

31 Risk management (continued)

	Year ended 31 December 2004
	<i>Middle East</i> US\$000
Specific provisions	
New provisions	65,197
Release of provisions no longer required	(18,053)
Recoveries of amounts previously written off	(12,634)
	<u>34,510</u>
General provisions	
Total bad and doubtful debt charge:	5,945
— bank	14
— customer	40,441
	<u>0.46%</u>
Customer bad and doubtful debt charge as a percentage of closing gross loans and advances	
31 December 2004	
Non-performing loans	327,430
Provisions	252,490

Renegotiated loans

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

Renegotiated loans that would otherwise be past due or impaired

	2005 US\$000
Loans and advances to customers	23,965
Loans and advances to banks	1,299
	<u>25,264</u>

(b) Liquidity and funding management

The bank maintains a diversified and stable funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets. The objective of the bank's liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due.

The Group's liquidity and funding management process includes:

- projecting cash flows by major currency and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and

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

Core retail deposits (current accounts and savings deposits payable on demand or at short notice) form a significant part of the group's overall funding. Considerable importance is attached to this core deposit base which, over the years, has been stable and predictable. The HSBC Group prefers to grow its balance sheet through increasing core retail deposits where possible.

HSBC Global Markets is an important player in the money markets and debt capital markets. As a leading market maker in loans and deposits, the bank routinely accepts deposits, often of a short-term nature, from banks and other institutions and makes advances to similar organisations. In addition, the funding of capital markets activities, by repo arrangements for example, will often result in funding directly in the wholesale market.

It is, however, HSBC Group's policy that on an all-currency basis all professional deposits with residual maturities up to 30 days, plus 5 per cent of deposit liabilities should be backed by liquid assets. This means that, in a crisis, the group would be able to meet its obligations as they fall due for at least 30 days without recourse to the wholesale markets.

Throughout the group's operations, sufficient liquidity is maintained to meet their day-to-day needs and local regulatory requirements unless specific arrangements are made for Global Markets in Dubai or London to provide the necessary support.

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

(c) Market risk management

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

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

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

Value at risk ('VAR')

One of the principal tools used by HSBC to monitor and limit market risk exposure is VAR. VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence (for HSBC, 99 per cent). HSBC calculates VAR daily. The VAR model used by HSBC is predominantly based on historical simulation. The historical simulation model derives plausible future scenarios from historical market rates time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years. HSBC has changed the assumed holding period from a 10-day period to a 1-day period as this reflects the way the risk positions are managed. Comparative VAR numbers have been re-stated to reflect this change.

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

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

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- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in 1 day. This may not fully reflect the market risk arising from times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

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

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

Total		US\$000
At 31 December 2005		2,535
At 31 December 2004		2,284
	Average	Minimum
	US\$000	US\$000
2005	2,438	2,010
2004	2,071	877
		Maximum
		US\$000
		2,767
		3,340

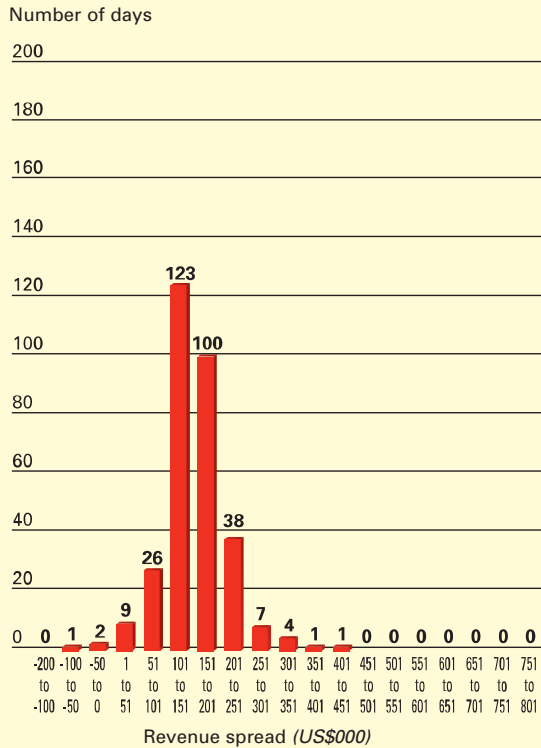
The daily revenue earned from market risk-related treasury activities includes accrual book net interest income and funding related to dealing positions. The histogram below illustrates the frequency of daily revenue arising from such market risk-related activities.

The average daily revenue earned from market risk-related treasury activities in 2005, including accrual book net interest income and funding of dealing positions, was US\$152 thousand compared with US\$153 thousand in 2004. The standard deviation of these daily revenues was US\$58 thousand compared with US\$46 thousand in 2004. The standard deviation measures the variation of daily revenues about the mean value of those revenues.

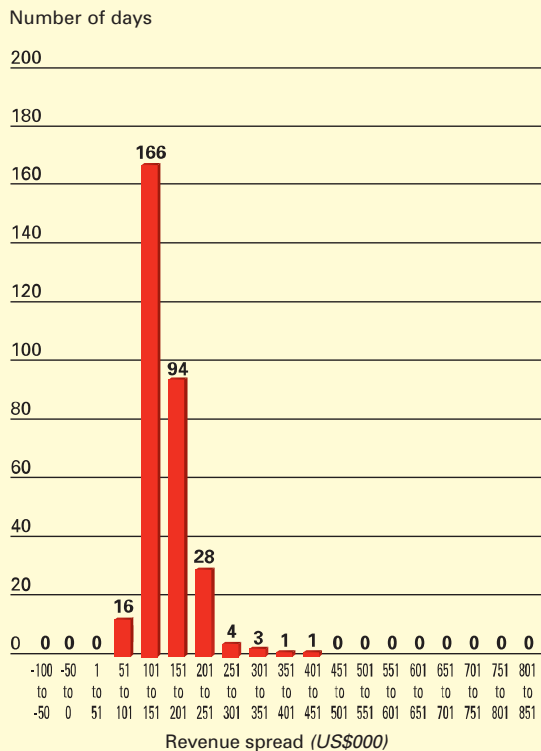
An analysis of the frequency distribution of daily revenues shows that there were 3 days with negative revenues during 2005 compared with no days in 2004. The most frequent result was a daily revenue of between US\$101 thousand and US\$151 thousand, with 123 occurrences.

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Daily distribution of market risk revenues 2005
HSBC Bank Middle East Limited Treasury



Daily distribution of market risk revenues 2004
HSBC Bank Middle East Limited Treasury



Fair value and price verification control

Where certain financial instruments are carried on the group's balance sheet at fair values, the valuation and the related price verification processes are subject to careful governance across the group. Financial instruments which are accounted for on a fair value basis include assets held in the trading portfolio, financial instruments designated at fair value, obligations related to securities sold short and all derivative financial instruments.

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

The responsibility for the determination of accounting policies and procedures governing valuation and validation ultimately rests with the HSBC Group Finance and the Corporate, Investment Banking and Markets Finance functions, which report to the HSBC Group Finance Director. All significant valuation policies, and any changes thereto, must be approved by senior finance management. HSBC's governance of financial reporting requires that:

Financial Control departments across the Group are independent of the risk-taking businesses, with the Finance functions having ultimate responsibility for the determination of fair values included in the financial statements, and for ensuring that the Group's policies and relevant accounting standards are adhered to. Both senior management and the HSBC Group Audit Committee assess the resourcing and expertise of Finance functions within the Group on a regular basis to ensure that the Group's financial control and price verification processes are properly staffed to support the required control infrastructure.

Trading

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

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

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Total trading VAR by risk type

	Foreign US\$000	Interest rate trading US\$000	Total trading US\$000
At 31 December 2005	195	4	197
At 31 December 2004	54	230	235
Average			
2005	173	108	216
2004	56	169	183
Minimum			
2005	65	2	134
2004	24	23	44
Maximum			
2005	284	687	850
2004	167	383	394

Non-trading

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

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

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

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

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

Net interest income

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

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well as standard scenarios required to be used across the group. The standard scenarios are consolidated to illustrate the combined pro forma impact on the group's consolidated portfolio valuations and net interest income.

The impact on future net interest income of a 25 basis points parallel fall or rise in all yield curves worldwide in each quarter during the 12 month period from 1 January 2006 would decrease or increase planned net interest income by US\$6,707 thousand (\$2,683 thousand from 1 January 2005). These scenarios differ from those disclosed in the Annual Report and Accounts 2004 which assumed an immediate 100 basis points parallel rise or fall in all yield curves on the first day of the 12 month period. The revised scenarios, although still simplified, are considered more relevant.

The figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the group's current interest rate risk profile. This effect, however, does not incorporate actions that could be taken by Global Markets or in the business units to mitigate the impact of this interest rate risk. In reality, Global Markets would seek to proactively change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections also make other simplifying assumptions, including that all positions run to maturity.

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

- Core deposit franchises: these are exposed to changes in the value of the deposits raised and spreads against wholesale funds; in a low interest rate environment, the value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is, however, asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.
- Global Markets: the residual interest rate risk is managed within Global Markets. This reflects the group's policy of transferring all interest rate risk, other than structural risk, to Global Markets to be managed within defined limits and with flexibility as to the instruments used.

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

- Reinvestment rates — for the purpose of the sensitivity projections, it has been assumed maturing interest earning assets and interest bearing liabilities replenish at the prevailing market rates and on similar terms.
- The projected movements from rate changes are computed assuming simultaneous change in customer rates.
- Economic environment — the projected effect of interest rate moves assumes no significant changes in the existing economic environment, interest rate and exchange rate policies of the regions where the group operates.

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

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

Following the adoption of IFRS, the group monitors the sensitivity of reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cashflow hedges due to parallel movements of plus or minus 100bps in all yield curves. The table below describes the sensitivity to these movements at 31 December 2005 and the maximum and minimum month figures during the year then ended:

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	<i>At 31 December 2005 US\$000</i>	<i>Maximum impact US\$000</i>	<i>Minimum impact US\$000</i>
+ 100 basis point parallel move all in yield curves As a percentage of shareholders funds at 31 December 2005	(3,552) (0.28) %	(5,183) (0.41) %	(3,552) (0.28) %
- 100 basis point parallel move all in yield curves As a percentage of shareholders funds at 31 December 2005	3,552 0.28 %	5,183 0.41 %	3,552 0.28 %

Structural foreign exchange exposures

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

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

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

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

(d) Operational risk management

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

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

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

- Operational risk management responsibility is assigned at senior management level within the business operation;
- Information systems are used to record the identification and assessment of operational risks and generate appropriate, regular management reporting;
- Operational risks are identified by assessments covering operational risks facing each business and risks

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inherent in processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;

- Operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the Group Audit Committee and the Risk Management Meeting; and
- Risk mitigation, including insurance, is considered where this is cost-effective.

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

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

(e) Capital management

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

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

The group's capital is divided into two tiers:

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

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

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

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

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

The group complied during the period with the JFSC's capital adequacy requirements, with one exception. A short-term substantial long US dollar position arose in the UAE as a result of demand for UAE dirhams required by foreign investors for subscription in a major regional IPO in which the group was a receiving bank. Such positions are not risk-weighted in the UAE, but are risk weighted under the JFSC's regulations. The UAE

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dirhams/US\$ peg means that such positions have minimal economic risk, however this position caused the JFSC's regulatory minimum capital adequacy ratio to be temporarily breached. This breach was taken very seriously and after advising the JFSC, consequential capital injections totalling US\$200 million were made and enhanced monitoring and changes to internal operational guidelines were agreed and implemented to address the deficiencies which caused this exception.

(f) Reputational risk management

The safeguarding of HSBC's reputation is of paramount importance to its continued prosperity and is the responsibility of every member of staff. Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business, but it can also be affected by the way in which clients, to whom it provides financial services, conduct themselves.

Reputational risks are considered and assessed by the HSBC Board, the HSBC Group Management Board, the HSBC Risk Management Meeting, subsidiary company boards, board committees and/or senior management during the formulation of policy and the establishment of HSBC standards. Standards on all major aspects of business are set for HSBC and for individual subsidiaries, businesses and functions. These policies, which are an integral part of the internal control systems, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies set out operational procedures in all areas of reputational risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations.

Management in all operating entities is required to establish a strong internal control structure to minimise the risk of operational and financial failure, and to ensure that a full appraisal of reputational implications is made before strategic decisions are taken. The HSBC Group internal audit function monitors compliance with policies and standards.

32 Contingent liabilities and contractual commitments

(a) Contingent liabilities and commitments

	2005	2004
	US\$000	US\$000
Contract amounts		
Contingent liabilities:		
Acceptances and endorsements	—	532,324
Guarantees and assets pledged as collateral security:		
— guarantees and irrevocable letters of credit	4,251,725	2,456,505
Other contingent liabilities	—	700
	<u>4,251,725</u>	<u>2,989,529</u>
Commitments:		
Documentary credits and short-term trade-related transactions	925,191	845,956
Undrawn formal standby facilities, credit lines and other commitments to lend:		
— over 1 year	653,783	937,284
— 1 year and under	11,118,332	5,335,470
	<u>12,697,306</u>	<u>7,118,710</u>

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

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

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32 Contingent liabilities and contractual commitments (continued)

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

	2005	2004
	US\$000	US\$000
Guarantees and assets pledged by the bank as collateral security	420,295	162,964
Documentary credits and short-term trade-related transactions	3,301	42,510
	<u>423,596</u>	<u>205,474</u>

(b) Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December 2005 were as follows:

Guarantee type	<u>At 31 December 2005</u>		<u>At 31 December 2004</u>	
	<i>Guarantees in favour of third parties</i> US\$000	<i>Guarantees by the group in favour of other HSBC group entities</i> US\$000	<i>Guarantees in favour of third parties</i> US\$000	<i>Guarantees by the group in favour of other HSBC group entities</i> US\$000
Acceptances and endorsements ¹	—	—	532,324	—
Financial guarantees ²	318,081	108,120	235,098	24,180
Standby letters of credit which are financial guarantees ³	350,091	—	257,150	—
Other direct credit substitutes ⁴	119,945	—	60,835	—
Performance bonds ⁵	1,603,520	176,717	816,016	77,670
Bid bonds ⁵	253,671	70,985	189,264	18,407
Other transaction-related guarantees ⁵	1,186,122	64,473	735,178	42,707
Total	<u>3,831,430</u>	<u>420,295</u>	<u>2,825,865</u>	<u>162,964</u>

1 *Acceptances and endorsements arise when the group agrees to guarantee payment on a negotiable instrument drawn up by a customer. The accepted instrument is then sold into the market on a discounted basis. From 1 January 2005, acceptances and endorsements are recognised on-balance sheet in 'Other assets' and 'Other liabilities' as a result of the adoption of IAS 32.*

2 *Financial guarantees include undertakings to fulfill the obligations of customers or group entities should the obligated party fail to do so. Intra-group financial guarantees include a guarantee of a capital nature issued by the group to a group entity for inclusion as capital support by the latter's regulator.*

3 *Standby letters of credit which are financial guarantees are irrevocable obligations on the part of the bank to pay a third party when a customer fails to meet a commitment.*

4 *Other direct credit substitutes include re-insurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*

5 *Performance bonds, bid bonds and other transaction-related guarantees are undertakings by which the requirement to make payment under the guarantee depends on the outcome of a future event which is unconnected to the creditworthiness of the customer.*

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Approximately 90 per cent of the above guarantees have a term of less than one year. Guarantees with terms of more than one year are subject to the group's annual credit review process.

32 Contingent liabilities and contractual commitments (continued)

When the group gives a guarantee on behalf of a customer, it retains the right to recover from that customer amounts paid under the guarantee. At 31 December 2005, the group held collateral of US\$98,657 thousand (2004: US\$126,502 thousand) from which amounts paid under the guarantees disclosed above could be recovered.

The group had commitments to purchase from a number of suppliers within one year, land and buildings and other fixed assets for a value of US\$8,018 thousand at 31 December 2005 (2004: US\$10,735 thousand).

(c) Associates

The group and its operations are contingently liable with respect to lawsuits and other matters that arise in the normal course of business. Management is of the opinion that while it is impossible to ascertain the ultimate legal and financial liability with respect to these contingencies, their eventual outcome is not expected to materially affect the group's financial position and operations.

33 Lease commitments

(a) Finance lease commitments

	2005			2004		
	<i>Total future payments</i> US\$000	<i>Interest charges</i> US\$000	<i>Present value</i> US\$000	<i>Total future payments</i> US\$000	<i>Interest charges</i> US\$000	<i>Present value</i> US\$000
No later than one year	494	—	494	494	—	494
Later than one year and no later than five years	2,472	—	2,472	2,472	—	2,472
Later than five years	3,203	—	3,203	3,529	—	3,529
	6,169	—	6,169	6,495	—	6,495

(b) Operating lease commitments

At 31 December 2005, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

	2005 US\$000	2004 US\$000
Annual commitments under non-cancellable operating leases were:		
Land and buildings expiring:		
— no later than one year	319	323
— later than one year and no later than five years	6,253	4,102
— later than five years	2,538	928
	9,110	5,353

In 2005, US\$9,752 thousand (2004: US\$6,533 thousand) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

(c) Lease receivables

	2005			2004		
	<i>Total future payments</i> US\$000	<i>Interest charges</i> US\$000	<i>Present value</i> US\$000	<i>Total future payments</i> US\$000	<i>Interest charges</i> US\$000	<i>Present value</i> US\$000
No later than one year	9,361	(3,311)	6,050	7,127	(252)	6,875
Later than one year and no later than five years	117,525	(9,266)	108,259	83,179	(3,642)	79,537
Later than five years	7,848	(794)	7,054	7,828	(680)	7,148
	134,734	(13,371)	121,363	98,134	(4,574)	93,560

Notes on the Financial Statements (continued)**33 Lease commitments** (*continued*)**Amounts receivable under operating leases**

	2005	2004
	US\$000	US\$000
Future minimum lease payments under non-cancellable operating leases were:		
Land and buildings expiring:		
— no later than one year	90	87

34 Litigation

The bank, through a number of its branches, is named in and is defending legal actions in various jurisdictions arising from its normal business. None of these proceedings is regarded as material litigation.

35 Related party transactions

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

	2005			2004		
	<i>Number of persons</i>	<i>Highest balance during the year¹</i>	<i>Balance at year end¹</i>	<i>Number of persons</i>	<i>Highest balance during the year¹</i>	<i>Balance at year end¹</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>
Directors and connected persons and companies controlled by them						
Loans	1	144	144	1	65	48
Credit card transactions	1	13	13	1	11	5
	2	157	157	2	76	53

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

35 Related party transactions (continued)

(b) Transactions with other related parties

	2005		2004	
	<i>Highest balance during the year¹</i>	<i>Balance at the year end¹</i>	<i>Highest balance during the year¹</i>	<i>Balance at the year end¹</i>
	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>
Amounts due from associates:				
— Subordinated	15,415	15,415	15,415	15,415
— Unsubordinated	10	—	24	24
	<u>15,425</u>	<u>15,415</u>	<u>15,439</u>	<u>15,439</u>
Amounts due to associates	<u>31,005</u>	<u>4,095</u>	<u>2,736</u>	<u>864</u>
	2005		2004	
	<i>Highest balance during the year¹</i>	<i>Balance at the year end¹</i>	<i>Highest balance during the year¹</i>	<i>Balance at the year end¹</i>
	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>
Subsidiaries				
Assets:				
Cash and balances at central banks	15	15	22	12
Trading assets	176,759	176,759	173,390	148,056
Loans and advances to banks	105	45	1,342	1,342
Loans and advances to customers	509,297	508,685	423,937	423,937
Financial investments	17,613	17,613	5,414	5,414
Intangible assets	836	672	984	878
Property, plant and equipment	141	119	529	141
Other assets	64,271	42,432	44,205	40,981
Prepayments and accrued income	4,038	3,837	3,412	2,812
Liabilities:				
Items in the course of transmission to other banks	3,224	3,224	2,618	2,566
Other liabilities	701,984	701,984	579,050	579,050
Accruals and deferred income	2,662	1,127	3,359	3,167
Provisions for liabilities and charges	24	—	81	24
Income Statement:				
Interest income	10,346	36,780	7,741	27,782
Interest expense	(4,853)	(15,519)	(2,447)	(7,455)
Trading income	230	11	34	34
Gains less losses from financial investments	1,857	1,975	1,336	1,414
Dividend income	285	496	—	—
Fee income	1,462	5,132	3,576	8,032
Fee expense	(1,007)	(2,988)	(768)	(2,472)
Other operating income	383	916	236	578
Loan impairment charges and other credit risk provisions	1,409	1,237	1,074	2,450
General and administrative expenses	3,668	(13,603)	(6,214)	(15,877)

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

Notes on the Financial Statements (continued)

36 Ultimate holding company

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

The largest and smallest group in which the financial statements of the bank are consolidated is that headed by HSBC Holdings plc. Copies of the HSBC Holdings plc Annual Review 2005 and/or Annual Report and Accounts 2005 may be obtained by writing to Group Corporate Affairs, HSBC Holdings plc, 8 Canada Square, London E14 5HQ, United Kingdom; or from the HSBC web site, www.hsbc.com

37 Events after the balance sheet date

On 26 January 2006, the Directors allotted to HSBC Bank Middle East Limited's sole shareholder 100,000,000 ordinary shares of US\$1.00 each at par.

On 27 February 2006, the Board of Directors authorised the financial statements for issue.

38 Transition to IFRSs

Key impact analysis on the opening balance sheet as at 1 January 2005

HSBC Bank Middle East Limited previously prepared its primary financial statements under UK GAAP, which differs in certain significant respects from IFRS. The following is a summary of the main differences applicable to HSBC Bank Middle East Limited:

IAS 19 'Employee Benefits' ('IAS 19')

IAS 19 requires pension fund assets to be assessed at fair value and liabilities on the basis of current actuarial assumptions using the projected unit credit method. As permitted by an amendment to IAS 19 approved by the IASB and expected to be endorsed by the EU, HSBC Bank Middle East Limited has elected to recognise all actuarial gains and losses directly in retained earnings.

IAS 10 'Events after the Balance Sheet Date' ('IAS 10')

Under IAS 10, equity dividends declared after the balance sheet date are not included as a liability at the balance sheet date. Accordingly, HSBC Bank Middle East Limited has reversed the liability for proposed dividends at each balance sheet date.

IAS 17 'Leases' ('IAS 17')

IAS 17 requires that unearned income on finance leases be taken to income at a rate calculated to give a constant rate of return on the net investment in the lease, with no account taken in calculating the net investment of the tax effects of the lease. In general, this leads to a deferral of finance income compared with the pattern of recognition under UK GAAP, where income is recognised at a constant rate of return on the net cash investment in the lease including the effect of tax.

Under UK GAAP, assets leased out under operating leases are depreciated over their useful lives so that, for each asset, rentals less depreciation are recognised at a constant periodic rate of return on the net cash invested in that asset. Under IFRS, operating leased assets are depreciated to ensure that in each period the depreciation charge is at least equal to that which would have arisen on a straight-line basis.

Under UK GAAP, leasehold land was separately identified within the valuation of land and buildings. IFRS generally requires leasehold land to be treated as held under an operating lease unless title is expected to pass to the lessee at the end of the lease. No revaluation is permitted in respect of such owner-occupied operating lease assets. HSBC Bank Middle East Limited has classified as operating leases all land and buildings held under leases whose unexpired portion is less than 500 years.

IFRS 2 'Share-based Payment' ('IFRS 2')

IFRS 2 requires companies to adopt a fair-value-based method of accounting for share-based compensation plans which takes into account vesting conditions related to market performance, for example total shareholder

38 Transition to IFRSs *(continued)*

return. Under this method, compensation cost is measured at the date of grant based on the assessed value of the award and is recognised over the service period, which is usually the vesting period.

In respect of other vesting conditions, an estimate of the number of options that will lapse before they vest is made at grant date and adjustments to this estimate are made over the service period. Accordingly, the expense recognised reflects, over time, the actual number of lapsed options for non-market performance-related conditions.

There is no exemption under IFRS 2 for Save-As-You-Earn schemes, as existed under UK GAAP.

IAS 12 'Income Taxes' ('IAS 12')

Under IAS 12, deferred tax liabilities and assets are generally recognised in respect of all temporary differences except where expressly prohibited by the Standard, subject to an assessment of the recoverability of deferred tax assets. Deferred tax assets are recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised.

In addition, unremitted earnings from subsidiaries and associates operating in lower tax jurisdictions result in a deferred tax liability unless the reporting entity is able to control the timing of the reversal of temporary differences and it is probable that the temporary differences will not reverse in the foreseeable future.

Under IFRS, fair value adjustments made on acquisition are tax-effected in order to present profitability on a tax-equalised basis: under UK GAAP no tax adjustments were required for items which did not affect the amount of tax payable or recoverable.

IAS 38 'Intangible Assets' ('IAS 38')

Where intangible assets have an indefinite useful life, or are not yet ready for use, they are tested for impairment annually. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current annual period.

IAS 38 further requires costs incurred in the development phase of a project to produce application software for internal use to be capitalised and amortised over the software's estimated useful life if the software will generate probable future economic benefits, and such costs can be measured reliably. Under UK GAAP these costs were expensed as incurred. The capitalisation of software previously expensed in full results in a decrease in general and administrative expenses and an increase in depreciation and amortisation charged in respect of capitalised software in the form of regular, ongoing amortisation and any impairment charge.

IAS 16 'Property, Plant and Equipment' ('IAS 16')

HSBC Bank Middle East Limited has adopted the 'cost' model by which assets are carried at cost less any accumulated depreciation and impairment losses. HSBC Bank Middle East Limited has also applied the exemption in IFRS 1 which allows fair value at the date of transition to IFRS to be used as deemed cost for the value of property in most circumstances.

IAS 21 'The Effects of Changes in Foreign Exchange Rates' ('IAS 21')

IAS 21 states that in consolidated financial statements, all exchange differences arising on the retranslation of foreign operations with functional currencies which differ from the entity's reporting currency should be recognised as a separate component of equity, in the foreign exchange reserve.

On disposal of a foreign operation, the exchange differences previously recognised in reserves in relation to that operation are recognised in the income statement for the period.

As permitted by IFRS 1, HSBC Bank plc has deemed cumulative translation differences at 1 January 2004 to be zero.

Notes on the Financial Statements (continued)

38 Transition to IFRSs (continued)

Reconciliation of previously reported profit attributable to shareholders under UK GAAP to profit attributable to shareholders under IFRSs for the year ended 31 December 2004

	Year ended 31 December 2004
	US\$000
Profit before tax under UK GAAP	310,185
Interest payable	(6,944)
Employee compensation	912
Retirement benefits	(1,402)
Share of income in associates	(1,876)
Share of tax in associates	(3,528)
Profit before tax under IFRSs	<u>297,347</u>
Tax — UK GAAP	(58,141)
Tax — IFRSs adjustments	(107)
Share of tax in associates	3,528
Minority interests — UK GAAP	(2,152)
Profit attributable to shareholders under IFRSs	<u>240,475</u>

Reconciliation of previously reported shareholders' funds under UK GAAP to total shareholders' equity under IFRSs at 31 December 2004

	At 31 December 2004	At 1 January 2004
	US\$000	US\$000
Shareholders' funds as previously reported under UK GAAP	1,270,377	927,443
Non-equity share capital and non-equity share premium reclassification	(400,000)	(300,000)
Dividends	—	20,000
Other	(2,121)	2,134
Tax	(2,688)	(2,703)
Total shareholders' equity under IFRSs	<u>865,568</u>	<u>646,874</u>

39 Key Impact Analysis on Opening Balance Sheet as at 1 January 2005

The opening balance sheet has been prepared in accordance with the parts of the Basis of preparation and Accounting policies notes set out in pages 12 to 29 which were applicable as at 1 January 2005.

Reconciliation of previously reported shareholders' funds under UK GAAP to total shareholders' equity under IFRSs at 1 January 2005

	At 1 January 2005
	US\$000
Shareholders' funds as previously reported under UK GAAP	1,270,377
Non IAS 32, IAS 39 and IFRS 4 adjustments	(404,809)
Total shareholders' equity under IFRSs excluding IAS 32, IAS 39 and IFRS 4	<u>865,568</u>
IAS 32, IAS 39 and IFRS 4 adjustments	
Investment securities	16,161
Tax	(282)
Total shareholders' equity under IFRSs	<u>881,447</u>

39 Key Impact Analysis on Opening Balance Sheet as at 1 January 2005 (continued)

Explanation of differences

Investment securities

Debt securities and equity shares intended to be held on a continuing basis under UK GAAP were disclosed as investment securities and included in the balance sheet at cost less provision for any permanent diminution in value. Other debt securities and equity shares held for trading purposes were included in the balance sheet at market value.

Under IAS 39, all investment securities (debt securities and equity shares) are classified and disclosed within one of the following three categories: 'held-to-maturity'; 'available-for-sale'; or 'at fair value through profit or loss'. Securities previously classified as held-for-trading purposes remain so classified. The accounting treatment for each of the categories above under IFRSs is described in Note 2, Principal accounting policies. On transition to IFRSs, under IAS 39 HSBC Bank plc classified most of its investment securities as available-for-sale. This resulted in an available-for-sale reserve of US\$6,239 thousand, representing the cumulative unrealised gain on these securities being recorded within shareholders' equity.

Non-equity share capital and non-equity share premium reclassification

Preference shares were previously classified in the balance sheet as non-equity share capital and non-equity share premium with preference share dividends recorded as non-equity dividends in the income statement. Under IAS 32, preference shares are generally classified in the balance sheet as liabilities. This had the impact of increasing liabilities by US\$400,000 thousand at 1 January 2005.

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Bahrain

Manama *Main Office*
Adliya
Muharraq
Manama *Offshore Banking Unit*

Iran

Tehran *Representative Office*

Jordan

Western Amman *Main Office*
Jebel Hussein

Kuwait

Kuwait City *Main Office*

Lebanon

Beirut *Main Office*
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Ras Beirut

Oman

Bait Al Falaj *Main Office*
Muscat
Qurum
Salalah
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Palestinian Autonomous Area

Ramallah *Main Office*

Qatar

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Bur Dubai *Main Office*
Deira
Jebel Ali

Fujairah

Fujairah

Ras Al Khaimah

Ras Al Khaimah

Sharjah

Sharjah

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HSBC Financial Services (Middle East) Limited
Dubai

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

ASSOCIATED COMPANIES

Arabian Real Estate Investment Trust Management Limited
Cayman Islands

British Arab Commercial Bank Limited*
London

Rewards Management Middle East Free Zone Limited Liability Company*
Dubai

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and 13 branches

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Cyprus

HSBC Bank Egypt S.A.E
Cairo *Head Office*, 22 other branches
and 8 mini-bank units

Gibbs Gulf Insurance Consultants Limited

HSBC Insurance Brokers Limited

HSBC Bank International Limited

HSBC Investment Company (Egypt) S.A.E

HSBC Securities (Egypt) S.A.E.

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

The Saudi British Bank*
Riyadh *Head Office*, 72 other branches
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