such collateral that have been sold or repledged is US\$Nil (2013: 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.

## Notes on the Financial Statements (continued)

### 18 Interests in associates

#### Accounting policy

The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries (Note 20) nor joint ventures, as associates. 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.

Goodwill arises on the acquisition of associates when the cost of investment exceeds the group's share of the net fair value of the associate's identifiable assets and liabilities.

An investment in an associate is tested for impairment when there is an indication that the investment may be impaired. Goodwill on acquisitions of interests in joint ventures and associates is not tested separately for impairment.

Profits on transactions between the group and its associates are eliminated to the extent of the group's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of the group's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

#### Associates of the group

	At 31 December 2014			
	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\$326 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 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.

**Notes on the Financial Statements** (continued)*Summarised financial information in respect of associates not individually significant*

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Carrying value .....	<b>55,555</b>	30,642
The group's share of		
- assets .....	<b>89,893</b>	52,100
- liabilities .....	<b>34,338</b>	21,458
- profit or loss from continuing operations .....	<b>3,013</b>	559
- total comprehensive income .....	<b>3,013</b>	559

*Movement in investment in associates*

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
At 1 January .....	<b>30,642</b>	30,632
Additions .....	<b>21,900</b>	-
Share of results .....	<b>3,013</b>	559
Dividends .....	-	(547)
Other movements and foreign exchange .....	-	(2)
At 31 December .....	<b>55,555</b>	30,642

**19 Intangible assets****Accounting policy**

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 include computer software, core deposit relationships, customer relationships and preferential lease intangible. Computer software includes both purchased and internally generated software.

The cost of internally generated software comprises all directly attributable costs necessary to create, produce and prepare the software to be capable of operating in the manner intended by management. Costs incurred in the 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

**Critical accounting estimates and judgements****Valuation of intangible assets recognised in business combinations**

Management is required to exercise judgement in valuing intangible assets recognised in business combinations. Intangible assets on the following basis:

- 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.

## Notes on the Financial Statements (continued)

- 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.

*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
<b>Cost</b>						
At 1 January 2014	33,351	16,308	13,152	43,343	1,447	107,601
Additions <sup>1</sup>	2,837	264	-	-	-	3,101
Disposals	(9,958)	(2,404)	-	-	-	(12,362)
Amounts written off	-	-	-	-	-	-
Other changes	2,337	(2,405)	-	(1)	-	(69)
<b>At 31 December 2014</b>	<b>28,567</b>	<b>11,763</b>	<b>13,152</b>	<b>43,342</b>	<b>1,447</b>	<b>98,271</b>
<b>Accumulated amortisation</b>						
At 1 January 2014	(26,111)	(13,104)	(2,763)	(9,128)	(211)	(51,317)
Charge for the year <sup>2</sup>	(3,115)	(599)	(1,878)	(6,176)	(196)	(11,964)
Impairment <sup>2</sup>	-	-	-	-	-	-
Disposals	9,943	2,404	-	-	-	12,347
Amounts written off	-	-	-	-	-	-
Other changes	(774)	886	-	-	-	112
<b>At 31 December 2014</b>	<b>(20,057)</b>	<b>(10,413)</b>	<b>(4,641)</b>	<b>(15,304)</b>	<b>(407)</b>	<b>(50,822)</b>
<b>Net carrying amount at 31 December 2014</b>	<b>8,510</b>	<b>1,350</b>	<b>8,511</b>	<b>28,038</b>	<b>1,040</b>	<b>47,449</b>
<b>Cost</b>						
At 1 January 2013	33,588	15,471	13,153	43,342	1,447	107,001
Additions <sup>1</sup>	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)
<b>At 31 December 2013</b>	<b>33,351</b>	<b>16,308</b>	<b>13,152</b>	<b>43,343</b>	<b>1,447</b>	<b>107,601</b>
<b>Accumulated amortisation</b>						
At 1 January 2013	(25,571)	(11,747)	(885)	(2,944)	(30)	(41,177)
Charge for the year <sup>2</sup>	(3,073)	(1,349)	(1,878)	(6,184)	(181)	(12,665)
Impairment <sup>2</sup>	(169)	-	-	-	-	(169)
Disposals	2,304	-	-	-	-	2,304
Amounts written off	229	-	-	-	-	229
Other changes	169	(8)	-	-	-	161
<b>At 31 December 2013</b>	<b>(26,111)</b>	<b>(13,104)</b>	<b>(2,763)</b>	<b>(9,128)</b>	<b>(211)</b>	<b>(51,317)</b>
<b>Net carrying amount at 31 December 2013</b>	<b>7,240</b>	<b>3,204</b>	<b>10,389</b>	<b>34,215</b>	<b>1,236</b>	<b>56,284</b>

<sup>1</sup> At 31 December 2014, the group did not have any contractual commitments to acquire intangible assets (2013: nil).

<sup>2</sup> 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)

### 20 Investments in subsidiaries

#### Accounting policy

The group classifies investments in entities which it controls as subsidiaries. The group's consolidation policy is described in Note 1(f). Subsidiaries which are structured entities are covered in Note 36.

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.

#### 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\$4.2 million (2013: US\$3.2 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).

	2014	2013
<b>HSBC Bank Oman S.A.O.G.</b>		
Proportion of ownership interests and voting rights held by non-controlling interests	<b>49%</b>	49%
Place of business .....	<b>Oman</b>	Oman
	<b>US\$000</b>	US\$000
Profit attributable to non-controlling interests .....	<b>15,895</b>	13,519
Dividends paid to non-controlling interests.....	<b>9,677</b>	2,545
Summarised financial information:		
- assets .....	<b>5,857,532</b>	5,810,336
- liabilities.....	<b>5,030,003</b>	4,993,861
- operating income .....	<b>186,443</b>	178,527
- profit after tax.....	<b>32,438</b>	27,591
- total comprehensive income .....	<b>30,774</b>	36,357

## Notes on the Financial Statements (continued)

### 21 Prepayments, accrued income and other assets

#### Accounting policy

##### Assets held for sale

Assets and liabilities of disposal groups and non-current assets are classified as held for sale ('HFS') when their carrying amounts will be recovered principally through sale rather than through continuing use. HFS assets are generally measured at the lower of their carrying amount and fair value less cost to sell.

Immediately before the initial classification as held for sale, the carrying amounts of the relevant assets and liabilities are measured in accordance with applicable IFRSs. On subsequent remeasurement of a disposal group, fair value less costs to sell of the disposal group is determined after each HFS asset is individually measured under applicable IFRSs.

##### 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.

	2014 US\$000	2013 US\$000
Prepayments and accrued income .....	127,945	137,574
Assets held for sale .....	-	901,032
Endorsements and acceptances .....	952,240	1,041,222
Other accounts .....	95,512	92,000
Property, plant and equipment .....	146,194	153,048
At 31 December .....	<u>1,321,891</u>	<u>2,324,876</u>

##### Property, plant and equipment – selected information

	2014 US\$000	2013 US\$000
Cost or fair value .....	273,171	310,173
Accumulated depreciation and impairment .....	126,977	157,125
Net carrying amount at 31 December .....	146,194	153,048
Additions at cost .....	18,427	18,381
Disposals at net book value .....	(6,406)	(2,457)
Property, plant and equipment includes:		
Land and buildings .....	122,098	128,130
- Freehold .....	95,514	101,080
- Medium and short leasehold .....	26,584	27,050

##### Assets held for sale

	2014 US\$000	2013 US\$000
Disposal group .....	-	901,032
Total assets held for sale .....	-	901,032

## Notes on the Financial Statements (continued)

At 31 December 2013, the disposal group related to the group's sale of its banking operations in Jordan. The transaction completed in June 2014. Associated liabilities of US\$1,005 million were included in 'Liabilities of disposal groups held for sale' as at 31 December 2013 (refer to Note 26).

### 22 Discontinued operations

#### Sale of the group's banking operations in Jordan

On 20 January 2014, the group announced an agreement to sell the group's banking operations in Jordan at the net asset value of the business on the completion date. On 19 June 2014 the group completed the disposal which resulted in no gain or loss on disposal

#### Sale of the group's banking operations in Pakistan

On 9 May 2014, the group announced an agreement to sell the group's banking operations in Pakistan at a purchase price based on a discount to the net asset value of the business on the completion date. On 17 October 2014 the group completed the disposal which resulted in a loss on disposal of US\$27.0 million.

### 23 Trading liabilities

#### Accounting policy

Trading liabilities 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 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. They are recognised on trade date, when the group enters into contractual arrangements with counterparties, and are normally derecognised when extinguished. They are initially measured at fair value, with subsequent changes in fair value and interest paid recognised in the income statement in 'Net trading income'.

The sale of borrowed securities is classified as trading liabilities.

	2014 US\$000	2013 US\$000
Deposits by banks .....	20,257	5,158
Customer accounts .....	1,909	541
Debt securities in issue .....	1,587,695	1,165,892
Other liabilities – net short positions .....	74,274	63,409
	<b>1,684,135</b>	<b>1,235,000</b>

### 24 Financial liabilities designated at fair value

#### Accounting policy

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

- eliminates or significantly reduces measurement or recognition inconsistencies;
- applies to groups of financial instruments 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.

Designated financial liabilities are recognised when the group enters into contracts with counterparties and are normally derecognised when extinguished. This includes long-term debt issues where the interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on certain interest rate swaps as part of a documented interest rate risk management strategy. An accounting

**Notes on the Financial Statements** (continued)

mismatch would arise if the debt securities issued were accounted for at amortised cost, and this mismatch is eliminated through the fair value designation.

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Debt securities in issue .....	<b>860,293</b>	503,448

At 31 December 2014, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of US\$8.1 million (2013: US\$2.0 million loss).

**25 Debt securities in issue****Accounting policy**

Financial liabilities for debt securities issued are recognised when the group enters into contractual 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 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.

	<b>2014</b>		2013	
	<b>Carrying amount</b>	<b>Fair value</b>	Carrying amount	Fair value
	<b>US\$000</b>	<b>US\$000</b>	US\$000	US\$000
Medium term notes .....	<b>4,672,945</b>	<b>4,674,037</b>	3,925,589	3,925,925
Non-equity preference shares .....	<b>950,000</b>	<b>889,108</b>	950,000	925,415
	<b>5,622,945</b>	<b>5,563,145</b>	4,875,589	4,851,340
Of which debt securities in issue reported as				
- trading liabilities (see Note 23) .....	<b>(1,587,695)</b>	<b>(1,587,695)</b>	(1,165,892)	(1,165,892)
- financial liabilities designated at fair value (see Note 24) .....	<b>(860,293)</b>	<b>(860,293)</b>	(503,448)	(503,448)
	<b>3,174,957</b>	<b>3,115,157</b>	3,206,249	3,182,000

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

**Non-equity preference share capital***Authorised*

The authorised non-equity preference share capital of the bank at 31 December 2014 was 1,350,000 (2013: 1,350,000) cumulative redeemable preference shares of US\$1.00 each and 1,150,000 (2013: 1,150,000) non-cumulative redeemable preference shares of US\$1.00 each.

## Notes on the Financial Statements (continued)

## 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

- 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.*
- Cumulative redeemable preference dividends are payable annually on the issue price of each perpetual share.*
- 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.*
- Each share carries one vote at meetings of the shareholders of the bank.*
- 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
11	16 December 2014	250,000	3 month US dollar LIBOR + 2.64	16 December 2019	16 December 2024
11	16 December 2014	250,000	3 month US dollar LIBOR + 2.94	16 December 2024	16 December 2029
12	30 December 2014	225,000	3 month US dollar LIBOR + 2.96	30 December 2024	30 December 2029

On 16 December 2014 the bank redeemed 200,000 and 300,000 cumulative redeemable preference shares of of US\$1.00 each (the "Eighth and Ninth issues") issued at a premium of US\$999.00 per share, and issued two tranches of 250,000 cumulative redeemable preference shares of USD1.00 each (the "Eleventh issues") issued at a premium of US\$999.00 per share.

On 30 December 2014 the bank redeemed 225,000 non-cumulative redeemable preference shares of USD1.00 each (the "Tenth issue") issued at a premium of US\$999.00 per share, and issued 225,000 cumulative redeemable preference shares of USD1.00 each (the "Twelfth issue") issued at a premium of US\$999.00 per share.

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

## Notes on the Financial Statements (continued)

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.

### 26 Accruals, deferred income and other liabilities

<i>Other liabilities</i>	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Liabilities of disposal group held for sale (see Note 21) .....	-	1,004,983
Accrual and deferred income.....	<b>151,599</b>	135,492
Share based payments liability to HSBC Holdings plc .....	<b>30,499</b>	34,711
Endorsements and acceptances .....	<b>952,240</b>	1,041,222
Employee benefits liabilities .....	<b>121,152</b>	95,473
Other liabilities .....	<b>767,188</b>	857,897
Obligations under finance leases.....	<b>2,994</b>	2,678
	<b>2,025,672</b>	<b>3,172,456</b>

### 27 Provisions

#### Accounting policy

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.

Contingent liabilities are possible obligations that arise from past events whose existence will be confirmed only by uncertain future events not wholly within the control of HSBC; or are present obligations that have arisen from past events where it is not probable that settlement will require an outflow of economic benefits or because the amount for settlement cannot be reliably measured. Contingent liabilities are not recognised on the balance sheet but are disclosed unless the probability of settlement is remote.

#### Critical accounting estimates and judgements

Judgement is involved in determining whether a present obligation exists and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on the assessment of litigation, property (including onerous contracts) and similar obligations.

Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When matters are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists, and estimating the probability and amount of any outflows that may arise. As matters progress, management and legal advisers evaluate on an ongoing basis whether provisions should be recognised, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically easier to make judgements and estimates around a better defined set of possible outcomes. However, the amount provisioned can remain very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result, it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved. Provisions for customer remediation also require significant levels of estimation and judgement and the amounts of provisions recognised depend on a number of different assumptions.

**Notes on the Financial Statements** (continued)

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
At 1 January .....	<b>64,008</b>	42,893
Additional provisions/increase in provisions .....	<b>23,061</b>	29,764
Provisions utilised .....	<b>(24,756)</b>	(12,069)
Amounts reversed .....	<b>(25,995)</b>	(8,477)
Exchange differences and other movements .....	<b>(8,357)</b>	11,897
At 31 December .....	<b>27,961</b>	64,008

Provisions include US\$1.0 million (2013: US\$8.1 million) relating to legal proceedings, investigations and regulatory matters, US\$0.3 million (2013: US\$1.0 million) relating to costs arising from contingent liabilities and contractual commitments, US\$4.3 million (2013: US\$22.1 million) relating to restructuring provisions; and US\$18.2 million (2013: US\$25.6 million) relating to customer remediation provisions.

**28 Maturity analysis of assets and liabilities**

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

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

*Maturity analysis of assets and liabilities*

	At 31 December 2014			At 31 December 2013		
	Due within one year	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
<b>Assets</b>						
Loans and advances to banks .....	8,761,424	482,769	9,244,193	7,186,684	405,638	7,592,322
Loans and advances to customers .....	14,982,886	10,942,849	25,925,735	13,596,210	10,033,508	23,629,718
Reverse repurchase agreements non- trading .....	18,533	-	18,533	24,455	-	24,455
Financial investments .....	9,225,876	1,171,763	10,397,639	10,115,640	1,151,602	11,267,242
Other financial assets .....	1,045,850	1,190	1,047,040	1,127,870	4,163	1,132,033
	<b>34,034,569</b>	<b>12,598,571</b>	<b>46,633,140</b>	<b>32,050,859</b>	<b>11,594,911</b>	<b>43,645,770</b>
<b>Liabilities</b>						
Deposits by banks .....	2,482,948	82	2,483,030	1,379,346	127	1,379,473
Customer accounts .....	31,748,452	335,305	32,083,757	31,240,928	74,754	31,315,682
Financial liabilities designated at fair value .....	-	860,293	860,293	-	503,448	503,448
Debt securities in issue .....	1,745,587	1,429,370	3,174,957	310,846	2,895,403	3,206,249
Other financial liabilities .....	1,665,737	53,683	1,719,420	1,842,700	56,396	1,899,096
	<b>37,642,724</b>	<b>2,678,733</b>	<b>40,321,457</b>	<b>34,773,820</b>	<b>3,530,128</b>	<b>38,303,948</b>

**Notes on the Financial Statements** (continued)

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

	On demand US\$000	Due within 3 months US\$000	Due between 3 and 12 months US\$000	Due between 1 and 5 years US\$000	Due after 5 years US\$000
<b>At 31 December 2014</b>					
Deposits by banks .....	2,015,779	320,597	147,117	81	-
Customer accounts .....	26,484,800	3,174,036	2,104,140	336,186	7,525
Trading liabilities .....	1,684,135	-	-	-	-
Financial liabilities designated at fair value .....	-	-	-	860,293	-
Derivatives .....	1,198,654	-	-	9,802	-
Debt securities in issue .....	225,000	714,491	1,152,379	316,662	781,644
Other financial liabilities .....	908,651	1,096,774	175,230	3,392	58,136
	<b>32,517,019</b>	<b>5,305,898</b>	<b>3,578,866</b>	<b>1,526,416</b>	<b>847,305</b>
Loan and other credit-related commitments.....	1,755,290	7,323,813	9,561,738	1,654,596	655,573
Financial guarantees and similar contracts.....	1,010,770	1,638,105	1,900,246	2,887,901	2,411
	<b>35,283,079</b>	<b>14,267,816</b>	<b>15,040,850</b>	<b>6,068,913</b>	<b>1,505,289</b>
<b>At 31 December 2013</b>					
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
	<b>34,642,849</b>	<b>13,511,777</b>	<b>11,723,170</b>	<b>6,664,626</b>	<b>542,362</b>

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'.

**29 Offsetting of financial assets and financial liabilities****Accounting policy**

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



## Notes on the Financial Statements (continued)

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

	Gross amounts of financial assets 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	Cash collateral received US\$000	Net amount US\$000
<b>At 31 December 2014</b>						
Derivatives (note 14) .....	1,178,406	–	1,178,406	–	–	1,178,406
Reverse repurchase, securities borrowing and similar agreements .....	18,533	–	18,533	–	–	18,533
Classified as:						
- loans and advances to banks at amortised cost .....	18,533	–	18,533	–	–	18,533
Loans and advances to customers excluding reverse repos at amortised cost .....	1,293,863	–	1,293,863	–	(309,689)	984,174
	<b>2,490,802</b>	<b>–</b>	<b>2,490,802</b>	<b>–</b>	<b>(309,689)</b>	<b>2,181,113</b>
<b>At 31 December 2013</b>						
Derivatives (note 14) .....	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
	<b>2,310,651</b>	<b>–</b>	<b>2,310,651</b>	<b>–</b>	<b>(316,954)</b>	<b>1,993,697</b>

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

	Gross amounts of 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	Cash collateral pledged US\$000	Net amount US\$000
<b>At 31 December 2014</b>						
Derivatives (note 14) .....	1,208,456	–	1,208,456	–	–	1,208,456
<b>At 31 December 2013</b>						
Derivatives (note 14) .....	1,132,836	–	1,132,836	–	–	1,132,836

For Loans and advance to customers and Customer accounts at amortised cost the amounts included in the table above typically relate to transactions entered into with corporate and commercial customers for working capital management purposes. The 'Amounts not set off in the balance sheet' relate to transactions where the customer 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.

For risk management purposes, the net amounts of such exposures are subject to limits which are monitored and the relevant customer agreements are subject to review and updated, as necessary, to ensure the legal right of offset remains appropriate.

**Notes on the Financial Statements** (continued)**30 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'.

*Net structural foreign currency exposures*

**Currency of structural exposure**

	2014 US\$000	2013 US\$000
Algerian dinar .....	220,273	245,136
Bahraini dinar .....	209,811	219,644
Jordanian dinar .....	(3,968)	75,161
Kuwaiti dinar .....	175,936	151,376
Lebanese pound .....	68,670	82,120
Omani riyal .....	422,020	416,384
Pakistani rupee .....	-	5,460
Qatari riyal .....	525,028	623,893
UAE dirham .....	2,203,705	3,073,721
Total .....	<u>3,821,475</u>	<u>4,892,895</u>

**31 Called up share capital****Accounting Policy**

Financial instruments issued are generally 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.

**Authorised**

The authorised ordinary share capital of the Bank at 31 December 2014 was 1,500,000,000 (2013: 1,500,000,000) ordinary shares<sup>1</sup> of US\$1.00 each.

**Issued and fully paid**

	Number	US\$000
At 1 January 2014 and 31 December 2014 .....	<u>931,055,000</u>	<u>931,055</u>
At 1 January 2013 and 31 December 2013 .....	<u>931,055,000</u>	<u>931,055</u>

<sup>1</sup>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*

	2014 US\$000	2013 US\$000
Depreciation, amortisation and impairment.....	31,464	39,534
Share-based payment expense .....	18,117	18,766
Loan impairment (releases)/losses gross of recoveries .....	(7,711)	(36,230)
Provisions .....	(2,934)	21,287
Impairment of financial investments .....	38	247
Charge for defined benefit plans .....	19,074	16,679
Accretion of discounts and amortisation of premiums .....	1,168	696
	<b>59,216</b>	<b>60,979</b>

*Change in operating assets*

	2014 US\$000	2013 US\$000
Change in prepayments, accrued income and other assets .....	996,131	38,934
Change in net trading securities and net derivatives .....	531,617	224,367
Change in loans and advances to banks .....	701,302	(103,146)
Change in loans and advances to customers .....	(2,330,563)	404,308
Change in reverse repurchase agreements – non-trading.....	(18,533)	-
	<b>(120,046)</b>	<b>564,463</b>

*Change in operating liabilities*

	2014 US\$000	2013 US\$000
Change in accruals, deferred income and other liabilities .....	(1,172,465)	206,984
Change in deposits by banks .....	1,103,557	(423,541)
Change in customer accounts .....	768,075	(722,494)
Change in debt securities in issue .....	(31,292)	(1,570,260)
Change in financial liabilities designated at fair value .....	356,845	(5,541)
Change in provisions .....	(24,756)	(12,069)
	<b>999,964</b>	<b>(2,526,921)</b>

*Cash and cash equivalents***Accounting Policy**

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.

	2014 US\$000	2013 US\$000
Cash and balances at central banks .....	952,640	1,573,701
Items in the course of collection from other banks .....	71,711	67,483
Loans and advances to banks of one month or less .....	7,159,958	4,831,240
Treasury bills, other bills and certificates of deposit less than three months .....	1,718,224	1,977,457
Less: items in the course of transmission to other banks .....	(458,068)	(561,153)
<b>Total cash and cash equivalents.....</b>	<b>9,444,465</b>	<b>7,888,728</b>

Total interest paid by the group during the year was US\$166 million (2013: US\$253 million). Total interest received by the group during the year was US\$1,317 million (2013: US\$1,438 million). Total dividends received by the group during the year were US\$14 million (2013: US\$9 million).

## Notes on the Financial Statements (continued)

### 33 Risk management

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

#### Risk governance and ownership

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

The Board approves the group's risk appetite framework, plans and performance targets for the group and its principal operating subsidiaries, the appointment of senior officers, the delegation of authorities for credit and other risks and the establishment of effective control procedures. The Audit and Risk Committees are responsible for advising the Board on material risk matters and providing non-executive oversight of risks. Under authority delegated by the Board, the separately convened Risk Management 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 their oversight and stewardship of risk management at group level, RMC are supported by a dedicated Risk function headed by the Chief Risk Officer ('CRO'), who is a member of RMC and reports to the Chief Executive Officer ('CEO') and functionally to the EMEA CRO in the HSBC Group.

#### Risk culture

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

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

#### Risk appetite

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

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

## Notes on the Financial Statements (continued)

- 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 CRO who reports to the CEO, with a functional reporting line to the EMEA CRO in the HSBC Group. 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 RMC, the Audit and Risk Committee and the Board of Directors.
- Acting on behalf of the group as the primary interface, for credit-related issues, with external parties including the rating agencies, corporate analysts, trade associations etc.

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

## Notes on the Financial Statements (continued)

### 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;

**Notes on the Financial Statements** (continued)

- in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily; and
- performing facilities with a principal (excluding security) of US\$1 million or below and/or with maturity dates shorter than three months.

**Credit exposure***Maximum exposure to credit risk*

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

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

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

## Notes on the Financial Statements (continued)

	At 31 December 2014			At 31 December 2013		
	Maximum exposure	Offset	Net	Maximum exposure	Offset	Net
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
Cash and balances at central banks .....	952,640	–	952,640	1,573,701	–	1,573,701
Items in the course of collection from other banks .....	71,711	–	71,711	67,483	–	67,483
Trading assets	465,421	–	465,421	515,374	–	515,374
- treasury and other eligible bills .....	175,141	–	175,141	109,046	–	109,046
- debt securities .....	216,074	–	216,074	303,121	–	303,121
- loans and advances to banks .....	1,543	–	1,543	87,049	–	87,049
- loans and advances to customers .....	72,663	–	72,663	16,158	–	16,158
Derivatives .....	1,178,406	–	1,178,406	1,135,352	–	1,135,352
Loans and advances to customers held at amortised cost .....	25,925,735	(292,574)	25,633,161	23,629,718	(314,632)	23,315,086
- personal .....	5,874,407	(23,254)	5,851,153	5,717,292	(13,337)	5,703,955
- corporate and commercial .....	16,809,564	(269,320)	16,540,244	15,524,485	(300,944)	15,223,541
- financial (non-bank institutions) .....	3,241,764	–	3,241,764	2,387,941	(351)	2,387,590
Loans and advances to banks held at amortised cost .....	9,244,193	–	9,244,193	7,592,322	–	7,592,322
Reverse repurchase agreements – non-trading .....	18,533	–	18,533	24,455	–	24,455
Financial investments .....	10,224,302	–	10,224,302	11,048,263	–	11,048,263
- treasury and other similar bills .....	2,072,834	–	2,072,834	1,612,736	–	1,612,736
- debt securities .....	8,151,468	–	8,151,468	9,435,527	–	9,435,527
Assets held for sale – disposal groups .....	–	–	–	901,032	–	901,032
Other assets .....	1,149,552	–	1,149,552	1,238,849	–	1,238,849
- endorsements and acceptances .....	952,240	–	952,240	1,041,222	–	1,041,222
- other .....	197,312	–	197,312	197,627	–	197,627
Financial guarantees as similar contracts .....	6,670,586	–	6,670,586	5,550,435	–	5,550,435
Loan commitments and other credit related commitments .....	20,951,015	–	20,951,015	19,465,099	–	19,465,099
	<b>76,852,094</b>	<b>(292,574)</b>	<b>76,559,520</b>	<b>72,742,083</b>	<b>(314,632)</b>	<b>72,427,451</b>

**Collateral and other credit enhancements held***Loans and advances held at amortised cost*

Although collateral can be an important mitigant of credit risk, it is the 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.



## Notes on the Financial Statements (continued)

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 therefore the level of collateral on the remaining balance of loans and advances to customers has not been quantified. In particular, loans shown in the tables below as not collateralised or partially collateralised may benefit from such credit mitigants.

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

	2014 US\$000	2013 US\$000
Non-impaired loans and advances		
Uncollateralised.....	2,504	45,203
Fully collateralised .....	2,430,000	2,233,802
- Less than 50% loan to value ('LTV') .....	1,323,564	747,793
- 51% to 75% LTV .....	856,011	1,094,352
- 76% to 90% LTV .....	211,901	348,242
- 91% to 100% LTV .....	38,524	43,415
Partially collateralised		
- greater than 100% LTV .....	60,053	42,096
- collateral value .....	44,458	36,658
	<b>2,492,557</b>	<b>2,321,101</b>
Impaired loans and advances		
Uncollateralised.....	254	37,158
Fully collateralised .....	121,917	85,414
- Less than 50% loan to value ('LTV') .....	54,027	10,369
- 51% to 75% LTV .....	28,529	31,287
- 76% to 90% LTV .....	18,818	33,520
- 91% to 100% LTV .....	20,543	10,238
Partially collateralised		
- greater than 100% LTV .....	31,411	5,998
- collateral value .....	22,510	5,576
	<b>153,582</b>	<b>128,570</b>
Total residential mortgages	<b>2,646,139</b>	<b>2,449,671</b>

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.

**Notes on the Financial Statements** (continued)*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.

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

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Rated CRR/EL 1 to 7		
Not collateralised .....	<b>360,511</b>	86,480
Fully collateralised .....	<b>21,720</b>	21,225
Partially collateralised.....	-	138,662
- collateral value .....	<b>-</b>	<b>24,378</b>
	<b>382,231</b>	246,367
Rated CRR/EL 8 to 10		
Not collateralised .....	<b>6,840</b>	7,291
Fully collateralised .....	<b>6,843</b>	102,648
LTV ratio:		
- Less than 50% .....	<b>6,843</b>	6,823
- 51% to 75% LTV .....	-	79,137
- 76% to 90% LTV .....	-	16,684
- 91% to 100% LTV .....	-	4
Partially collateralised.....	<b>180,851</b>	180,847
- collateral value .....	<b>88,609</b>	<b>88,614</b>
	<b>194,534</b>	290,786
Total commercial real estate loans and advances .....	<b>576,765</b>	537,153

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

**Notes on the Financial Statements** (continued)

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

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Rated CRR/EL 8 to 10		
Not collateralised .....	<b>827,331</b>	1,037,015
Fully collateralised .....	<b>218,671</b>	49,723
LTV ratio:		
- Less than 50% .....	<b>25,665</b>	2,766
- 51% to 75% LTV .....	<b>18,575</b>	46,607
- 76% to 90% LTV .....	<b>75,396</b>	–
- 91% to 100% LTV .....	<b>99,035</b>	350
Partially collateralised	<b>547,541</b>	1,298,048
- Collateral value.....	<b>92,861</b>	499,966
	<b>1,593,543</b>	2,384,786

*Loans and advances to banks*

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

	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Rated CRR/EL 1 to 8		
Not collateralised .....	<b>9,239,343</b>	7,591,038
Fully collateralised .....	–	23,648
	<b>9,239,343</b>	7,614,686
Rated CRR/EL 9 to 10		
Not collateralised .....	<b>20,534</b>	312,481
Total loans and advances to banks	<b>9,259,877</b>	7,927,167

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.

**Notes on the Financial Statements** (continued)

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:

Nature of assets	At 31 December	
	2014 US\$000	2013 US\$000
Residential property and motor vehicles .....	-	-

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 2014 and 31 December 2013 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.

***Debt securities, treasury bills and bonds***

At US\$10,224 million, total financial investments excluding equity securities were 7% lower at 31 December 2014 than at 31 December 2013. Debt securities, at US\$8,151 million, represented the largest concentration of financial investments at 80% of the total, compared with US\$9,436 million (85%) at 31 December 2013. 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\$10,044 million were 98% of overall financial investments excluding equity shares (2013 - US\$10,956 million (99%)).

***Derivatives***

Derivatives asset exposures at 31 December 2014 were US\$1,178 million, an increase of 4% from 31 December 2013, with increases across all interest rate and credit derivatives. Broad strengthening of the US dollar against major counterparts driven by the strengthening US economy and the flattening of

**Notes on the Financial Statements** (continued)

yield curves in major currencies lead to an increase in the fair value of derivative assets. 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**

	<b>Gross loans and advances to customers</b>	
	<b>Total US\$000</b>	<b>As a % of total gross loans %</b>
<b>At 31 December 2014</b>		
<b>Personal</b>		
Residential mortgages .....	2,646,139	9.73%
Other personal .....	3,413,934	12.56%
	<u>6,060,073</u>	<u>22.29%</u>
<b>Corporate and commercial</b>		
Commercial, industrial and international trade .....	10,413,972	38.31%
Commercial real estate .....	576,765	2.12%
Other property-related .....	1,570,660	5.78%
Government .....	1,443,252	5.31%
Other commercial .....	3,854,086	14.18%
	<u>17,858,735</u>	<u>65.70%</u>
<b>Financial</b>		
Non-bank financial institutions .....	3,263,773	12.01%
Total gross loans and advances to customers .....	<u>27,182,581</u>	<u>100.00%</u>
Impaired loans		
- as a percentage of gross loans and advances to customers	6.38%	
Total impairment allowances		
- as a percentage of gross loans and advances to customers	4.62%	
<b>At 31 December 2013</b>		
<b>Personal</b>		
Residential mortgages .....	2,449,671	9.78%
Other personal .....	3,555,414	14.19%
	<u>6,005,085</u>	<u>23.97%</u>
<b>Corporate and commercial</b>		
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%
	<u>16,606,192</u>	<u>66.30%</u>
<b>Financial</b>		
Non-bank financial institutions .....	2,437,047	9.73%
Total gross loans and advances to customers .....	<u>25,048,324</u>	<u>100.00%</u>
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%	

## Notes on the Financial Statements (continued)

### Areas of special interest

#### *Middle East and North Africa*

Although significant unrest and political changes continued to be witnessed in the Middle East and North Africa in 2014, 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. Overall credit quality remained stable, although the rise in business confidence seen towards the end of 2013 failed to continue throughout 2014 and generally remained low in many sectors given the uncertainties in both the global economic environment and the regional political situation.

During 2014, the group continued to reduce its counterparty exposures to the eurozone and additional control measures were introduced to manage its counterparty exposures in MENA countries most at risk from the uncertain political environment. While the absence of a full economic recovery and illiquid markets for certain assets increased the stress on certain relationships, the level of new problems arising was relatively low.

#### *Commercial real estate*

Commercial real estate lending to customers for the purpose of property investment at 31 December 2014 represented 2.12% (2013: 2.13%) of total gross loans and advances to customers. In 2014, credit quality across this sector was broadly stable but there remains 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. There was some downward pressure on external ratings towards the end of the year as a result of the falling oil price. 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; unsecured lending products such as overdrafts, credit cards and payroll loans; and debt consolidation loans which may be secured or unsecured.

During 2014, the growth strategy continued to focus on relationship led 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. The portfolio

## Notes on the Financial Statements (continued)

primarily consists of seasoned accounts, that have managed to maintain payments throughout the downturn, and recent originations that passed through a strong and sustainable credit criterion.

### Credit quality of financial instruments

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

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

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

#### Credit quality classification

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

<sup>1</sup> 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 2014							Total US\$000
	Neither past due nor impaired			Sub- Standard US\$000	Past due not impaired US\$000	Impaired US\$000	Impairment allowances US\$000	
	Strong US\$000	Good US\$000	Satisfactory US\$000					
Cash and balances at central banks .....	858,536	61,162	–	32,942	–	–	–	952,640
Items in the course of collection from other banks .....	–	–	71,711	–	–	–	–	71,711
Trading assets .....	192,195	13,257	242,095	17,874	–	–	–	465,421
treasury and other eligible bills .....	–	–	175,141	–	–	–	–	175,141
debt securities .....	119,532	13,257	65,411	17,874	–	–	–	216,074
loans and advances to banks .....	72,663	–	–	–	–	–	–	72,663
loans and advances to customers .....	–	–	1,543	–	–	–	–	1,543
Derivatives .....	123,829	230,301	763,388	60,888	–	–	–	1,178,406
Loans and advances held at amortised cost .....	17,683,131	9,292,490	6,108,289	1,096,222	511,045	1,753,877	(1,275,126)	35,169,928
loans and advances to banks .....	6,900,832	1,549,089	648,835	143,183	–	20,534	(18,280)	9,244,193
loans and advances to customers .....	10,782,299	7,743,401	5,459,454	953,039	511,045	1,733,343	(1,256,846)	25,925,735
Reverse repurchase agreements – non trading .....	18,533	–	–	–	–	–	–	18,533
Financial investments ...	241,014	25,347	9,957,941	–	–	–	–	10,224,302
treasury and other eligible bills .....	–	25,113	2,047,721	–	–	–	–	2,072,834
debt securities .....	241,014	234	7,910,220	–	–	–	–	8,151,468
Other assets .....	125,394	268,367	660,646	59,487	30,353	5,305	–	1,149,552
endorsements and acceptances .....	80,255	267,705	509,799	59,487	29,689	5,305	–	952,240
accrued income and other .....	45,139	662	150,847	–	664	–	–	197,312
Total financial instruments .....	19,242,632	9,890,924	17,804,070	1,267,413	541,398	1,759,182	(1,275,126)	49,230,493



## Notes on the Financial Statements (continued)

	31 December 2013							
	Neither past due nor impaired				Past due not impaired	Impaired	Impairment allowances	Total
	Strong US\$000	Good US\$000	Satisfactory US\$000	Sub-Standard US\$000	US\$000	US\$000	US\$000	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 .....	15,528,815	7,712,661	5,299,628	1,377,567	729,318	2,010,976	(1,436,925)	31,222,040
loans and advances to banks .....	5,919,834	1,319,034	189,440	161,926	–	20,405	(18,317)	7,592,322
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
Reverse repurchase agreements – non trading .....	24,455	–	–	–	–	–	–	24,455
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

*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
<b>At 31 December 2014</b>						
Loans and advances to customers held at amortised cost .....	336,323	78,039	74,672	13,373	8,638	511,045
- personal .....	<b>80,104</b>	<b>35,743</b>	<b>40,702</b>	<b>386</b>	-	<b>156,935</b>
- corporate and commercial....	<b>254,913</b>	<b>42,296</b>	<b>33,886</b>	<b>11,727</b>	<b>8,638</b>	<b>351,460</b>
- financial (non-bank institutions) .....	1,306	-	84	1,260	-	2,650
Other assets.....	<b>17,997</b>	<b>3,917</b>	<b>3,737</b>	<b>3,716</b>	<b>986</b>	<b>30,353</b>
Endorsements and acceptances other .....	<b>17,723</b>	<b>3,846</b>	<b>3,726</b>	<b>3,408</b>	<b>986</b>	<b>29,689</b>
	<b>274</b>	<b>71</b>	<b>11</b>	<b>308</b>	-	<b>664</b>
	<b>354,320</b>	<b>81,956</b>	<b>78,409</b>	<b>17,089</b>	<b>9,624</b>	<b>541,398</b>
<b>At 31 December 2013</b>						
Loans and advances to customers held at amortised cost .....	490,871	120,949	61,799	32,573	23,126	729,318
- personal .....	<b>83,462</b>	<b>25,219</b>	<b>28,587</b>	<b>8,854</b>	<b>178</b>	<b>146,300</b>
- corporate and commercial....	<b>405,330</b>	<b>95,730</b>	<b>32,093</b>	<b>23,719</b>	<b>22,935</b>	<b>579,807</b>
- financial (non-bank institutions) .....	2,079	-	1,119	-	13	3,211
Other assets.....	<b>13,887</b>	<b>2,712</b>	<b>410</b>	<b>559</b>	<b>1,905</b>	<b>19,473</b>
endorsements and acceptances other .....	<b>10,788</b>	<b>2,698</b>	<b>410</b>	<b>521</b>	<b>1,505</b>	<b>15,922</b>
	<b>3,099</b>	<b>14</b>	-	<b>38</b>	<b>400</b>	<b>3,551</b>
	<b>504,758</b>	<b>123,661</b>	<b>62,209</b>	<b>33,132</b>	<b>25,031</b>	<b>748,791</b>

**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.

## Notes on the Financial Statements (continued)

### 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.

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.

## Notes on the Financial Statements (continued)

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

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

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

For retail lending the minimum period of payment performance required depends on the nature of loans in the portfolio, but is typically not less than six months. Payment performance periods are monitored to ensure they remain appropriate to the levels of recidivism observed within the portfolio. 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.

## Notes on the Financial Statements (continued)

## Renegotiated loans and advances to customers

	At 31 December 2014			
	Neither past due nor impaired US\$000	Past Due but not impaired US\$000	Impaired US\$000	Total US\$000
Retail .....	35,420	5,716	43,869	85,005
- Residential Mortgages .....	19,189	840	37,600	57,629
- Other personal .....	16,231	4,876	6,269	27,376
Corporate and commercial.....	230,647	31,371	780,586	1,042,604
- Manufacturing and international trade services....	4,047	15,668	281,291	301,006
- Commercial real estate .....	185,102	1,245	366,563	552,910
- Other commercial .....	41,498	14,458	132,732	188,688
Financial .....	303,065	-	17,875	320,940
Total renegotiated loans and advances to customers	569,132	37,087	842,330	1,448,549
Total impairment allowance on renegotiated loans.....				392,206
	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

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.

**Notes on the Financial Statements** (continued)**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.

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

	<b>Banks</b>	<b>Customers</b>		<b>Total</b>
	<b>Individually assessed</b>	<b>Individually assessed</b>	<b>Collectively assessed</b>	
	<b>US\$000</b>	<b>US\$000</b>	<b>US\$000</b>	<b>US\$000</b>
At 1 January 2014 .....	18,317	1,053,512	365,096	1,436,925
Amounts written off .....	–	(51,647)	(144,653)	(196,300)
Recoveries of loans and advances written off in previous years .....	–	7,368	34,578	41,946
(Release)/charge to income statement .....	–	7,452	(9,449)	(1,997)
Exchange and other movements .....	(37)	799	(6,210)	(5,448)
<b>At 31 December 2014</b>	<b>18,280</b>	<b>1,017,484</b>	<b>239,362</b>	<b>1,275,126</b>
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

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

	At 31 December	
	2014	2013
	%	%
<i>Banks</i>		
Individually assessed impairment allowances .....	<b>0.20%</b>	0.24%
<i>Customers</i>		
Individually assessed impairment allowances .....	<b>3.74%</b>	4.20%
Collectively assessed impairment allowances .....	<b>0.88%</b>	1.46%
	<b>4.62%</b>	5.66%

**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.

## Notes on the Financial Statements (continued)

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 Group Management Board ('GMB') through the RMC 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\$44,158 million at 31 December 2014, funding from customers amounted to US\$32,084 million, of which US\$31,748 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 28.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US\$20,951 million), included cash, central bank balances, items in the course of collection and treasury and other bills (US\$3,097 million); loans to banks (US\$9,244 million, including US\$8,761 million repayable within one year); and loans to customers (US\$25,926 million, including US\$14,983 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.

## Notes on the Financial Statements (continued)

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 45% and 85%.

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 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		Stressed one month coverage ratio	
	during:		during:	
	2014	2013	2014	2013
	%	%	%	%
Year-end .....	<b>104.0</b>	96.7	<b>112.0</b>	134.0
Maximum .....	<b>106.1</b>	99.7	<b>132.0</b>	149.0
Minimum .....	<b>97.9</b>	92.5	<b>112.0</b>	125.0
Average .....	<b>102.5</b>	95.8	<b>121.8</b>	135.6

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



## Notes on the Financial Statements (continued)

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. VaR limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set.

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

## Notes on the Financial Statements (continued)

### Value at risk ('VAR')

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

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

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

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

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

### Stress testing

Stress testing is an important tool that is integrated into our market risk management tool to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables. In such abnormal scenarios, losses can be much greater than those predicted by VaR modelling.

Stress testing is implemented at legal entity, regional and overall Group levels. A standard set of scenarios is utilised consistently across all regions within the Group. Scenarios are tailored to capture the relevant events or market movements at each level. The risk appetite around potential stress losses for the Group is set and monitored against referral limits.

Sensitivities: Impact of a single risk factor, for example, break of a currency peg;

Technical: Impact of the largest move in each risk factor without consideration of any underlying market correlation;

Hypothetical: Impact of potential macroeconomic events, for example, a global flu epidemic;

Historical: Scenarios that incorporate historical observations of market movements;

Market risk reverse stress tests are undertaken on the premise that there is a fixed loss. The stress test process identifies which scenarios lead to this loss. The rationale behind the reverse stress test is to understand scenarios which are beyond normal business settings that could have contagion and systemic implications.

## Notes on the Financial Statements (continued)

### Trading and non-trading portfolios

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

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

<sup>1</sup>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

	2014 US\$000	2013 US\$000
At 31 December .....	4,105	2,479
Average .....	3,130	2,813
Minimum .....	1,822	2,090
Maximum .....	4,686	4,484

### Trading portfolios

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

Market-making and position-taking is undertaken within Global Markets. The VAR for such trading intent activity at 31 December 2014 was US\$0.9 million (2013: US\$0.6 million).

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

	Foreign exchange US\$000	Interest rate US\$000	Credit US\$000	Total <sup>1</sup> US\$000
<b>At 31 December 2014</b> .....	107	606	645	903
At 31 December 2013 .....	183	342	439	631
<b>Average</b>				
2014 .....	180	792	600	996
2013.....	195	979	930	1,433
<b>Minimum</b>				
2014 .....	105	192	149	253
2013.....	121	303	427	628
<b>Maximum</b>				
2014 .....	326	1,932	1,695	2,467
2013.....	366	2,961	2,453	3,000

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

### Gap risk

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

## Notes on the Financial Statements (continued)

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

The group incurred no material losses arising from gap risk movements in the underlying market price on such transactions in the 12 months ended 31 December 2014.

### De-peg risk

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

### Non-trading portfolios

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

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

The control of market risk in the non-trading portfolios is based on transferring the risks to the books managed by Global Markets 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 2014 was US\$173 million (2013: US\$219 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.

## Notes on the Financial Statements (continued)

### 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.

Business and Regional Risk Management Committees, which are a forward-looking holistic forum for all aspects of risk management including operational risk, ensure that all countries and business units maintain an operational risk management framework that meets the group's minimum standards.

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. Operational risk teams support the business management in their management and oversight of operational risk .

A centralised database is used to record the results of the operational risk management process. Operational risk and control assessments, control monitoring plans, incidents, issues and action plans 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 HSBC Group standards. Legal risk falls within the definition of operational risk and includes contractual risk, dispute risk, legislative risk and non-contractual rights risk.

## Notes on the Financial Statements (continued)

- **Contractual risk** is the risk of a group company suffering financial loss, reputational damage, or legal or regulatory action because its rights and/or obligations under a contract to which it is a party are technically defective.
- **Dispute risk** is the risk of a group company suffering financial loss or reputational damage due to an adverse dispute environment or the management of disputes.
- **Legislative risk** is the risk of a group company failing 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 protected 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 legal claims against group companies, as well as in respect of non-routine debt recoveries or other litigation commenced by a group company against third parties. There are legal departments in a number of countries in which the group operates.

Operating companies must notify the appropriate legal department and General Counsel immediately if any litigation or contentious regulatory matter is either threatened or commenced against the group company or an employee. They, in turn, must provide appropriate reports to the HSBC Group Legal Head Office on contentious regulatory matters, criminal proceedings, actual or threatened litigation where the amount claimed is (or is likely to be) at or in excess of US\$5 million or has significant reputational risk.

In addition, operating companies are required to submit bi-annual litigation returns detailing, amongst other matters, (a) individual outstanding claims which (i) are at or exceed US\$10 million, (ii) are or may be reputationally sensitive, (iii) involve criminal proceedings against a group company, or (iii) involve a regulatory authority, (b) other claims below US\$10 million for which the HSBC Group Legal Head Office has requested bi-annual litigation returns be completed, and (c) group of claims where the same issue is involved. 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.

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.

**Notes on the Financial Statements** (continued)

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)*

	2014 Basel II US\$000	2013 Basel II US\$000
<b>Composition of regulatory capital</b>		
Tier 1 capital .....	4,938,251	4,891,124
Tier 2 capital .....	831,520	856,567
Total regulatory capital .....	<u>5,769,771</u>	<u>5,747,691</u>
<b>Risk weighted assets</b>		
Credit and counterparty risk .....	31,477,531	30,928,840
Market risk .....	1,919,050	2,641,250
Operational risk .....	3,533,676	3,659,932
	<u>36,930,257</u>	<u>37,230,022</u>
<b>Capital ratios</b>		
Capital adequacy ratio.....	<u>15.62</u>	<u>15.44</u>

**34 Contingent liabilities, contractual commitments and guarantees****Contingent liabilities**

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security as well as contingent liabilities related to legal proceedings or regulatory matters (see Note 37), 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 is not probable that settlement will require the 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.

**Financial guarantee contracts**

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

	2014 US\$000	2013 US\$000
<b>Guarantees and other contingent liabilities</b>		
Guarantees .....	<u>13,384,450</u>	<u>11,787,834</u>
<b>Commitments</b>		
Documentary credits and short-term trade-related transactions .....	884,959	1,385,937
Undrawn formal standby facilities, credit lines and other commitments to lend: .....	<u>20,066,056</u>	<u>18,079,162</u>
	<u>20,951,015</u>	<u>19,465,099</u>

The above table discloses the nominal principal amounts of commitments, guarantees and other contingent liabilities. 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:

	2014 US\$000	2013 US\$000
Guarantees and assets pledged by the bank as collateral security .....	1,503,135	1,421,900
Documentary credits and short-term trade-related transactions .....	147,003	156,303
	<b>1,650,138</b>	<b>1,578,203</b>

### 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:

Guarantee type	At 31 December 2014		At 31 December 2013	
	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
Financial guarantees <sup>1</sup> .....	1,930,078	322,770	1,582,216	404,255
Credit related guarantees <sup>2</sup> .....	4,740,508	446,076	3,968,219	316,781
Other guarantees .....	5,210,729	734,289	4,815,499	700,864
Total .....	<b>11,881,315</b>	<b>1,503,135</b>	<b>10,365,934</b>	<b>1,421,900</b>

<sup>1</sup> 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. 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.

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

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

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

	2014 US\$000	2013 US\$000
Other items .....	293	1,034
	<b>293</b>	<b>1,034</b>

### Other commitments

In addition to the commitments disclosed above, at 31 December 2014 the group had US\$ Nil (2013: 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

#### Accounting policy

Agreements which transfer substantially all the risks and rewards incidental to the ownership of assets, are classified as finance leases. As a lessor under finance leases, the group presents the amounts due under the leases, after deduction of unearned charges, in 'Loans and advances to banks' or 'Loans and advances to customers'. As a lessee under finance leases, the group presents the leased assets in 'Property, plant and equipment' with the corresponding liability included in 'Other liabilities'. A finance lease asset 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.

All other leases are classified as operating leases. As lessor, the group presents assets subject to operating leases in 'Property, plant and equipment'. Impairment losses are recognised to the extent that carrying values are not fully recoverable. As a lessee, leased assets are not recognised on the balance sheet.

Finance income or charges on the finance lease are recognised in 'Net interest income' over the lease periods so as to give a constant rate of return. Rentals payable or receivable under operating leases are spread on a straight-line basis over the lease periods and are recognised in 'General and administrative expenses' or in 'Other operating income'.

#### Operating lease commitments

At 31 December 2014, 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.

	<b>Land and buildings</b>	
	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Future minimum lease payments under non-cancellable operating leases expiring:		
no later than one year .....	<b>37,003</b>	39,811
later than one year and no later than five years .....	<b>111,985</b>	126,646
later than five years .....	<b>8,584</b>	18,854
	<b>157,572</b>	185,311

In 2014, US\$36.7 million (2013: US\$36.4 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.

	<b>Present value of finance lease commitments</b>	
	<b>2014</b>	2013
	<b>US\$000</b>	US\$000
Lease receivables:		
- no later than one year .....	<b>44,516</b>	52,940
- later than one year and no later than five years .....	<b>24,341</b>	116,441
- later than five years .....	<b>—</b>	75,313
	<b>68,857</b>	244,694

## Notes on the Financial Statements (continued)

### 36 Structured entities

#### Accounting Policy

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 arrangements. Structured entities often have restricted activities and a narrow and well defined objective.

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

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 both consolidated and unconsolidated structured entities, which may be established by HSBC or by a third party.

#### Consolidated structured entities

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

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

	2014	2013
Nature of structured entity	US\$000	US\$000
Corporate debt issuer		
HBME Sukuk Company Limited .....	<b>458,700</b>	502,400

#### 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:*

	2014	2013
	US\$000	US\$000
Non-group managed funds.....	<b>32,926</b>	71,260

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

## Notes on the Financial Statements (continued)

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

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

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

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

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

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

In November 2014, a complaint was filed in the US District Court for the Eastern District of New York on behalf of representatives of US persons killed or injured in Iraq between April 2004 and November 2011. The complaint was filed against HSBC Holdings, HSBC Bank plc, HSBC Bank USA and HSBC Bank Middle East, as well as other non-HSBC banks and the Islamic Republic of Iran (together, the 'Defendants'). The plaintiffs allege that defendants conspired to violate the US Anti-Terrorism Act of 2001, by altering or falsifying payment messages involving Iran, Iranian parties and Iranian banks for transactions processed through the US. Defendants' motion to dismiss is due to be filed in March 2015. This matter is at

## Notes on the Financial Statements (continued)

an early stage. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of this matter, including the timing or any possible impact on HSBC.

### 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

	2014 US\$000	2013 US\$000
Remuneration (wages and bonus).....	4,491	6,351
Post-employment benefits .....	99	208
Share based payments – value of shares awarded .....	2,852	3,209
	<b>7,442</b>	<b>9,768</b>

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.

	2014		2013	
	Highest balance during the year <sup>1</sup> US\$000	Balance at 31 December <sup>1</sup> US\$000	Highest balance during the year <sup>1</sup> US\$000	Balance at 31 December <sup>1</sup> US\$000
<b>Key Management Personnel and connected persons and companies controlled by them</b>				
Loans .....	1,154	764	1,180	762
Credit cards .....	70	23	82	37

<sup>1</sup> 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.

**Notes on the Financial Statements** (continued)**Transactions with other related parties***Associates*

	2014		2013	
	Highest balance during the year <sup>1</sup> US\$000	Balance at 31 December <sup>1</sup> US\$000	Highest balance during the year <sup>1</sup> US\$000	Balance at 31 December <sup>1</sup> US\$000
Amounts due from associates .....	345	199	332	248
Amounts due to associates .....	75,384	16,437	16,437	13,121

<sup>1</sup> 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

	2014		2013	
	Highest balance during the year <sup>1</sup> US\$000	Balance at 31 December <sup>1</sup> US\$000	Highest balance during the year <sup>1</sup> US\$000	Balance at 31 December <sup>1</sup> US\$000
<b>Assets</b>				
Loans and advances to customers .....	1,114	1,114	738	198
<b>Liabilities</b>				
Customer accounts .....	22,389	1,280	25,408	20,060
Subordinated amounts due .....	300,000	-	300,000	300,000

<sup>1</sup> 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 2014 US\$000	For the year ended 31 December 2013 US\$000
<b>Income Statement</b>		
Interest expense .....	19,318	20,100
Fee expense .....	4,877	5,361
Other operating income .....	472	(163)
General and administrative expenses .....	29,601	30,145

## Notes on the Financial Statements (continued)

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

	2014		2013	
	Highest balance during the year <sup>1</sup> US\$000	Balance at the year end <sup>1</sup> US\$000	Highest balance during the year <sup>1</sup> US\$000	Balance at the year end <sup>1</sup> US\$000
<b>Assets</b>				
Trading assets .....	247,440	72,663	286,269	87,049
Derivatives .....	732,807	593,073	914,675	732,807
Loans and advances to banks .....	2,837,447	1,615,268	2,837,447	2,387,447
<b>Liabilities</b>				
Trading liabilities .....	202,630	20,257	261,443	5,158
Deposits by banks .....	1,217,961	1,217,961	238,748	238,748
Derivatives .....	1,079,107	1,079,107	1,375,372	1,023,545
Subordinated amounts due .....	950,000	950,000	750,000	650,000
Guarantees .....	404,255	312,056	404,255	404,255

<sup>1</sup> 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 2014 US\$000	For the year ended 31 December 2013 US\$000
<b>Income Statement</b>		
Interest income .....	3,703	5,203
Interest expense .....	29,265	25,965
Fee income .....	69,492	62,964
Fee expense .....	15,457	25,795
Other operating income .....	35,824	40,698
General and administrative expenses .....	116,809	119,398

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

	2014		2013	
	Highest balance during the year <sup>1</sup> US\$000	Balance at the year end <sup>1</sup> US\$000	Highest balance during the year <sup>1</sup> US\$000	Balance at the year end <sup>1</sup> US\$000
<b>Assets</b>				
Loans and advances to banks .....	80,524	15,865	84,325	45,961
Loans and advances to customers .....	378,065	378,065	376,785	373,968
<b>Liabilities</b>				
Deposits by banks .....	143,790	57,492	141,769	141,769
Customer accounts .....	50,269	33,970	74,064	50,245

<sup>1</sup> 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.

### 39 Events after the balance sheet date

A fourth interim dividend for 2014 of US\$135 million was declared by the Directors on 10 February 2015.

These accounts were approved by the Board of Directors on 10 February 2015 and authorised for issue.

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

HSBC Bank Middle East Limited  
Head Office  
HSBC House, Esplanade,  
St. Helier, Jersey JE4 8UB,  
Channel Islands  
Tel: (44-1534) 606512  
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

KUWAIT  
Kuwait City - Qibla Area

LEBANON  
Beirut – Minet El-Hosn  
Beirut – Ras-Beirut Branch Rbeiz Building  
Greater Beirut – Dora Branch

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  
Jebel Ali – Free Trade Zone  
Fujairah – Hamad Bin Abdulla St  
Ras Al Khaimah – Corniche Rd  
Sharjah – King Faisal Road  
12 Customer Service Units and 2  
Management Offices

HSBC Bank Middle East Limited - DIFC  
Branch  
Dubai International Financial Centre  
Dubai, UAE

LIBYA  
HSBC Bank Middle East Limited  
(Representative office licence)

PRINCIPAL SUBSIDIARY COMPANIES  
HSBC Bank Oman S.A.O.G.  
Muscat Head Office, 77 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  
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 9 branches

HSBC Bank Egypt S.A.E.  
Cairo, Head Office, 63 branches, 10  
Corporate Implants, 2 Customer Service Unit  
and 2 Relationship Management centres.

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 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*

**REGISTERED OFFICE**

HSBC House, Esplanade, St Helier, Jersey, JE4 8UB, Channel Islands

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