

**12 Derivatives** (continued)

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

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Trading income'.

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

	2005	2004
	US\$000	US\$000
Exchange rate	13,285,433	5,641,645
Interest rate	5,696,039	1,281,808
Total derivatives	<u>18,981,472</u>	<u>6,923,453</u>

**Hedging Instruments**

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

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, as described below.

The following table summarises the contract amounts of derivatives held for hedging purposes by product type:

	At 31 December 2005 Fair value hedge US\$000
Interest rate	<u>61,007</u>

With respect to interest rate contracts, the notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

**Fair value hedges**

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

## Notes on the Financial Statements (continued)

### 12 Derivatives (continued)

adjustment over the remainder of the hedging period.

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2005, were assets of US\$1,257 thousand and liabilities of US\$1,421 thousand.

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

	2005 US\$000
Gains arising from the change in fair value of fair value hedges:	
— on hedged items attributable to the hedged risk	<u>92</u>

### 13 Loans and advances to banks

	2005 Book value US\$000	Fair value <sup>1</sup> US\$000	2004 Book value US\$000
Loans and advances to banks	<u>4,845,167</u>	<u>4,842,183</u>	<u>2,073,071</u>

<sup>1</sup> 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.

### 14 Loans and advances to customers

	2005 Book value US\$000	Fair value <sup>1</sup> US\$000	2004 Book value US\$000
Loans and advances to customers	<u>11,372,418</u>	<u>11,420,230</u>	<u>8,463,372</u>

<sup>1</sup> 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.

Loans and advances to customers include finance leases with a present value amounting to US\$121,363 thousand (2004: US\$93,559 thousand).

### 15 Financial investments

	2005 US\$000	2004 US\$000
Financial investments:		
— not subject to repledge or resale by counterparties	<u>992,540</u>	<u>1,164,554</u>
	2005 Book value and fair value <sup>1</sup> US\$000	2004 Book value US\$000
Treasury and other eligible bills:		
— available-for-sale	145,451	168,580
Debt securities:		
— available-for-sale	835,964	990,292
Equity securities:		
— available-for-sale	11,125	5,682
Total financial investments	<u>992,540</u>	<u>1,164,554</u>

## 15 Financial investments (continued)

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.

## 16 Interests in associates

Principal associates of the bank

Name of associate	Country of incorporation	At 31 December 2005		
		Principal activity	The bank's interest in equity capital	Issued equity capital
Arabian Real Estate Investment Trust Management Limited	Cayman Islands	Real estate	40.00%	US\$1 million of which US\$0.8 million is fully paid
British Arab Commercial Bank Limited	England	Banking	46.51%	US\$81 million and £32 million fully paid £5 million nil paid
Rewards Management Middle East Free Zone Limited Liability Company	Dubai, UAE	Multi-participant loyalty programmes	40.00%	AED0.5 million

On 12 December 2005, the bank purchased 40% of the equity share capital of Arabian Real Estate Investment Trust Management Limited at a cost of US\$400 thousand.

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

The bank's share of associates' contingent liabilities amounted to US\$435,509 thousand at 31 December 2005 (2004: US\$398,002 thousand).

The associates are unlisted.

Arabian Real Estate Investment Trust Management Limited operates in Dubai.

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

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

Movement in investments in associates:

	<b>2005</b>
	<b>US\$000</b>
At 1 January 2005	132,124
IFRSs transition adjustment at 1 January 2005	10,368
Additions	400
Retained profits and losses	19,467
Exchange and other movements	(22,974)
<b>At 31 December 2005</b>	<b>139,385</b>

## Notes on the Financial Statements (continued)

### 16 Interests in associates (continued)

Summarised aggregated financial information of associates is as follows:

	2005	2004
	US\$000	US\$000
Assets	1,756,930	1,691,650
Liabilities	1,618,093	1,566,279
Revenues	51,004	24,443
Profit	37,084	11,960

### 17 Intangible assets

The analysis of the movement of intangible assets for the year ended 31 December 2005 is as follows:

	Software			
	2005		2004	
	<i>Cost</i>	<i>Accumulated depreciation</i>	<i>Cost</i>	<i>Accumulated depreciation</i>
	US\$000	US\$000	US\$000	US\$000
At 1 January	4,862	(3,096)	3,940	(2,696)
Additions	215	—	1,478	—
Disposals	(244)	248	(561)	178
Charge for the year <sup>1</sup>	—	(687)	—	(563)
Exchange translation differences	1	(1)	—	—
Other changes	(24)	45	5	(15)
<b>At 31 December</b>	<b>4,810</b>	<b>(3,491)</b>	<b>4,862</b>	<b>(3,096)</b>
<b>Net book value at 31 December</b>	<b>1,319</b>		<b>1,766</b>	

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

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

Computer software which is capitalised as an intangible asset is amortised over its useful life, but no longer than five years. When amortising the cost of the software, the residual value is always assumed to be zero as the bank does not sell the software once its useful life has expired.

### 18 Property, plant and equipment

	<i>Freehold land and buildings</i>	<i>Short leasehold land and buildings</i>	<i>Equipment, fixtures and fittings</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000
<b>Cost or fair value</b>				
At 1 January 2005	38,577	41,734	64,450	144,761
Additions at cost	90	3,107	10,817	14,014
Disposals	—	(1,575)	(4,671)	(6,246)
Transfers	—	—	(20)	(20)
Exchange translation differences	(104)	11	5	(88)
Other changes	(21)	—	(39)	(60)
<b>At 31 December 2005</b>	<b>38,542</b>	<b>43,277</b>	<b>70,542</b>	<b>152,361</b>

## 18 Property, plant and equipment (continued)

<b>Accumulated depreciation</b>				
At 1 January 2005	—	(20,117)	(49,778)	(69,895)
Depreciation charge for the year	(882)	(2,512)	(7,051)	(10,445)
Disposals	—	1,579	4,478	6,057
Transfers	—	(9)	(30)	(39)
Exchange translation differences	12	(10)	(14)	(12)
Other changes	45	(42)	(16)	(13)
<b>At 31 December 2005</b>	<b>(825)</b>	<b>(21,111)</b>	<b>(52,411)</b>	<b>(74,347)</b>
<b>Net book value at 31 December 2005</b>	<b>37,717</b>	<b>22,166</b>	<b>18,131</b>	<b>78,014</b>

	<i>Freehold land and buildings</i>	<i>Short leasehold land and buildings</i>	<i>Equipment, fixtures and fittings</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000
<b>Cost or fair value</b>				
At 1 January 2004	39,721	40,450	63,586	143,757
Additions at cost	262	2,227	5,658	8,147
Disposals	(1,006)	(947)	(4,811)	(6,764)
Transfers	—	—	1,488	1,488
Exchange translation differences	121	4	26	151
Other changes	(521)	—	(1,497)	(2,018)
<b>At 31 December 2004</b>	<b>38,577</b>	<b>41,734</b>	<b>64,450</b>	<b>144,761</b>
<b>Accumulated depreciation</b>				
At 1 January 2004	—	(18,624)	(45,906)	(64,530)
Depreciation charge for the year	(826)	(2,285)	(6,720)	(9,831)
Disposals	315	794	3,242	4,351
Transfers	—	—	(1,185)	(1,185)
Exchange translation differences	(10)	(2)	(18)	(30)
Other changes	521	—	809	1,330
<b>At 31 December 2004</b>	<b>—</b>	<b>(20,117)</b>	<b>(49,778)</b>	<b>(69,895)</b>
<b>Net book value at 31 December 2004</b>	<b>38,577</b>	<b>21,617</b>	<b>14,672</b>	<b>74,866</b>

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

	2005		2004	
	<i>Cost</i>	<i>Accumulated depreciation</i>	<i>Cost</i>	<i>Accumulated depreciation</i>
	US\$000	US\$000	US\$000	US\$000
At 1 January	41,699	(20,085)	39,789	(18,561)
Additions	3,107	—	2,072	—
Disposals	(1,575)	1,579	(188)	164
Transfers	—	(9)	77	(64)
Depreciation charge for the year	—	(2,512)	—	(2,285)
Exchange translation differences	11	(8)	5	—
Other changes	—	(42)	(56)	661
<b>At 31 December</b>	<b>43,242</b>	<b>(21,077)</b>	<b>41,699</b>	<b>(20,085)</b>
<b>Net book value at 31 December</b>	<b>22,165</b>		<b>21,614</b>	

## Notes on the Financial Statements (continued)

### 19 Investments

The principal subsidiary undertakings of the bank are:

	<i>Country of incorporation or registration</i>	<i>Bank's interest in equity capital</i>
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%

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

The subsidiary undertakings are directly owned and are included in the consolidation.

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

The subsidiary undertakings are unlisted.

### 20 Other assets

	2005 US\$000	2004 US\$000
Assets held for resale	2,394	2,786
Deferred taxation (Note 25)	29,109	24,745
Endorsements and acceptances	560,364	—
Other accounts	49,809	44,391
	<u>641,676</u>	<u>71,922</u>

The composition of the assets held for sale is as follows:

	2005 US\$000	2004 US\$000
Repossessed property	2,394	2,786

The intent to sell repossessed properties is published in two daily newspapers, bi-annually. Once the pricing has been agreed, the relevant documentation and registration is completed and a sale is recorded.

No fair value is calculated for repossessed properties.

### 21 Deposits by banks

	2005		2004
	Book value US\$000	Fair value <sup>1</sup> US\$000	Book value US\$000
Deposits by banks	<u>758,287</u>	<u>758,095</u>	<u>1,709,781</u>

<sup>1</sup> 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.

## 22 Customer accounts

	2005		2004
	Book value US\$000	Fair value <sup>1</sup> US\$000	Book value US\$000
Customer accounts	<u>14,174,426</u>	<u>14,178,515</u>	<u>8,996,885</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.

## 23 Debt securities in issue

	2005		2004
	Book value US\$000	Fair value <sup>1</sup> US\$000	Book value US\$000
Medium term notes, by remaining maturity			
— between 2 and 5 years	1,064,328	1,060,658	298,364
Non-equity preference shares	500,000	500,000	400,000
Debt securities in issue	<u>1,564,328</u>	<u>1,560,658</u>	<u>698,364</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.

### Medium term notes

On 11 October 2004, the bank established a Debt Issuance Programme providing for the issue of up to US\$1,000,000,000 in debt securities in the form of medium-term notes. On 14 December 2004, the bank issued, under the Programme, a first tranche of US\$300,000,000 floating rate notes due 14 December 2009. On 5 May 2005, the bank issued, under the Programme, a second tranche of US\$700,000,000 floating rate notes due 5 May 2010. The costs of the issue have been amortised over the life of the notes.

### Non-equity preference shares

#### Authorised

At 31 December 2005 and 2004, the authorised non-equity preference share capital of the bank was 750,000 cumulative redeemable preference shares of US\$1 each.

#### Issued

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

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

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

The first issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 31 October 2002. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.

## Notes on the Financial Statements (continued)

### 23 Debt securities in issue (continued)

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

The second issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 2 April 2003. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.

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

The redemption of the third issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 17 December 2013 and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the bank on any date after 17 December 2008, without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.

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

The redemption of the fourth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 26 August 2014 and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the bank on any date after 26 August 2009, without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.

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

The redemption of the fifth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 19 December 2015 and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the bank on any date after 19 December 2010, without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.

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.

## 24 Other liabilities

	2005 US\$000	2004 US\$000
Current taxation	105,769	65,604
Obligations under finance leases	6,169	6,495
Endorsements and acceptances	560,364	—
Other liabilities	148,879	91,760
	<u>821,181</u>	<u>163,859</u>
Obligations under finance leases falling due:		
— over 5 years	<u>6,169</u>	<u>6,495</u>

## 25 Provisions for liabilities and charges

### (a) Deferred tax

	<i>Amount of deferred tax asset recognised in the balance sheet</i>		<i>Amount of deferred tax liability recognised in the balance sheet</i>	
	2005 US\$000	2004 US\$000	2005 US\$000	2004 US\$000
Temporary difference:				
— loan impairment provisions	25,024	23,214	—	—
— relief for losses	—	601	—	—
— revaluation of non-investment property	—	—	2,647	2,688
— other	4,085	930	—	—
<b>At 31 December 2005</b>	<u>29,109</u>	<u>24,745</u>	<u>2,647</u>	<u>2,688</u>

### (b) Other provisions for liabilities and charges

	<i>Provisions for contingent liabilities and commitments</i> US\$000	<i>Other Provisions</i> US\$000	<i>Total</i> US\$000
At 1 January 2005	3,690	2,017	5,707
Additional provisions/increase in provisions	118	5,516	5,634
Provisions utilised	(1,127)	(4,256)	(5,383)
Amounts reversed	(921)	—	(921)
Exchange and other movements	(167)	153	(14)
<b>At 31 December 2005</b>	<u>1,593</u>	<u>3,430</u>	<u>5,023</u>

Included within “provisions for contingent liabilities and commitments” is an amount of US\$939 thousand (2004: US\$1,487 thousand) relating to the “HSBC In The Community Middle East Foundation”. This is a charitable trust established by the bank, whose aim is to provide funding to Middle East nationals, primarily for educational and environmental purposes. Funding is provided on a case by case basis, throughout the year.

## Notes on the Financial Statements (continued)

## 26 Maturity analysis of liabilities

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

	<i>On demand</i>	<i>Due within 3 months</i>	<i>Due between 3 and 12 months</i>	<i>Due between 1 and 5 years</i>	<i>Due after 5 years</i>	<i>Total</i>
	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>
Deposits by banks	44,518	243,841	29,461	19,829	—	337,649
Customer accounts	5,840,550	7,349,540	983,292	230,503	2,917	14,406,802
Debt securities in issue	—	34,035	102,104	1,608,883	922,444	2,667,466
Other financial liabilities	8,048	499,142	132,010	13,623	3,203	656,026
<b>Total at 31</b>						
December 2005	<u>5,893,116</u>	<u>8,126,558</u>	<u>1,246,867</u>	<u>1,872,838</u>	<u>928,564</u>	<u>18,067,943</u>

## At 31 December 2005

	<i>Due within 1 year</i>	<i>Due after more than 1 year</i>	<i>Total</i>
	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>
<b>Assets</b>			
Loans and advances to banks	4,820,908	24,259	4,845,167
Loans and advances to customers	7,537,303	3,835,115	11,372,418
Financial investments	508,308	484,232	992,540
Other financial assets	549,213	11,151	560,364
	<u>13,415,732</u>	<u>4,354,757</u>	<u>17,770,489</u>
<b>Liabilities</b>			
Deposits by banks	742,701	15,586	758,287
Customer accounts	13,990,639	183,787	14,174,426
Debt securities in issue	—	1,564,328	1,564,328
Other financial liabilities	549,707	16,826	566,533
	<u>15,283,047</u>	<u>1,780,527</u>	<u>17,063,574</u>

## At 31 December 2004

	<i>Due within 1 year</i>	<i>Due after more than 1 year</i>	<i>Total</i>
	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>
<b>Assets</b>			
Loans and advances to banks	2,043,888	29,183	2,073,071
Loans and advances to customers	5,581,087	2,882,285	8,463,372
Financial investments	750,330	414,224	1,164,554
	<u>8,375,305</u>	<u>3,325,692</u>	<u>11,700,997</u>
<b>Liabilities</b>			
Deposits by banks	1,679,554	30,227	1,709,781
Customer accounts	8,952,351	44,534	8,996,885
Debt securities in issue	—	698,364	698,364
Other financial liabilities	494	6,001	6,495
	<u>10,632,399</u>	<u>779,126</u>	<u>11,411,525</u>

## 27 Foreign currency exposures

(a) Assets and liabilities denominated in foreign currency	2005 US\$000	2004 US\$000
<b>Assets</b>		
Denominated in US dollars	7,732,169	4,482,572
Denominated in currencies other than US dollars	11,179,333	8,184,864
Total assets	<u>18,911,502</u>	<u>12,667,436</u>
<b>Equity and liabilities</b>		
Denominated in US dollars	10,578,443	4,812,528
Denominated in currencies other than US dollars	8,333,059	7,854,908
Total equity and liabilities	<u>18,911,502</u>	<u>12,667,436</u>

### (b) Structural currency exposures

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

The group's management of structural foreign currency exposures is discussed in the 'Market risk' section on pages 60 to 65.

The group's structural currency exposures as at the year-end were as follows:

#### Net structural currency exposures

Currency of structural exposure	2005 US\$000	2004 US\$000
Bahraini dinar	61,755	46,579
Jordanian dinar	73,057	64,316
Kuwaiti dinar	49,505	—
Lebanese pound	40,429	36,169
Omani rial	77,416	64,074
Qatari rial	98,228	72,655
Sterling	246	292
UAE dirham	1,109,224	759,198
<b>Total</b>	<u>1,509,860</u>	<u>1,043,283</u>

## 28 Called up share capital

### Authorised

The authorised ordinary share capital of the bank at 31 December 2005 and 2004 was 1,000,000,000 ordinary shares of US\$1 each.

### Issued and fully paid

	Number of ordinary shares	US\$000
At 1 January and 31 December 2005	<u>331,055,000</u>	<u>331,055</u>
At 1 January and 31 December 2004	<u>331,055,000</u>	<u>331,055</u>

## Notes on the Financial Statements (continued)

## 29 Reserves

	2005							
	Other reserves							
	<i>Called up share capital</i>	<i>Retained earnings</i>	<i>Available-for- sale fair value reserve</i>	<i>Foreign exchange reserve</i>	<i>Share-based payment reserve</i>	<i>Total share- holders' equity</i>	<i>Minority interests</i>	<i>Total equity</i>
<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	
At 1 January	331,055	534,513	—	—	—	865,568	4,239	869,807
IFRSs transition adjustment at 1 January 2005	—	8,806	6,239	—	834	15,879	—	15,879
Profit for the year attributable to shareholders	—	382,333	—	—	—	382,333	—	382,333
Share of changes recognised directly in equity in the associate's equity	—	(30,422)	—	—	—	(30,422)	—	(30,422)
Actuarial gains on post- employment benefits schemes	—	817	—	—	—	817	—	817
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	—	—	—	94	—	94	—	94
Fair value gains taken to equity	—	—	7,095	—	—	7,095	—	7,095
Charge to the income statement in respect of equity settled share- based payment transactions	—	—	—	—	1,276	1,276	—	1,276
Exchange and other movements	—	7,615	—	—	—	7,615	—	7,615
Profit attributable to minority interests	—	—	—	—	—	—	1,962	1,962
Dividends to minority interests	—	—	—	—	—	—	(2,124)	(2,124)
<b>At 31 December</b>	<b>331,055</b>	<b>903,662</b>	<b>13,334</b>	<b>94</b>	<b>2,110</b>	<b>1,250,255</b>	<b>4,077</b>	<b>1,254,332</b>

29 Reserves (continued)

	2004							
	Other reserves							Total equity
	<i>Called up share capital</i>	<i>Retained earnings</i>	<i>Available-for-sale fair value reserve</i>	<i>Foreign exchange reserve</i>	<i>Share-based payment reserve</i>	<i>Total shareholders' equity</i>	<i>Minority interests</i>	
<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>		
At 1 January	331,055	315,819	—	—	—	646,874	4,537	651,411
Profit for the year attributable to shareholders	—	240,475	—	—	—	240,475	—	240,475
Dividends to shareholders of the parent company	—	(35,000)	—	—	—	(35,000)	—	(35,000)
Share of changes recognised directly in equity in the associate's equity	—	10,667	—	—	—	10,667	—	10,667
Exchange and other movements	—	2,552	—	—	—	2,552	—	2,552
Profit attributable to minority interests	—	—	—	—	—	—	2,152	2,152
Dividends to minority interests	—	—	—	—	—	—	(2,450)	(2,450)
At 31 December	<u>331,055</u>	<u>534,513</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>865,568</u>	<u>4,239</u>	<u>869,807</u>

## Notes on the Financial Statements (continued)

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

	2005	2004
	US\$000	US\$000
(a) Non-cash items included in profit and loss		
Depreciation and amortisation	13,638	10,594
Loan impairment losses	28,676	40,455
Loans written off net of recoveries	(25,651)	(38,902)
Provisions for liabilities and charges	4,712	14,373
Provisions utilised	(5,383)	(14,310)
Accretion of discounts and amortisation of premiums	—	(645)
	<u>15,992</u>	<u>11,565</u>
(b) Change in operating assets		
Change in prepayments and accrued income	(50,566)	(5,234)
Change in net trading securities and net derivatives	(46,418)	(109,005)
Change in loans and advances to banks	50,034	(91,263)
Change in loans and advances to customers	(2,914,139)	(2,249,441)
Change in other assets	(628,027)	(42,434)
	<u>(3,589,116)</u>	<u>(2,497,377)</u>
(c) Change in operating liabilities		
Change in accruals and deferred income	13,447	15,406
Change in deposits by banks	(784,640)	125,847
Change in customer accounts	5,173,841	1,521,087
Change in debt securities in issue	765,964	298,364
Change in other liabilities	686,314	46,780
	<u>5,854,926</u>	<u>2,007,484</u>
(d) Cash and cash equivalents comprise		
Cash and balances at central banks	260,817	246,455
Items in the course of collection from other banks	132,752	123,631
Loans and advances to banks of one month or less	4,177,196	1,576,331
Treasury bills, other bills and certificates of deposit less than three months	19,757	349,085
Less: items in the course of transmission to other banks	(89,493)	(66,016)
	<u>4,501,029</u>	<u>2,229,486</u>

### 31 Risk management

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

#### (a) Credit risk management

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

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

### 31 Risk management (continued)

estimates and comprising up to 22 categories, is being progressively implemented across the HSBC Group and is already operative in most major business units.

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

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

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

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

#### Maximum exposure to credit risk

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

	At 31 December 2005		
	<i>Carrying value</i> US\$000	<i>Off-balance sheet exposure</i> US\$000	<i>Maximum exposure</i> US\$000
Trading assets:			
— debt securities	25,902	—	25,902
Derivatives	146,569	—	146,569
Loans and advances to banks	4,330,201	—	4,330,201
Loans and advances to customers	11,371,503	—	11,371,503
Financial investments:			
— treasury and other similar bills	145,451	—	145,451
— debt securities	835,964	—	835,964
Other assets:			
— endorsements and acceptances	560,364	—	560,364
Financial guarantees and other credit related contingent liabilities	—	16,528,736	16,528,736
	17,415,954	16,528,736	33,944,690

## Notes on the Financial Statements (continued)

### 31 Risk management (continued)

#### *Collateral and other credit enhancements*

##### *Loans and advances*

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

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

##### *Other securities*

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

#### *Concentrations of exposure*

	<b>2005</b>	2004
	%	%
Middle East	<b>47.20</b>	63.90
United Kingdom	<b>13.40</b>	14.10
Rest of Continental Europe	<b>21.10</b>	13.80
Asia	<b>16.20</b>	0.10
United States	<b>2.10</b>	8.10
	<b>100.00</b>	<b>100.00</b>

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

- the majority of the bank's exposure to credit risk is concentrated in the Middle East. Within the Middle East, the bank's credit risk is diversified over a wide range of industrial and economic groupings; and
- the bank's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2005 and 31 December 2004 was concentrated in mainland Europe and the Middle East.
- There are no special collateral requirements relating to industrial concentrations, with the exception of exposures to the property sector. The majority of exposures to the property and construction industry and the residential mortgage market are secured on the underlying property.

### 31 Risk management (continued)

#### Credit quality

##### Loans and advances

Distribution of loans and advances, by facility grade, that are neither past due nor impaired as at 31 December 2005:

	<u>At 31 December 2005</u>	
	<i>Loans and advances to customers US\$000</i>	<i>Loans and advances to banks US\$000</i>
Grade 1 — low risk	1,821,748	3,077,034
Grade 2 — satisfactory risk	3,187,205	1,474,001
Grade 3 — fair risk	5,808,119	236,371
Grade 4 — watch list	445,895	51,251
Grade 5 — sub-standard but not impaired	72,831	—
	<u>11,335,798</u>	<u>4,838,657</u>
Other securities		

##### Debt securities and other bills by rating agency designation

The following table presents an analysis of debt and similar securities, other than loans, by rating agency designation at 31 December 2005, based on Standard and Poor's ('S&P') ratings or their equivalent:

	<u>At 31 December 2005</u>		
	<i>Treasury bills US\$000</i>	<i>Debt securities US\$000</i>	<i>Total US\$000</i>
AAA	94,888	8,998	103,886
AA - to AA +	—	18,629	18,629
A - to A +	—	317,106	317,106
Lower than A -	—	99,476	99,476
Unrated	50,563	417,657	468,220
Total	<u>145,451</u>	<u>861,866</u>	<u>1,007,317</u>
Of which issued by:			
— governments	138,587	615,945	754,532
— corporates	6,864	245,922	252,786
Of which classified as:			
— held-for-trading debt securities	—	25,902	25,902
— available-for-sale securities	145,451	835,965	981,416

#### Impairment assessment

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

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

## Notes on the Financial Statements (continued)

### 31 Risk management (continued)

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

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

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

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

#### *Non-performing loans*

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

#### *Charge-offs*

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

### 31 Risk management (continued)

#### Impaired loans

##### Individually impaired loans by industry sector

	At 31 December 2005	
	Gross loans and advances to customers US\$000	Gross loans by industry sector as a % of total gross loans %
<b>Personal</b>		
Residential mortgages	1,277	0.01
Other personal	52,400	0.45
Total personal	<u>53,677</u>	<u>0.46</u>
<b>Corporate and commercial</b>		
Commercial, industrial and international trade	108,823	0.94
Other property-related	22,498	0.19
Government	5	0.00
Other commercial	71,263	0.61
Total corporate and commercial	<u>202,589</u>	<u>1.74</u>
<b>Financial</b>		
Non-bank financial institutions	1,437	0.01
Total impaired loans and advances to customers	<u>257,703</u>	<u>2.21</u>

#### Impairment allowances

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

##### Movement in allowance accounts for total loans and advances

	At 31 December 2005		
	Individually assessed US\$000	Collectively assessed US\$000	Total US\$000
At 1 January	217,548	37,614	255,162
Amounts written off	(1,927)	(45,228)	(47,155)
Recoveries of loans and advances written off in previous years	6,190	—	6,190
Charge to income statement	(8,205)	36,881	28,676
Exchange and other movements	(47,184)	62,726	15,542
At 31 December	<u>166,422</u>	<u>91,993</u>	<u>258,415</u>

## Notes on the Financial Statements (continued)

### 31 Risk management (continued)

#### Impairment allowances against loans and advances to customers

	2005	2004
	%	%
<b>Total impairment allowances to gross lending<sup>1</sup></b>		
Individually assessed impairment allowances	(0.06)	0.40
Collectively assessed impairment allowances	0.32	0.07
Total provisions to gross lending		
Specific provisions	1.42	2.46
General provisions	0.79	0.43
Total	<u>2.47</u>	<u>3.36</u>

1 Net of settlement accounts.

#### Net impairment charge to income statement by geographical region

	Year ended 31 December 2005
	<i>Middle East</i>
	<i>US\$000</i>
<b>Individually assessed impairment allowances</b>	
New allowances	16,084
Release of allowances no longer required	(18,100)
Recoveries of amounts previously written off	(6,190)
	<u>(8,206)</u>
<b>Collectively assessed impairment allowances</b>	
New allowances	59,398
Release of allowances no longer required	(7,206)
Recoveries of amounts previously written off	(15,310)
	<u>36,882</u>
Total charge for impairment losses:	
— bank	(1,740)
— customer	<u>30,416</u>
Customer charge for impairment losses as a percentage of closing gross loans and advances	<u>0.26%</u>
<b>31 December 2005</b>	
<b>Customer balances outstanding</b>	
Non-performing loans	294,323
Impairment allowances	257,703

#### Net charge to the profit and loss account for bad and doubtful debts by geographical region