

## 2 Principal accounting policies (continued)

- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties were evident;
- the amount and timing of expected receipts and recoveries;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not in local currency; and
- when available, the secondary market price of the debt.

Releases on individually calculated specific provisions were recognised whenever the group had reasonable evidence that the established estimate of loss had reduced.

### *Cross-border exposures*

Specific provisions were established in respect of cross-border exposures to countries assessed by management to be vulnerable to foreign currency payment restrictions. This assessment included analysis of both economic and political factors.

Provisions were applied to all qualifying exposures within these countries unless these exposures:

- were performing, trade-related and of less than one year's maturity;
- were mitigated by acceptable security cover which was, other than in exceptional cases, held outside the country concerned; or
- were represented by securities held for trading purposes for which a liquid and active market existed, and which were marked to market daily.

### *General provisions*

General provisions augmented specific provisions and provided cover for loans that were impaired at the balance sheet date but which would not be individually identified as such until some time in the future. The group required operating companies to maintain a general provision, which was determined after taking into account:

- historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of a specific provision against that loss; and
- management's judgement as to whether the then economic and credit conditions were such that the actual level of inherent loss was likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification (as evidenced by the establishment of a specific provision for that loss) was determined by local management for each identified portfolio.

### *Loans on which interest was being suspended and non-accrual loans*

Loans were designated as non-performing as soon as management had doubts as to the ultimate collectibility of principal or interest or when contractual payments of principal or interest were 90 days overdue. When a loan was designated as non-performing, interest was not normally credited to the income statement and either interest accruals ceased ('non-accrual loans') or interest was credited to an interest suspense account in the

## Notes on the Financial Statements (continued)

### 2 Principal accounting policies (continued)

balance sheet which was netted against the relevant loan ('suspended interest').

Within portfolios of low value, high volume, homogeneous loans, interest was normally suspended on facilities 90 days or more overdue. In certain operating subsidiaries, interest income on credit cards may have continued to be included in earnings after the account was 90 days overdue, provided that a suitable provision was raised against the portion of accrued interest which was considered to be irrecoverable.

The designation of a loan as non-performing and the suspension of interest could be deferred for up to 12 months in either of the following situations:

- cash collateral was held covering the total of principal and interest due and the right of set-off was legally sound; or
- the value of any net realisable tangible security was considered more than sufficient to cover the full repayment of all principal and interest due, and credit approval had been given to the rolling-up or capitalisation of interest payments.

Interest on non-performing loans was charged to the customer's account provided that there was a realistic prospect of interest being paid at some future date. However, the interest was not credited to the income statement but to an interest suspense account in the balance sheet, which was netted against the relevant loan.

When the probability of receiving interest payments was remote, interest was no longer accrued and any suspended interest balance was written off.

On receipt of cash (other than from the realisation of security), the overall risk was re-evaluated and, if appropriate, suspended or non-accrual interest was recovered and taken to the income statement. A specific provision of the same amount as the interest receipt was then raised against the principal balance. Amounts received from the realisation of security were applied to the repayment of outstanding indebtedness, with any surplus used to recover any specific provisions and then suspended interest.

Loans were not reclassified as accruing until interest and principal payments were up-to-date and future payments were reasonably assured.

Loan write-offs

Loans (and the related provisions) were normally written off, either partially or in full, when there was no realistic prospect of recovery of these amounts and when the proceeds from the realisation of security had been received.

#### (g) Trading assets and trading liabilities

##### *From 1 January 2005*

Treasury bills, debt securities, equity shares and short positions in securities are classified as held-for-trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised initially at fair value using trade date accounting, with transaction costs taken to the income statement. Subsequently, their fair values are remeasured, and all gains and losses from changes therein, together with related interest income, interest expense and dividends, are recognised in the income statement in 'Trading income' as they arise.

##### *From 1 January 2004 to 31 December 2004*

Treasury bills, debt securities, equity shares and short positions in securities were included in 'Trading assets' or 'Trading liabilities' in the balance sheet at market value. Changes in the market value of these assets and liabilities were recognised in the income statement as 'Trading income' as they arose. For liquid portfolios, market values were determined by reference to independently sourced mid-market prices. In certain less liquid

## 2 Principal accounting policies (continued)

portfolios, securities were valued by reference to bid or offer prices as appropriate. When independent prices were not available, market values were estimated by discounting the expected future cash flows using a suitable interest rate adjusted for the counterparty's credit risk. Interest income, interest expense and dividends arising from trading assets and liabilities were aggregated in the income statement with similar amounts arising from other activities, as they arose separately from 'Trading income'.

### (h) Financial instruments designated at fair value

#### *From 1 January 2005*

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

- eliminates or significantly reduces valuation or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the group has designated unit-linked investment contracts, financial assets held to back certain insurance contracts, and certain portfolios of securities and debt issues that are managed in conjunction with financial assets or liabilities measured on a fair value basis; or
- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, the group has designated financial assets held to back certain insurance contracts, and certain asset-backed securities; or
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Financial assets and financial liabilities so designated are recognised initially at fair value using trade date accounting, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, with gains and losses from changes therein recognised in the income statement as they arise, together with related interest income, interest expense and dividends, in 'Net income from financial instruments designated at fair value'.

Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are also included in 'Net income from financial instruments designated at fair value'.

### (i) Financial instruments

#### *From 1 January 2005*

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2(h)), are classified as 'available-for-sale' or 'held-to-maturity'.

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

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

## Notes on the Financial Statements (continued)

### 2 Principal accounting policies (continued)

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

- if the fair value of a debt instrument classified as available-for-sale increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement;
- impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

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

#### *From 1 January 2004 to 31 December 2004*

Treasury bills, debt securities and equity shares intended to be held on a continuing basis were classified as financial investments and included in the balance sheet at cost less provision for any permanent diminution in value.

When dated financial investments had been purchased at a premium or discount, those premiums and discounts were amortised through the income statement over the period from the date of purchase to the date of maturity so as to give a constant rate of return. If the maturity was at the borrowers' option within a specified range of years, the earliest maturity was adopted. Those financial investments were included in the balance sheet at cost adjusted for the amortisation of premiums and discounts arising on acquisition. The amortisation of premiums and discounts was included in 'Interest income'. Any gain or loss on realisation of these securities was recognised in 'Gains less losses from financial investments' in the income statement as it arose.

#### (j) Determination of fair value

Fair values for trading instruments and available-for-sale securities that are quoted in active markets are based on bid/offer prices at the time. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

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

#### (k) Sale and repurchase agreements (including stock lending and borrowing)

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities purchased under commitments to sell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate.

## 2 Principal accounting policies (continued)

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

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

### (l) Derivatives and hedge accounting

#### *From 1 January 2005*

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values are obtained from quoted market prices in active markets, or by using valuation techniques when an active market does not exist. All derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative.

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

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives if three circumstances apply: (i) their economic characteristics and risks are not clearly and closely related to those of the host contract; (ii) the terms of the embedded derivative are the same as those of a stand-alone derivative; and (iii) the combined contract is not designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists, and the parties intend to settle the cash flows on a net basis.

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

#### **Hedge accounting**

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

## Notes on the Financial Statements (continued)

### 2 Principal accounting policies (continued)

#### Fair value hedge

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

If a hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item for which the effective interest rate method is used is amortised to the income statement over the residual period to maturity. An adjustment relating to the carrying amount of a hedged available-for-sale equity security remains in equity until the disposal of the equity security.

#### Cash flow hedge

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

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

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

#### Net investment hedge

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

#### *Hedge effectiveness testing*

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

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

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

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

#### *Derivatives that do not qualify for hedge accounting*

All gains and losses from changes in the fair values of any derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value, in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'.

## 2 Principal accounting policies (continued)

### *From 1 January 2004 to 31 December 2004*

Derivative financial instruments comprised futures, forward, swap and option transactions undertaken by the group in the foreign exchange, interest rate, equity, credit derivative, and commodity markets that were held off-balance sheet. Netting was applied where a legal right of set-off existed.

Accounting for these instruments was dependent upon whether the transactions were undertaken for trading or non-trading purposes.

#### *Trading transactions*

Trading transactions included transactions undertaken for market-making, to service customers' needs and for proprietary purposes, as well as any related hedges.

Transactions undertaken for trading purposes were marked to market and the net present value of any gain or loss arising was recognised in the income statement as 'Trading income', after appropriate deferrals for unearned credit margins and future servicing costs. Derivative trading transactions were valued by reference to an independent liquid price when this was available. For those transactions with no readily available quoted prices, predominantly over the counter transactions, market values were determined by reference to independently sourced rates, using valuation models. If market observable data was not available, the initial increase in fair value indicated by the valuation model, but based on unobservable inputs, was not recognised immediately in the income statement. This amount was held back and recognised over the life of the transaction where appropriate, or released to the income statement when the inputs became observable, or when the transaction matured or was closed out. Adjustments were made for illiquid positions where appropriate.

Assets, including gains, resulting from derivative exchange rate, interest rate, equities, credit derivative and commodity contracts which were marked to market were included in 'Derivatives' on the assets side of the balance sheet. Liabilities, including losses, resulting from such contracts, were included in 'Derivatives' on the liabilities side of the balance sheet.

#### *Non-trading transactions*

Non-trading transactions, which were those undertaken for hedging purposes as part of the group's risk management strategy against cash flows, assets, liabilities or positions, were measured on an accrual basis. Non-trading transactions included qualifying hedges and positions that synthetically altered the characteristics of specified financial instruments.

Non-trading transactions were accounted for on an equivalent basis to the underlying assets, liabilities or net positions. Any gain or loss arising was recognised on the same basis as that arising from the related assets liabilities or positions.

To qualify as a hedge, a derivative was required effectively to reduce the price, foreign exchange or interest rate risk of the asset, liability or anticipated transaction to which it was linked and be capable of designation as a hedge at inception of the derivative contract. Accordingly, changes in the market value of the derivative were required to be highly correlated with changes in the market value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. If these criteria were met, the derivative was accounted for on the same basis as the underlying hedged item. Derivatives used for hedging purposes included swaps, forwards and futures. Interest rate swaps were also used to alter synthetically the interest rate characteristics of financial instruments. In order to qualify for synthetic alteration, a derivative instrument had to be linked to specific individual, or pools of similar, assets or liabilities by the notional principal and interest rate risks of the associated instruments, and had to achieve a result that was consistent with defined risk management objectives. If these criteria were met, accruals-based accounting was applied, i.e. income or expense was recognised and accrued to the next settlement date in accordance with the contractual terms of the agreement.

Any gain or loss arising on the termination of a qualifying derivative was deferred and amortised to earnings over the original life of the terminated contract. When the underlying asset, liability or position was sold or terminated, the qualifying derivative was immediately marked-to-market and any gain or loss arising was taken to the income statement.

## Notes on the Financial Statements (continued)

### 2 Principal accounting policies (continued)

#### (m) Derecognition of financial assets and liabilities

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

#### (n) Offsetting financial assets and financial liabilities

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

#### (o) Associates

- (i) Investments in associates are initially stated at cost and are adjusted thereafter for the post-acquisition change in the group's share of net assets.
- (ii) Unrealised gains 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. Unrealised losses are also eliminated to the extent of the group's interest in the associates unless the transaction provides evidence of an impairment of the asset transferred.

#### (p) Intangible assets

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

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

#### (q) Property, plant and equipment

- (i) 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, and land held under leases greater than 500 years (which are treated as finance leases), are not depreciated; and
  - buildings are depreciated on cost or valuation at the greater of two per cent per annum on a straight-line basis or, if leasehold, over the unexpired terms of the leases, or over their remaining useful lives.
- (ii) Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their accumulated useful lives, which run to a maximum of 35 years but are generally between five years and 20 years.

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

#### (r) Finance and operating leases

- (i) Agreements which transfer to counterparties substantially all the risks and rewards associated with the ownership of assets, other than legal title, are classified as finance leases. When the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to customers'. Finance income receivable is recognised over the periods of the leases

## 2 Principal accounting policies (continued)

so as to give a constant rate of return on the net investment in the leases.

- (ii) When the group is a lessee under finance leases the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. Leases of land exceeding 500 years to expiry at inception are recognised as finance leases. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.
- (iii) All other leases are classified as operating leases. When acting as lessor, the group includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the equipment is thereby impaired. When the group is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

### (s) Income tax

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

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

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

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

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

### (t) Post-employment benefits

The bank contributes to the Government pension and social security schemes in the countries in which it operates, as per local regulations. End of service benefits are calculated and paid in accordance with local law. The bank's net obligation in respect of such end of service benefits is the amount of future benefits that employees have earned in return for their service in current and prior periods. The obligation is calculated by a qualified actuary using the projected unit credit method (using an emerging cash flow model) allowing for assumed future experience. The discount rate used is the yield on a suitable index of US corporate bonds (Merill Lynch US Corporate AA 15+ Year Index). All actuarial gains or losses are recognised in shareholders' equity.

The bank also makes contributions to the HSBC International Staff Retirement Benefit Scheme in respect of a small number of International Managers being seconded to the bank by the HSBC Group. The bank

## Notes on the Financial Statements (continued)

### 2 Principal accounting policies (continued)

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.

#### (u) Equity compensation plans

Shares awarded to an employee on joining the group that are made available immediately, with no vesting period attached to the award, are expensed immediately. When an inducement is awarded to an employee on commencement of employment with the group, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting.

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

The cost of guaranteed bonuses awarded in respect of service in the past, where an employee must complete a specified period of service until entitled to the award, is spread over the period of service rendered to the vesting date.

Discretionary bonuses awarded in respect of service in the past are expensed over the vesting period which, in this case, is the period from the date the bonus is announced until the award vests.

#### (v) Foreign currencies

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

(ii) Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined.

(iii) The results of branches, subsidiaries and associates not reporting in US dollars are translated into US dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are accounted for in a separate foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary financial statements. In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. In accordance with IFRS 1, the group has set the cumulative translation differences for all foreign operations to zero at the date of transition to IFRSs. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

#### (w) Provisions

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

## 2 Principal accounting policies (continued)

### (x) Debt securities in issue and subordinated liabilities

#### *From 1 January 2005*

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

#### *From 1 January 2004 to 31 December 2004*

Debt securities in issue were initially measured at fair value, which was the consideration received net of transaction costs incurred. Premiums and discounts on the issue of debt and fair value adjustments to debt arising on acquisitions were amortised to interest payable so as to give a constant interest rate over the life of the debt. Where debt was callable, either by the group or the holder, the premium or discount was amortised over the period to the earliest call date.

### (y) Share capital

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

## 3 Net operating income

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Net operating income for the year ended 31 December 2005 is stated after the following items of income, expense, gains and losses:

	<b>2005</b>
	<b>US\$000</b>
<b>Income</b>	
Fees earned on financial assets that are not held for trading or designated at fair value and that is not included in their effective interest rates	<b>116,292</b>
Fees earned on trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	<b>10,602</b>
<b>Expense</b>	
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	<b>(269,636)</b>
<b>Gains/(losses)</b>	
Impairment losses on:	
— loans and advances	<b>28,676</b>

## Notes on the Financial Statements (continued)

### 4 Employee compensation and benefits

	2005 US\$000	2004 US\$000
Wages and salaries	188,904	152,792
Social security costs	3,068	1,294
Post-employment benefits (Note 2(t))	18,841	11,035
	<u>210,813</u>	<u>165,121</u>

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

	2005 Number	2004 Number
Personal Banking	1,369	1,277
Commercial Banking	662	553
Corporate and Institutional Banking	124	106
Global Markets	75	85
Private Banking	2	—
Other	1,504	1,315
	<u>3,736</u>	<u>3,336</u>

### 5 General and administrative expenses

#### Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to US\$588 thousand (2004: US\$513 thousand). The following remuneration was paid by the group to the group's principal auditor, KPMG Channel Islands Limited and its affiliated firms ('KPMG'):

	2005 US\$000	2004 US\$000
Audit services		
— statutory audit	588	513
— audit-related regulatory reporting	297	140
Total audit services	<u>885</u>	<u>653</u>
Further assurance services	293	208
Tax services	21	10
Other services		
— other services	38	43
Total other services	<u>352</u>	<u>261</u>
Total fees paid to KPMG	<u>1,237</u>	<u>914</u>

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

- Audit-related regulatory reporting services include services for assurance and other services that are reasonably related to the performance of the audit or review of financial statements, including comfort letters and interim reviews.
- Further assurance services include services for advice on accounting matters, reporting on internal controls not connected with the financial statements and due diligence work.
- Tax services include services for tax compliance and tax advice.

## 5 General and administrative expenses (continued)

- Other services include other assurance and advisory services such as translation services, review of financial models and advice on IT security.

## 6 Share-based payments

During 2005, US\$1,806 thousand was charged to the income statement in respect of equity-settled share-based payment transactions (2004: Nil). This expense was based on the fair value of the share-based payment transactions when contracted. All of the expense arose under employee share awards made within HSBC's reward structures.

### Calculation of fair values

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

The significant weighted average assumptions used to estimate the fair value of the options granted in 2005 were as follows:

	Group Share Option Plan	3-year Savings Related Share Option Schemes	5-year Savings Related Share Option Schemes
Risk-free interest rate (%) <sup>1</sup>	4.6	4.3	4.3
Expected life (years) <sup>2</sup>	7.8	3.0	5.0
Expected volatility (%) <sup>3</sup>	20.0	20.0	20.0
Expected dividend yield (US\$ per share) <sup>4</sup>	0.7	0.7	0.7

- <sup>1</sup> The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan awards and UK Savings-Related Share Option Schemes. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.
- <sup>2</sup> Expected life is not a single input parameter but a function of various behavioural assumptions.
- <sup>3</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.
- <sup>4</sup> Expected dividend yield was based on historic levels of dividend growth.

### HSBC Share Plan

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

#### *Performance share awards*

Performance share awards are made to Senior Executives taking into account individual performance in the prior year. Performance Share Awards are divided into two equal parts for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return measure, based on HSBC's ranking against a comparator group of 28 major banks. The other half of the award is subject to an Earnings Per Share target. For each element of the award, shares would be released to the employee according to a sliding scale from 30 to 100 per cent of the award, dependent upon the scale of achievement against the benchmarks. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if HSBC performance fails to meet the minimum criteria.

## Notes on the Financial Statements (continued)

### 6 Share-based payments (continued)

	2005 Number (000's)
Outstanding at 1 January	222
Granted in the year	57
Expensed in the year	(33)
Outstanding at 31 December	<u>246</u>

The weighted average fair value of shares awarded by HSBC for Performance Share Awards in 2005 was **£2,295 thousand**.

#### *Restricted Share Awards*

Restricted Share Awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from date of award. The bank granted Restricted Share Awards to certain executives in the years 2002, 2003, 2004 and 2005. These awards confer the right to the employees concerned to own shares of HSBC Holdings plc upon completion of a minimum number of years of service from the date of award. Should the employee not satisfy this condition, subject to certain exceptions, the award would lapse. The cost of the restricted shares is determined by HSBC Holdings plc and is paid by the bank up-front. The cost is thereafter spread over the vesting period of the award.

#### *Achievement Share Awards*

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

	2005		
	Number of employees	Number of shares (000's)	Average award (000's)
Forfeited in the year <sup>1</sup>	118	181	2
Outstanding at 31 December	<u>118</u>	<u>181</u>	<u>2</u>

The weighted average fair value of shares awarded by HSBC for Achievement Share Awards in 2005 was **£1,689 thousand**.

#### Savings-related share option plans

The savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plan is to align the interests of all employees to the creation of shareholder value. The options are exercisable within six months following either the third or the fifth anniversary of the commencement of the savings contract depending on conditions set at grant. The exercise price is set at a 20 per cent (2004: 20 per cent) discount to the market value at the date of grant.

## 6 Share-based payments (continued)

	2005		2004	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	2,069	5.98	2,375	5.88
Granted in the year	652	6.66	511	6.47
Exercised in the year	(818)	6.08	(607)	6.00
Forfeited in the year	(162)	6.18	—	—
Expired in the year	(9)	5.10	(210)	5.99
Outstanding at 31 December <sup>1</sup>	<u>1,732</u>	<u>6.18</u>	<u>2,069</u>	<u>5.98</u>

The weighted average fair value of options granted in the year as at the date of grant was £6,083 thousand (2004: £4,492 thousand). The number of options and the weighted average exercise price outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2005	2004
Exercise price range (£)	£5.35-£6.75	£5.35-£6.75
Number (000's)	1,732	2,069
Weighted average exercise price (£)	6.18	5.98

### Restricted Share Plan

#### *Conditional awards under the Restricted Share Plan*

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

#### *Other awards made under the Restricted Share Plan*

Other awards were made under the Restricted Share Plan as part deferral of annual bonus. Awards were also made for recruitment and retention purposes. The awards generally vest from one to three years from the date of award. Awards made under this plan ceased in 2004. Awards of restricted shares in 2005 were made under the Rules of the HSBC Share Plan.

#### *Group Share Option Plan*

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

## Notes on the Financial Statements (continued)

### 6 Share-based payments (continued)

	2005	
	Number	Weighted average exercise price
	(000's)	£
Outstanding at 1 January	1,844	7.79
Granted in the year	125	6.68
Exercised in the year	(167)	7.06
Expired in the year	(4)	7.81
Outstanding at 31 December	<u>1,798</u>	<u>7.78</u>

The weighted average fair value of options granted in the year as at the date of grant was £3.09 (2004: £2.96). The number of options and weighted average exercise price outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2005
	£5.35-£6.75
Exercise price range (£)	
Number (000's)	1,798
Weighted average exercise price (£)	7.78

#### Executive Share Option Scheme

The Executive Share Option Scheme was a long-term incentive scheme available to certain senior HSBC employees with grants made each year until the adoption of the Group Share Option Plan in 2000. The aim of the plan was to align the interests of those higher performing senior employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets to be attained in order for the awards to vest. Options were granted at market value and were exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. No awards have been made under this plan since 1999.

### 7 Tax expense

The charge for taxation comprises:

	2005	2004
	US\$000	US\$000
<b>Current tax</b>		
Overseas tax — current year	98,046	55,660
Overseas tax — adjustment in respect of prior years	(734)	(1,457)
	<u>97,312</u>	<u>54,203</u>
<b>Deferred tax</b>		
Origination and reversal of temporary differences	(5,547)	517
Effect of write-downs / reversal of write-downs of deferred tax assets	<u>(5,547)</u>	<u>517</u>
Tax expense	<u>91,765</u>	<u>54,720</u>

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

## 7 Tax expense (continued)

	2005 US\$000	2004 US\$000
<b>Analysis of overall tax charge</b>		
Taxation at UAE tax rate of 20 per cent (2004: 20 per cent)	89,829	58,989
Impact of overseas profits in principal locations taxed at different rates <sup>1</sup>	9,247	3,664
Income not subject to tax	(10,173)	(7,592)
Expenses not deductible for tax purposes	2,215	3,108
Prior period adjustments	(809)	(5,046)
Other items	1,456	1,597
Overall tax charge	<u>91,765</u>	<u>54,720</u>

1 Overseas profits taxed at different rates to that which applies in the UAE contributed to an increase in the effective tax rate of 1.13 per cent (2004: decrease of 0.26 per cent). The increase in the effective tax rate was more in 2005 than in 2004 because of the greater proportion of group profits arising in Qatar, where they are subject to a higher rate of tax than in the UAE, in 2005.

## 8 Dividends

	2005		2004	
	US\$ per share	US\$000	US\$ per share	US\$000
First interim	—	—	0.060	20,000
Second interim	—	—	0.045	15,000

## 9 Segment analysis

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

### (a) By geographical region

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

	<i>Middle East</i>	<i>Europe</i>	<i>Total</i>
	US\$000	US\$000	US\$000
<b>2005</b>			
<b>Gross income</b>			
Interest receivable	773,981	33,572	807,553
Dividend income	497	—	497
Fees and commissions receivable	237,074	—	237,074
Dealing profits	84,079	(496)	83,583
Other operating income	9,844	153	9,997
Total gross income	<u>1,105,475</u>	<u>33,229</u>	<u>1,138,704</u>
Profit on ordinary activities before tax	473,787	2,273	476,060
Attributable profit	382,230	103	382,333
Depreciation and amortisation	(11,078)	(54)	(11,132)
Provisions	(28,676)	—	(28,676)
Cost to acquire property, plant and equipment	(14,009)	(5)	(14,014)
Cost to acquire intangibles	(215)	—	(215)
Net assets	1,130,595	123,737	1,254,332
Total assets	18,864,764	46,738	18,911,502
Total liabilities	17,652,728	4,442	17,657,170

## Notes on the Financial Statements (continued)

### 9 Segment analysis (continued)

2004	<u>Middle East</u> US\$000	<u>Europe</u> US\$000	<u>Total</u> US\$000
Gross income			
Interest receivable	484,077	817	484,894
Dividend income	15	—	15
Fees and commissions receivable	174,408	2	174,410
Dealing profits	55,932	555	56,487
Other operating income	5,456	117	5,573
<b>Total gross income</b>	<b>719,888</b>	<b>1,491</b>	<b>721,379</b>
Profit on ordinary activities before tax	297,138	209	297,347
Attributable profit/(loss)	241,669	(1,194)	240,475
Depreciation and amortisation	(10,214)	(180)	(10,394)
Provisions	(40,223)	—	(40,223)
Cost to acquire property, plant and equipment	(8,107)	(40)	(8,147)
Cost to acquire intangibles	(1,478)	—	(1,478)
Net assets	741,218	128,589	869,807
Total assets	12,578,998	88,438	12,667,436
Total liabilities	11,791,067	6,562	11,797,629

#### (b) By customer group

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

#### (c) By class of business

	2005 US\$000	2004 US\$000
<b>Profit on ordinary activities before tax</b>		
Personal Banking	100,622	67,433
Commercial Banking	226,250	149,605
Corporate and Institutional Banking	75,529	43,499
Investment Banking	72,445	54,470
Private Banking	1,214	—
Other	—	(17,660)
<b>Net assets</b>		
Personal Banking	137,555	127,956
Commercial Banking	450,488	326,994
Corporate and Institutional Banking	253,181	130,667
Investment Banking	131,248	57,599
Other	281,860	226,591
<b>Total assets</b>		
Personal Banking	5,386,055	4,551,024
Commercial Banking	7,517,841	4,995,614
Corporate and Institutional Banking	3,890,758	2,223,461
Investment Banking	8,024,896	5,983,476
Private Banking	1,174,772	—
Other	2,634,915	947,774

## 10 Analysis of financial assets and liabilities by measurement bases

	<i>Held for trading</i> <i>US\$000</i>	<i>Loans and receivables</i> <i>US\$000</i>	<i>Available-for-sale securities</i> <i>US\$000</i>	<i>Financial assets and liabilities at amortised cost</i> <i>US\$000</i>	<i>Derivatives designated as fair value hedging instruments</i> <i>US\$000</i>	<i>Total</i> <i>US\$000</i>
<b>ASSETS</b>						
Cash and balances at central banks	—	—	—	260,817	—	260,817
Items in the course of collection from other banks	—	—	—	132,752	—	132,752
Trading assets	202,963	—	—	—	—	202,963
Derivatives	145,312	—	—	—	1,257	146,569
Loans and advances to banks	—	4,845,167	—	—	—	4,845,167
Loans and advances to customers	—	11,372,418	—	—	—	11,372,418
Financial investments	—	—	992,540	—	—	992,540
Other assets	—	—	—	641,676	—	641,676
Total financial assets	<u>348,275</u>	<u>16,217,585</u>	<u>992,540</u>	<u>1,035,245</u>	<u>1,257</u>	<u>18,594,902</u>
Total non-financial assets						316,600
Total assets						<u>18,911,502</u>
<b>LIABILITIES</b>						
Deposits by banks	—	—	—	758,287	—	758,287
Customer accounts	—	—	—	14,174,426	—	14,174,426
Items in the course of transmission to other banks	—	—	—	89,493	—	89,493
Derivatives	135,065	—	—	—	1,421	136,486
Debt securities in issue	—	—	—	1,564,328	—	1,564,328
Other liabilities	—	—	—	821,181	—	821,181
Total financial liabilities	<u>135,065</u>	<u>—</u>	<u>—</u>	<u>17,407,715</u>	<u>1,421</u>	<u>17,544,201</u>
Total non-financial liabilities						112,969
Total liabilities						<u>17,657,170</u>

## 11 Trading assets

	2005 US\$000	2004 US\$000
Trading assets:		
— not subject to repledge or resale by counterparties	<u>202,963</u>	<u>192,611</u>
Debt securities	25,902	44,411
Equity securities	177,061	148,200
	<u>202,963</u>	<u>192,611</u>

*In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

## Notes on the Financial Statements (continued)

### 12 Derivatives

#### Fair values of derivatives open positions by product contract type held by the group<sup>1</sup>

	At 31 December 2005					
	Assets			Liabilities		
	Trading US\$000	Hedging US\$000	Total US\$000	Trading US\$000	Hedging US\$000	Total US\$000
Exchange rate	119,415	—	119,415	(111,653)	—	(111,653)
Interest rate	25,897	1,257	27,154	(23,412)	(1,421)	(24,833)
Total	<u>145,312</u>	<u>1,257</u>	<u>146,569</u>	<u>(135,065)</u>	<u>(1,421)</u>	<u>(136,486)</u>
				At 31 December 2004		
				Total assets	Total liabilities	
				US\$000	US\$000	
Exchange rate				70,181	(63,711)	
Interest rate				5,567	(3,618)	
Total				<u>75,748</u>	<u>(67,329)</u>	

1 In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.

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

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

#### Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in IAS 39. All other derivative instruments are classified as held-for-trading. The held-for-trading classification includes two types of derivative instruments: those used in sales and trading activities, and those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second type of held-for-trading category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with offsetting deals being utilised to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures as are used for traditional lending.

#### Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating