



HANG SENG BANK

# CHARTING A STEADY COURSE

Annual Report 2011







# CHARTING A STEADY COURSE



In the current challenging environment, Hang Seng Bank is more focused than ever on long-term value creation.

As a financially-strong, forward-looking bank, we are dedicated to increasing shareholder value, meeting changing customer needs in wealth management and enhancing market leadership.



This year's theme – Charting a Steady Course – reflects our commitment to sustainable growth. We are building on our trusted brand, prudent management and superior service to deepen stakeholder relationships and move firmly forward.



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\* Where possible, percentages in this section have been rounded to the nearest percentage point to facilitate easy reading. Percentage-based indicators remain at 1 or 2 decimal places as appropriate.







# CORPORATE PROFILE

Founded in 1933, Hang Seng Bank is one of Hong Kong's largest listed companies and among the 50 largest listed banks in the world in terms of market capitalisation (HK\$176.2bn as at the end of December 2011).

In Hong Kong, we serve over half of Hong Kong's adult population through about 220 service outlets. We also maintain a branch in Shenzhen for foreign currency wholesale business, branches in Macau and Singapore, and representative offices in Xiamen and Taipei.

Established in 2007 and headquartered in Shanghai, wholly owned mainland China subsidiary Hang Seng Bank (China) Limited operates a network of 39 outlets in Beijing, Shanghai, Guangzhou, Shenzhen, Dongguan, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming, Foshan, Zhongshan and Huizhou.

Hang Seng is a principal member of the HSBC Group, one of the world's largest banking and financial services organisations.



## RESULTS IN BRIEF

|  | 2011           | 2010         | Change   |
|--|----------------|--------------|----------|
| <b>For the year</b>                                | <b>HK\$m</b>   | <b>HK\$m</b> | <b>%</b> |
| Operating profit excluding loan impairment charges | <b>14,621</b>  | 14,475       | 1        |
| Operating profit                                   | <b>14,181</b>  | 14,085       | 1        |
| Profit before tax                                  | <b>19,213</b>  | 17,345       | 11       |
| Profit attributable to shareholders                | <b>16,680</b>  | 14,917       | 12       |
|  | <b>HK\$</b>    | <b>HK\$</b>  | <b>%</b> |
| Earnings per share                                 | <b>8.72</b>    | 7.80         | 11.8     |
| Dividends per share                                | <b>5.20</b>    | 5.20         | –        |
| <b>At year-end</b>                                 | <b>HK\$m</b>   | <b>HK\$m</b> | <b>%</b> |
| Shareholders' funds                                | <b>78,755</b>  | 70,012       | 12       |
| Total assets                                       | <b>975,445</b> | 916,911      | 6        |
| <b>Ratios</b>                                      | <b>%</b>       | <b>%</b>     |          |
| <i>For the year</i>                                |                |              |          |
| Return on average shareholders' funds              | <b>22.6</b>    | 22.8         |          |
| Cost efficiency ratio                              | <b>35.0</b>    | 33.7         |          |
| Average liquidity ratio                            | <b>33.6</b>    | 38.1         |          |
| <i>At year-end</i>                                 |                |              |          |
| Capital adequacy ratio*                            | <b>14.3</b>    | 13.6         |          |
| Core capital ratio*                                | <b>11.6</b>    | 10.8         |          |

\* Capital ratios at 31 December 2011 were compiled in accordance with the Banking (Capital) Rules (the "Capital Rules") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II. Having obtained approval from the Hong Kong Monetary Authority to adopt the advanced internal ratings-based approach ("AIRB") to calculate the risk-weighted assets for credit risk from 1 January 2009, the Bank used the AIRB approach to calculate its credit risk exposure. The standardised (operational risk) approach and internal models approach were used to calculate its operational risk and market risk respectively.

The basis of consolidation for calculation of capital ratios under the Capital Rules follows the basis of consolidation for financial reporting with the exclusion of subsidiaries which are "regulated financial entities" (e.g. insurance and securities companies) as defined by the Capital Rules. Accordingly, the investment costs of these unconsolidated regulated financial entities are deducted from the capital base.



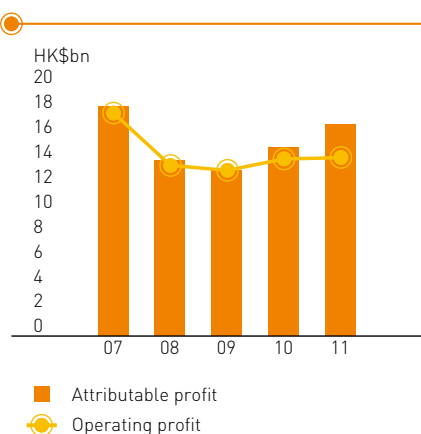
## FIVE-YEAR FINANCIAL SUMMARY

|  | 2007   | 2008   | 2009   | 2010   | 2011         |
|--|--------|--------|--------|--------|--------------|
| <b>For the year</b>                            | HK\$bn | HK\$bn | HK\$bn | HK\$bn | HK\$bn       |
| Operating profit                               | 17.7   | 13.6   | 13.2   | 14.1   | <b>14.2</b>  |
| Profit before tax                              | 21.4   | 15.7   | 15.4   | 17.3   | <b>19.2</b>  |
| Profit attributable to shareholders            | 18.1   | 13.9   | 13.1   | 14.9   | <b>16.7</b>  |
| <b>At year-end</b>                             | HK\$bn | HK\$bn | HK\$bn | HK\$bn | HK\$bn       |
| Shareholders' funds                            | 59.2   | 55.0   | 62.1   | 70.0   | <b>78.8</b>  |
| Issued and paid up capital                     | 9.6    | 9.6    | 9.6    | 9.6    | <b>9.6</b>   |
| Total assets                                   | 749.4  | 766.0  | 830.7  | 916.9  | <b>975.4</b> |
| Total liabilities                              | 690.2  | 711.0  | 768.6  | 846.9  | <b>896.7</b> |
| <b>Per share</b>                               | HK\$   | HK\$   | HK\$   | HK\$   | HK\$         |
| Earnings per share                             | 9.49   | 7.29   | 6.87   | 7.80   | <b>8.72</b>  |
| Dividends per share                            | 6.30   | 6.30   | 5.20   | 5.20   | <b>5.20</b>  |
| <b>Ratios</b>                                  | %      | %      | %      | %      | %            |
| Post-tax return on average shareholders' funds | 33.6   | 24.3   | 22.9   | 22.8   | <b>22.6</b>  |
| Post-tax return on average total assets        | 2.6    | 1.8    | 1.7    | 1.7    | <b>1.8</b>   |
| Capital adequacy ratio*                        | 11.2   | 12.5   | 15.8   | 13.6   | <b>14.3</b>  |
| Core capital ratio*                            | 8.4    | 9.5    | 12.8   | 10.8   | <b>11.6</b>  |
| Cost efficiency ratio                          | 26.9   | 29.6   | 32.6   | 33.7   | <b>35.0</b>  |

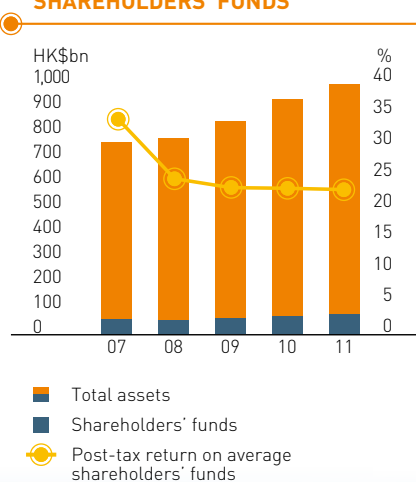
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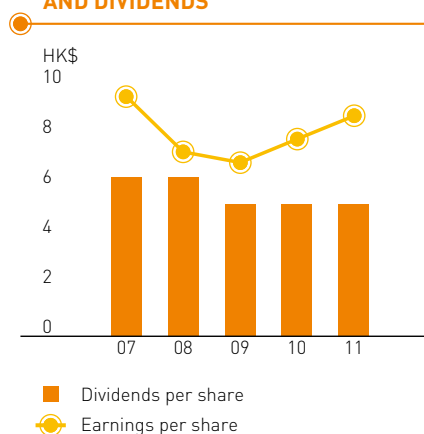
## RESULTS



## TOTAL ASSETS AND SHAREHOLDERS' FUNDS



## PER SHARE EARNINGS AND DIVIDENDS





## MAJOR MILESTONES

### JAN – MAR

- Hang Seng signs memorandum of understanding with Industrial Bank to further strengthen bilateral cooperation
- Hang Seng Indexes announces the launch of the HSI Volatility Index and the Hang Seng Risk Adjusted Index Series



### APR – JUN

- Hang Seng China celebrates opening of new national headquarters in Shanghai
- Hang Seng celebrates 10th anniversary of its credit card Cash Dollars scheme





## JUL – SEP

- Hang Seng launches first fund in Hong Kong which tracks local Corporate Sustainability Index
- Hang Seng China opens new sub-branch in Huizhou
- Hang Seng Indexes launches Hang Seng Foreign Companies Composite Index and Hang Seng Global Composite Index
- Hang Seng launches a new generation of e-Banking services for personal customers
- Hang Seng China receives approval to set up Xiamen Branch



## OCT – DEC

- Hang Seng becomes first local bank in Hong Kong to be included as a constituent stock on the Dow Jones Sustainability Asia Pacific Index
- Hang Seng Securities and Guangzhou Securities apply to set up first joint venture securities investment advisory company under CEPA VI in Guangdong province
- Hang Seng becomes first local bank in Hong Kong to attain internationally recognised ISO 14001 certification for all offices and branches
- Hang Seng opens new Mortgage Centre



## RECOGNITION



## AWARDS

### Best Domestic Bank in Hong Kong (for 12th consecutive year)

*The Asset*

### Best Domestic Bank in Hong Kong

*Asiamoney*

### House of the Year, Hong Kong

*Asia Risk*

### Best Local Private Bank in Hong Kong

*Euromoney*

### Best Private Bank in Hong Kong

*Private Banker International*

### Achievement Award for Cash Management in Hong Kong

*The Asian Banker*

### SME's Best Partner Award

*Hong Kong General Chamber of Small and Medium Business*

### Trusted Brands Gold Award – Bank (Hong Kong)

### Trusted Brands Gold Award – Credit Card Issuing Bank (Hong Kong)

*Reader's Digest*

### China's Best Foreign Retail Bank (Hang Seng China)

*Money Week*

### Outstanding Risk Management Bank of the Year (Hang Seng China)

*Economic Observer*

### Best Cross Border Trade Settlement Service Award (Hang Seng China)

*CFO World*





## RATINGS

### MOODY'S INVESTORS SERVICE

#### Hang Seng Bank

|   |         |
|---|---------|
| Long-term Bank Deposit<br>(local and foreign currency)  | Aa1     |
| Short-term Bank Deposit<br>(local and foreign currency) | Prime-1 |
| Subordinated Debt<br>(foreign currency)                 | Aa2     |
| Bank Financial Strength                                 | B+      |
| Outlook   | Stable  |

#### Hang Seng Bank (China) Limited

|   |         |
|---|---------|
| Long-term Bank Deposit<br>(local and foreign currency)  | A1      |
| Short-term Bank Deposit<br>(local and foreign currency) | Prime-1 |
| Bank Financial Strength                                 | D       |
| Outlook   | Stable  |

### STANDARD & POOR'S

#### Hang Seng Bank

|  |        |
|--|--------|
| Long-term Counterparty Credit<br>(local and foreign currency)  | AA-    |
| Short-term Counterparty Credit<br>(local and foreign currency) | A-1+   |
| Outlook  | Stable |

#### Hang Seng Bank (China) Limited

|  |        |
|--|--------|
| Long-term Counterparty Credit<br>(local and foreign currency)  | AA-    |
| Short-term Counterparty Credit<br>(local and foreign currency) | A-1+   |
| Outlook  | Stable |



FOCUS





# NAVIGATING THROUGH CHALLENGES



# CHAIRMAN'S STATEMENT

In the challenging environment of 2011, we built on our trusted brand to enhance long-term growth and achieved a solid operating result.

We continued to develop areas of strength and deepened our penetration into segments that offer growth opportunities. Our core strategies of financial prudence and innovating to deliver more value served us in good stead.

In the volatile market conditions, we drew on our time-to-market wealth management capabilities to offer comprehensive products catering for the changing financial needs of our customers, targeting mainland China customers among other segments.

In our commercial and corporate banking businesses, our good industry knowledge, strong cross-border capabilities and total solutions helped enhance our status as a preferred partner for trade-related services and our franchise in corporate wealth management.

The Mainland will remain a major focus for our future expansion. Reflecting our efforts to take advantage of the opening up of the Mainland financial sector, the gradual internationalisation of the renminbi and the closer economic integration of Hong Kong and the Mainland, we achieved encouraging growth in our cross-border services and renminbi-related businesses.

In an important milestone, Hang Seng Bank (China) Limited moved into new headquarters in Shanghai's Lujiazui financial district in May 2011. The move signifies our long-term commitment to developing our business on the Mainland.

Our strengths continued to win recognition. The Bank was named the Best Domestic Bank in Hong Kong for the 12th consecutive year by *The Asset* and the Best Domestic Bank in Hong Kong by *Asiamoney*.





## VISION

**Raymond Ch'ien**  
Chairman



In 2011, Hang Seng became the first local bank in Hong Kong to be included as a constituent stock on the Dow Jones Sustainability Asia Pacific Index, which tracks the performance of companies that lead the field in terms of corporate sustainability.

Our brand has come to represent financial soundness, trustworthiness, value creation and superior service. Hang Seng's brand value was ranked 65th globally in the 2012 Brand Finance Banking 500, the highest ranking for Hong Kong banks.

## FINANCIAL HIGHLIGHTS

Profit attributable to shareholders rose by 12% to HK\$16,680m and profit before tax was up 11% at HK\$19,213m. Earnings per share were up 12% to HK\$8.72 per share.

The return on average shareholders' funds was 22.6%, compared with 22.8% in 2010. The return on average total assets was 1.8%, compared with 1.7% a year earlier.

At 31 December 2011, our capital adequacy ratio was 14.3%, compared with 13.6% at the end of 2010. The core capital ratio was 11.6%, compared with 10.8% a year earlier. The rise in both capital and core capital ratios reflected the combined effect of the increase in profit after accounting for dividends in 2011 and the decrease in risk-weighted assets.

The Directors have declared a fourth interim dividend of HK\$1.90 per share, payable on 29 March 2012. This brings the total distribution for 2011 to HK\$5.20 per share, the same as for 2010.

## OPERATING ENVIRONMENT

The operating environment in 2011 was affected by growing global economic uncertainties, including the deepening sovereign debt crisis in the eurozone, the continuing fragility of the US economic recovery, and the effects of the devastating earthquake and tsunami in Japan on global supply chains. As a result, the growth momentum in Hong Kong eased in the second half of the year as external demand slowed.

China headed towards a soft landing as economic growth moderated due to persistent monetary tightening by the government and weaker external demand. The economy was mainly supported by strong investment and consumption growth. The high inflationary pressure began to ease after peaking in July.

In 2012, the prevailing economic uncertainties in the eurozone and the US will continue to dominate globally. The downgrade of the credit ratings of the US and various eurozone countries by credit rating agencies over the past year indicates continued downside risks in the world economic outlook.

Against this backdrop, Hong Kong's economic growth is likely to slow this year. Exports will be adversely affected by the difficult global environment, but domestic demand should remain resilient on the back of steady income growth and continued expansion of public sector construction works. Inflation is expected to come down due to the recent easing in global food and commodity prices, and the expected economic slowdown.

We undertake to increase value  
in every way we can for our  
customers and shareholders.



Economic growth on the Mainland is expected to slow further, although its economy remains among the fastest growing in the world. Since December 2011, China's central bank has cut the reserve requirement ratio for commercial lenders twice in a sign it is easing monetary policy to stimulate domestic demand. Although exports should continue to soften given weakening external demand, consumption growth is expected to remain resilient given the increasing personal wealth of the Mainland population. Investment growth is also expected to remain steady as the government gradually eases monetary conditions. Inflation is likely to fall steadily.

In the banking sector, loan growth is expected to moderate while competition for deposits will remain keen. Banks will encounter more challenges, including evolving regulatory requirements.

## ACKNOWLEDGEMENTS

I would like to take this opportunity to thank our stakeholders for their strong support in the challenging economic environment. We undertake to increase value in every way we can for our customers and shareholders. We will continue to enhance shareholder value and to provide total financial solutions to meet customer needs in wealth creation and asset protection.

I must especially thank our staff, who work as a team to make the real difference in our service delivery. Their dedication and hard work in providing superb customer support has reinforced the strength of the Hang Seng brand in an increasingly competitive market.

Mrs Margaret Leung will retire from her position as Vice-Chairman and Chief Executive of Hang Seng and from the Board of Directors with effect from the conclusion of the Bank's Annual General Meeting to be held on 11 May 2012.

On behalf of the Board of Directors, I would like to thank Mrs Leung for her outstanding contributions. She has successfully steered Hang Seng through the challenges of the prevailing international financial crisis and the continuing problems of the eurozone. Under her outstanding leadership, Hang Seng has emerged stronger than ever as a trustworthy, solidly-managed, and award-winning financial institution providing innovative products and exemplary customer service. We also owe her our gratitude for strengthening Hang Seng's position as a caring and socially responsible community bank in Hong Kong and the Mainland. We wish her all the best in her retirement.

Mrs Leung's position will be taken up by Ms Rose Lee, who is currently Advisor, China and Hong Kong, The Hongkong and Shanghai Banking Corporation Limited. The Board extends a warm welcome to Ms Lee, who is an excellent choice to build on the legacy and strengths of Hang Seng with her great experience and knowledge of the Mainland and Hong Kong markets.

The year ahead will be demanding. Through the years, our Bank has navigated through change and challenges to create value for our stakeholders. Our goal is to become the leading personal and private bank for affluent and middle-class customers in Hong Kong and on the Mainland; and the leading trade bank in Greater China. We will redouble our efforts to continue creating sustainable value for our stakeholders as we move closer to our goal.



**Raymond Ch'ien**

Chairman

Hong Kong, 27 February 2012

# CHIEF EXECUTIVE'S REPORT

The global economic uncertainties in the second half of 2011 posed significant challenges to the banking sector.

Our strong financial fundamentals, relationship building strategies and capture of new business opportunities helped us achieve a solid operating result. Operating profit excluding loan impairment charges increased by 1% to HK\$14,621m for the year and grew 1% in the second half of the year compared with the first half.

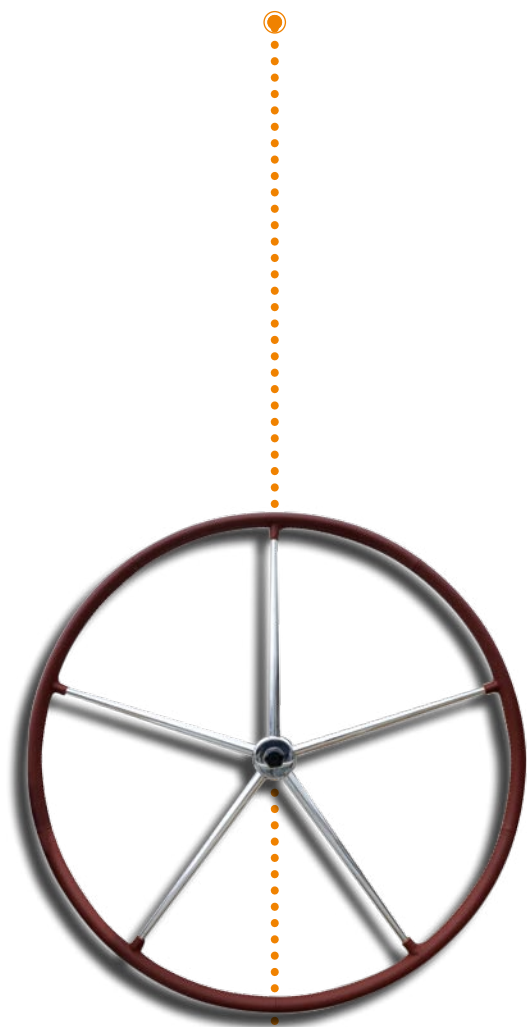
Amid intense market competition, our commercial and corporate banking businesses recorded strong growth. The further enhancement of our cross-border operations to support business customers reinforced our leading position in the provision of renminbi financial services. This was offset by lower revenues in Retail Banking and Wealth Management, particularly as income from our wealth management services declined given the weaker investor sentiment in the second half of 2011.

Our wholly owned subsidiary Hang Seng Bank (China) Limited delivered encouraging results as we tapped China's expanding economy and rising personal incomes.

Our cost efficiency ratio remained among the lowest in the industry. In order to improve operational efficiency and facilitate customer convenience, internet-based banking platforms were further strengthened. At the year-end, our Personal e-Banking and Business e-Banking customer bases were up 12% and 16% respectively, compared with a year earlier.

## FINANCIAL PERFORMANCE

Total assets rose by HK\$58.5bn, or 6%, to HK\$975.4bn. Customer advances increased by 2%, with growth in the commercial and corporate lending businesses, while we maintained sound loan quality. The trade finance business declined as certain trade finance loans matured in the second half of the year. Customer deposits, including certificates of deposit and other debt securities in issue, rose by 5%, driven in part by strong growth in renminbi deposits. Reflecting the deployment of the commercial surplus to high-quality treasury bills and debt securities for yield enhancement, financial investments and trading assets increased by 5% and 146% respectively.



## LEADERSHIP

**Margaret Leung**

Vice-Chairman and  
Chief Executive





Operating profit rose by 1% to HK\$14,181m, while the increased contribution from our associates and higher gains on revaluing investment properties led to an increase in profit attributable to shareholders of 12% to HK\$16,680m.

Net interest income rose by 10% to HK\$15,736m due to a 10% growth in average interest-earning assets, improved loan spreads and higher contribution from balance sheet management, partly offset by increased deposit costs. The net interest margin was maintained at 1.78%, the same level as in 2010. At 1.80% in the second half of the year, the net interest margin was up five basis points from the first half.

Affected by the unfavourable investment climate, non-interest income declined by 9%, compared with 2010. Net fee income decreased slightly by 1%, with income from the wealth management business dropping by 6%. Card services income grew by 15% as we increased our market share in terms of card base in the competitive business. Fee income from credit facilities rose by 30%, due mainly to higher fees from increased corporate lending.

Trading income decreased by 13% to HK\$1,796m. The 4% increase in foreign exchange income was partly offset by reduced income from funding swap activities.

While continuing to exercise a high degree of prudence in managing costs, investment for future growth led to a 7% rise in operating expenses. Our cost efficiency ratio remained low at 35.0%, compared with 33.7% a year earlier. Excluding our Mainland operations, operating expenses rose by 5% and the cost efficiency ratio was 32.0%.

Loan impairment charges registered an increase of HK\$50m, or 13%, to HK\$440m, mainly due to the increase in collectively assessed impairment charges.

Reflecting our good credit risk management, total loan impairment allowances as a percentage of gross advances to customers decreased to 0.35% at the end of 2011, compared with 0.39% a year earlier. Gross impaired advances as a percentage of gross advances to customers fell to 0.33%, compared with 0.42% at the end of 2010.

## CUSTOMER GROUPS

**Retail Banking and Wealth Management** reported profit before tax of HK\$6,623m, down 16% from 2010. Operating profit excluding loan impairment charges was HK\$6,441m, a drop of 18% from a year earlier.

Net interest income recorded a year-on-year decline of 4% as market competition levied pressure on deposit income. Higher interest rates were offered to grow our deposits, resulting in a 16% drop in net interest income from deposits, compared with 2010.

With a quality credit card customer base, income from unsecured lending remained a key income driver and grew by 11%, compared with 2010. The card base increased by 10% to 2.23 million during the year. Card spending and receivables rose by 16% and 18% respectively. Personal loan balances were up 15%.

Repricing of our mortgage portfolio affected our market share initially. However, our market share in Hong Kong in terms of new registrations rebounded to reach 19% in December 2011.

We continued to enhance our role as a prominent provider of insurance coverage by offering improved protection propositions. Life insurance annualised new premiums increased by 12% and total policies in force grew by 8%, compared with 2010. Despite the strong sales, income from insurance fell as market conditions led to lower investment returns on the life insurance fund portfolios.

The euro debt problem intensified in the second half of 2011. This severely affected investment appetite leading to lower distribution income from investment services, as reflected by slower fund sales and securities broking activities in the second half of the year. Income from investment services for the year fell by 11% year-on-year.

## We intend to reinforce our role as a key player and pioneer in renminbi services.

Brand awareness of our private banking services was enhanced. The Bank was named the Best Local Private Bank by *Euromoney* and the Best Private Bank in Hong Kong by *Private Banker International*.

**Commercial Banking** achieved an increase of 34% in profit before tax to HK\$5,031m. Operating profit excluding loan impairment charges was up 29% to HK\$3,442m.

Net interest income increased by 26% while non-interest income grew by 13%. Customer deposits grew by 5% during the year.

Various initiatives to grow fee income achieved satisfactory results, notably from loan-related fees, remittances and corporate wealth management. Our competitive corporate wealth management products, targeting the top-end customer segment in particular, provided enhanced corporate investment, insurance and treasury products to capture the shift in investment sentiment as well as meet customers' yield enhancement or hedging needs. Income from corporate wealth management rose by 15% and contributed to 13% of Commercial Banking's net operating income.

We continued to take advantage of the growth in renminbi trade settlement. Besides close collaboration between colleagues in Hong Kong and the Mainland, we also cooperate with strategic partners on the Mainland to enhance our cross-border services. This proved to be a valuable source of referral business. At

the end of 2011, we had over 70,000 commercial renminbi accounts in Hong Kong and renminbi cross-border trade-related business routed through the Bank had increased.

We expanded our network of Business Banking Centres by three to a total of seven, to reach more customers, especially SMEs. The Commercial Banking customer base increased by 13% during the year.

With a growing online customer base, the number of Business e-Banking transactions grew by 14%, compared with 2010.

**Corporate Banking** achieved growth of 46% in profit before tax to HK\$1,843m. Operating profit excluding loan impairment charges rose by 42% to HK\$1,794m. The profit growth was mainly attributable to increases in net interest income and non-interest income, which rose by 39% and 14% respectively.

Against a backdrop of tightening market liquidity, we built on our strong industry knowledge, effective risk management as well as dedicated business teams in Hong Kong and on the Mainland to achieve selective growth of 10% in customer advances. Through offering total cash management solutions to customers and capitalising on an efficient cross-border relationship management system, customer deposits grew by 29%.

Leveraging our well-established business infrastructure, Corporate Banking stepped up efforts to grow non-interest income, offering a wide spectrum of tailor-made treasury, hedging, wealth management and insurance solutions.

**Treasury** recorded a 26% increase in profit before tax to HK\$4,227m, while operating profit rose by 24% to HK\$2,729m. The growth in total operating income was mainly the result of an increase in net interest income which was partly offset by lower trading income.

In spite of persistently low interest rates, net interest income rose by 50% to reach HK\$2,108m. The increase was attributed to a larger commercial surplus for investment as the Bank's balance sheet grew, more positioning taken in balance sheet management and the contribution from funding swap activities. It was also due to better margins for inter-bank lending in both Hong Kong and the Mainland.

Trading income fell by 14% to HK\$1,001m, affected by the decrease in income from funding swap activities. However, foreign exchange trading income recorded encouraging growth, boosted in part by the growing demand for renminbi-denominated products.

## MAINLAND BUSINESS

Hang Seng Bank (China) Limited recorded encouraging growth in profit before tax to HK\$482m as it increased its foothold on the Mainland.

With the opening of its third cross-city sub-branch in Huizhou, Hang Seng China operated a strategically located network of 39 outlets across 14 Mainland cities at the year-end. Applications to establish a new branch in Xiamen, a sub-branch each in Beijing and Tianjin, and a cross-city sub-branch each in Guangdong's Shunde, Zhuhai and Jiangmen respectively have been approved.

Diversification of  
income streams will  
remain important.

Through focusing on the growing financial needs of target Mainland customers with rapidly rising incomes, the Mainland personal customer base increased by 21%. The enhancement of wealth management services facilitated a 26% rise in the number of Prestige Banking customers. As we capitalised on our good cross-border capabilities, the number of corporate and commercial banking customers also increased by 8%.

Driven by the expanded customer base and with continued emphasis on credit quality, advances to customers rose by 23%. Total deposits increased by 34%. Underpinned by strong growth in net interest income and other operating income, total operating income was 46% higher than in 2010.

The Mainland business contributed 22% to the Bank's total profit before tax, compared with 15% in 2010. This includes the share of profit from our Mainland investments, where our share of profit from Industrial Bank increased by about 40% during the year.

## POSITIONING FOR FUTURE GROWTH

We are likely to see slower economic growth in both Hong Kong and the Mainland in 2012 amid lingering debt problems in Europe and a fragile global recovery.

In the banking sector, competition will remain strong, adding pressure to funding costs.

In this operating environment, we have charted a course for long-term growth. We will build on our market leadership, service excellence and time-to-market offerings to deepen relationships with our loyal customers and reach out to a new client base.

In our personal banking business, we will strengthen our wealth management and private banking services to satisfy customer needs at different life stages, targeting affluent and middle-class customers in particular. We will enhance our status as a preferred partner for trade-related services by building on our



trade and corporate wealth management capabilities. Treasury will develop effective hedging solutions and new renminbi-related products.

The closer economic integration of Hong Kong and the Mainland, the opening-up of the Mainland market and the further liberalisation of offshore renminbi financial services offer vast opportunities. We intend to reinforce our role as a key player and pioneer in the provision of renminbi services.

In February 2012, the Bank launched the world's first renminbi-denominated gold exchange-traded fund (ETF) and Hong Kong's first renminbi ETF – the Hang Seng RMB Gold ETF. We will continue to design more renminbi products to cater for the growing investor demand in this area.

Our wholly owned subsidiary Hang Seng Securities Limited partnered with Guangzhou Securities Company Limited to apply in 2011 to set up the first joint venture securities investment advisory company under CEPA VI in Guangdong province. Subject to regulatory approval for its establishment, the joint venture will become a showcase for cooperation in this area under CEPA.

We will further expand our network on the Mainland. We intend to reach out to more affluent Mainland customers who are seeking new investment opportunities at home and in Hong Kong. We will also target Mainland business customers with high growth potential in key industries, in particular those supported under China's 12th Five-Year Plan. Our cross-border collaboration between our Hong Kong and Mainland teams will be strengthened and our referral partner network will further help us grow our client base.

Deposit growth will provide a solid foundation for our business expansion. Leveraging our strong balance sheet and credit risk management, we will prudently grow our quality loan portfolio, including renminbi lending, while maintaining a competitive pricing strategy. Diversification of income streams will remain important.

Even as we invest for future growth, cost efficiency will be improved through resource optimisation and technological advancement.

This will be my last annual report for Hang Seng as I will retire from my position as Vice-Chairman and Chief Executive and from the Board of Directors with effect from the conclusion of the Bank's Annual General Meeting to be held on 11 May 2012. It has been an honour to serve Hang Seng since 2009 and a pleasure to see it grow from strength to strength as an award-winning financial institution and caring community bank in Hong Kong and the Mainland.

I wish to express my sincere appreciation to my fellow Directors for their wise counsel and thank my colleagues for their hard work and commitment to enhancing Hang Seng's standing as a trustworthy and well-managed bank. I must also convey my heartfelt gratitude to our customers and shareholders for their continuous support.

I take this opportunity to wish my successor, Ms Rose Lee – currently Advisor, China and Hong Kong, The Hongkong and Shanghai Banking Corporation Limited – every success in her new position.

Hang Seng is firmly committed to providing superior financial solutions to our customers as their preferred service provider. In the challenging operating environment, we are confident that as a financially-strong, forward-looking bank, our business strategies will drive steady growth in the long term.



**Margaret Leung**

Vice-Chairman and Chief Executive  
Hong Kong, 27 February 2012





COMMITMENT

COMMUNITY  
BETTERMENT



# CORPORATE RESPONSIBILITY

Hang Seng Bank has a longstanding and unwavering commitment to community betterment.



As one of Hong Kong's largest corporate citizens, we place a strong emphasis on engaging in sustainable business practices, supporting community development initiatives and raising awareness of social and environmental issues among our staff and the general public.

We work to continuously improve the sustainability of our operations and encourage customers and suppliers to do the same through our procurement, investment and financing policies.

In 2011, Hang Seng became the first local bank in Hong Kong to be included as a constituent stock on the Dow Jones Sustainability Asia Pacific Index, which tracks the performance of companies that lead the field in terms of corporate sustainability.

In other international recognition of our corporate sustainability performance, the Bank has been a constituent member of the FTSE4Good Global Index since 2001.

Over the past decade, we have allocated more than HK\$217m in donations and community sponsorships – including about HK\$25m in 2011 – to support various environmental, education, community and sports development programmes.

Our annual Corporate Responsibility Report, available on our website since 2006, provides more details of our sustainability principles, relationships with key stakeholders and major corporate social responsibility projects. In 2011, the Bank became the first local bank in Hong Kong to publish its Corporate Responsibility Report using Global Reporting Initiative guidelines. Not only does this increase the credibility of the information we report, it also ensures the Bank's own measurements are in line with widely recognised global practices.

## 60,000

Young people benefiting from education programmes

## 25,000 HOURS

Community service by staff and their families





Staff volunteers pose with villagers in Yunnan province whose lives have been changed by a Bank-sponsored biogas project providing 6,600 villagers to date with renewable energy.

## GREEN INITIATIVES

We nurture a culture of environmental responsibility in our business. In addition to reducing the environmental impacts of our operations, we engage in activities that encourage our stakeholders to adopt good environmental practices.

Our Environmental Management Committee implements and monitors our environmental system. In 2011, we became the first local bank in Hong Kong to attain the internationally recognised ISO 14001 certification for all offices and branches. Our Hong Kong operations have been carbon neutral since 2007.

The Bank strongly supports environmental initiatives in the broader community. We encourage manufacturing companies in Hong Kong and the Pearl River Delta to enhance their environmental performance by recognising their green achievements in the annual Hang Seng Pearl River Delta Environmental Awards, which are held jointly with the Federation of Hong Kong Industries. Nearly 2,000 environmental projects have been implemented since the Awards were launched in 2007.

The 2010/11 Awards attracted a record entry of 182 participating companies and 651 environmental projects, which represented an increase of 26% and 17% respectively compared with the previous year.

# 28,000,000 sheets

Paper saved through electronic statements





Projects entered in the 2010/11 Awards collectively reduced waste by 630,000 tonnes – an amount that would cover Shing Mun Reservoir about 226 times. The projects also cut water usage by 2.95 million tonnes (the volume of 740 standard 50-metre swimming pools) and electricity consumption by over 85 million kWh (equivalent to the electricity consumed annually by 13,000 average four-member families). In addition, almost 11,000 tonnes of materials have been recycled (equivalent to an area covering about 300 Victoria Parks).

In recognition of our contributions to the green movement in the Pearl River Delta region, the Awards received the overall Most Creative Campaign Award as well as a Certificate of Merit in the corporate social responsibility category of the Hong Kong Public Relations Awards in April 2011.

In November 2011, staff volunteers travelled to Yunnan province to assist in a Bank-sponsored project organised by the Conservancy Association, under which biogas facilities were made available to 550 households this year, providing renewable energy to 2,200 local villagers. This brings the total number of

households benefiting from biogas facilities constructed since 2007 under this project to 1,650, providing renewable energy to around 6,600 villagers in Yunnan – saving approximately 3,740 tonnes of firewood per year (equivalent to about 8,250 acres of forest) and cutting annual carbon dioxide emissions by approximately 18,700 tonnes.

Through our e-Statement and e-InvestAdvice services, we encourage our e-Banking customers to reduce the consumption of resources by receiving statements and notices in electronic rather than paper format. By the end of 2011, subscribers to the e-Statement service had increased to over 510,000 and customers using the e-InvestAdvice service had risen to more than 103,000 – collectively saving over 28 million sheets of paper a year.

We are playing our part in helping to conserve biodiversity. We comply with the WWF Hong Kong's Seafood Guide. We stopped serving shark's fin at Bank functions in 2003, and have since extended this policy to include endangered reef fish species and black moss. In 2011, we introduced a sustainable seafood menu endorsed by WWF Hong Kong at the Bank's banquet hall.





In 2011, we reduced energy consumption per full-time employee by 1.9%. We also recycled more than 4,000 pieces of obsolete computer equipment and nearly 14,000 pieces of toner and printer ink cartridges, saving about 66 tonnes of electronic waste.

The Bank promoted green messages to staff, suppliers and customers through various channels, including talks, training, seminars and outings. In November and December 2011, about 160 staff and their family members helped collect 150 bags of trash during a beach cleaning campaign in Lung Kwu Chau organised by the Eco-education and Resource Centre in support of the International Coastal Cleanup campaign. We continued our tradition of making a donation to charity in lieu of sending Christmas cards.

Social and environmental considerations are an important element of our financing decisions. We include environmental factors in our credit assessments and support the Equator Principles, which address sustainability risks in project financing. We also follow sector-specific guidelines for financing activities in ecologically sensitive industry sectors.

We are a participant in the Carbon Disclosure Project, which provides a forum for the world's largest institutional investors to collectively consider the business implications of climate change.

## EDUCATION INITIATIVES

Given the crucial role that education plays in community betterment, we reached out to about 60,000 young people in 2011 through more than 30 Bank-supported education programmes.

Since 1995, we have provided more than HK\$56m under various scholarship schemes, benefiting over 1,700 outstanding students from Hong Kong and mainland China.

We continued to support youth development programmes, working with the Hong Kong Federation of Youth Groups to produce the "Hang Seng Bank Leaders to Leaders Lecture Series", which gives students the opportunity to engage in direct dialogue with prominent community leaders. With "Modern China – Mapping Out Our New Future" as the 2011 theme, over 300 students took part in each of the 10 lectures that were held.

The Ming Pao Student Reporter Programme, which we have sponsored for over a decade, benefited about 500 students from 200 schools. The programme, which uses media



Bank-supported education programmes benefited about 60,000 young people in 2011.

training activities to improve participants' critical thinking and language skills as well as promote a better understanding of current affairs, has benefited nearly 7,000 students in the past 15 years.

We maintained our strong support for the arts, which enrich communities by providing a variety of channels for debate and the exchange of ideas. Since 2007, our sponsorship of various student ticket schemes has helped open up access to artistic performances for more than 72,000 young people.

In a new initiative, we helped launch the Hang Seng Bank – Fight Against Women's Illiteracy 2011 campaign, organised by Aide et Action Education Foundation, to support basic education for about 15,000 illiterate rural women on the Mainland.

In other new programmes, the Bank sponsored exclusive shows by the Hong Kong Repertory Theatre for more than 2,000 students from low income families in commemoration of the 100th anniversary of the Xinhai Revolution under the Boundless Movement – Hang Seng Bank Student Matinees. The Bank also supported the Hang Seng Bank – The Chinese Youth Film Contest 2011, organised by the Hong Kong Federation of Youth Groups, which attracted about 1,000 entrants from the Mainland, Taiwan and Hong Kong.

In collaboration with the Pathways Foundation, we helped children with specific learning disabilities and attention deficit/hyperactivity disorders to explore their potential and alternative ways of learning through a series of after-school activities and family workshops.



The Bank facilitates charitable donations by customers through our e-Donation channel. In 2011, about HK\$2.26m was raised for over 60 charitable organisations via this online service. Nearly HK\$22m has been donated to deserving causes since the launch of the service in December 2001.

For the eighth consecutive year, we were named a Caring Company by the Hong Kong Council of Social Service.

### SPORTS INITIATIVES

The Bank recognises the importance of sports in promoting commitment, determination and teamwork within the community, and is a keen supporter of local sports development.

The Hang Seng Table Tennis Academy, which celebrated its 10th anniversary in 2011, has built greater awareness of

### COMMUNITY INITIATIVES

Beyond work, our staff volunteer their time and skills to serve the community and help make a difference.

In 2011, our staff and their family members collectively contributed about 25,000 hours to community service, an increase of about 30% from the previous year. The Bank organised more than 100 volunteer activities. These activities included a murals painting project in a hospital, visits to places of interest for underprivileged children, festival lunches and hairdressing for the elderly, and environmental and conservation activities.

As a long-term supporter of the Community Chest of Hong Kong, which provides funding for 150 charities in Hong Kong, we have made donations of more than HK\$28m to the organisation over the past decade. Matching staff donations on a dollar-for-dollar basis, we raised over HK\$1.1m for the Chest's annual Dress Casual Day campaign in 2011.

In partnership with the Regeneration Society, we promoted the importance of positive life values through the Hang Seng Bank – Regeneration Society Top Ten Regeneration Warriors Programme, which highlighted the stories of 10 selected "Regeneration Warriors" who had overcome chronic illness to live rewarding lives. We also invited the warriors to share their stories with a wider community, including our staff.

table tennis among the community and helps hone the talents of rising young stars in the sport. Since its establishment in 2001, over 3,700 activities have been held for more than 190,000 participants, including over 20,000 participants in 2011. Activities held during the year included two fun days for more than 300 underprivileged children.

We have provided more than HK\$31m since 1991 to fund table tennis training and development programmes for players and coaches.

In order to recognise the hard work and achievements of top local athletes, cash incentives will be awarded to outstanding performers at the 2012 Olympic and Paralympic Games in London through the Hang Seng Athlete Incentive Awards Scheme, a joint initiative with the Hong Kong Sports Institute. Since 1996, the Scheme has given out over HK\$26.6m to local athletes.

We strive to promote a good work-life balance among our staff by offering a wide range of sporting and recreational activities. The total number of participants in various sports activities exceeded 20,000 in 2011. To foster strong team spirit, we organised a family fun day and six sporting events – badminton, ten-pin bowling, table tennis, golf, basketball and football – under the Hang Seng Cup.

## ENVIRONMENTAL PERFORMANCE

|  | 2011         | 2010  | 2009  | 2008 | 2007 | 2011 vs<br>2010 [%] | 2010 vs<br>2009 [%] |
|--|--------------|-------|-------|------|------|---------------------|---------------------|
| Greenhouse gas emissions per person*<br>(tonnes CO <sub>2</sub> /FTE)                      | <b>2.96</b>  | 3.01  | 3.13  | 3.28 | 3.3  | -1.90%              | -3.76%              |
| Greenhouse gas emissions per m <sup>2</sup> *<br>(tonnes CO <sub>2</sub> /m <sup>2</sup> ) | <b>0.16</b>  | 0.17  | 0.17  | 0.2  | 0.2  | -1.66%              | -1.50%              |
| Greenhouse gas emissions*<br>(kilotonnes CO <sub>2</sub> )                                 | <b>23.62</b> | 23.97 | 24.52 | 27.4 | 26.7 | -1.44%              | -2.26%              |
| Electricity consumption (GWh)  | <b>36.30</b> | 35.32 | 36.5  | 38.1 | 35.9 | 2.77%               | -3.24%              |
| Gas consumption (GWh)  | <b>0.38</b>  | 0.39  | 0.4   | 0.42 | 0.7  | -3.76%              | -1.36%              |
| Water consumption (000 m <sup>3</sup> )  | <b>65.88</b> | 71.16 | 55.85 | 50.8 | 54.1 | -7.41%              | 27.40%              |
| IT/electrical waste recycled (tonnes)  | <b>66.02</b> | 50.84 | 85.03 | 64.9 | 59   | 29.86%              | -40.21%             |

Data coverage: Hang Seng Bank's Hong Kong operations

\* Hang Seng Bank's Hong Kong operations have been carbon neutral since 2007.

Key:

FTE: Full-time equivalent

m<sup>2</sup>: Square metres

m<sup>3</sup>: Cubic metres

CO<sub>2</sub>: Carbon dioxide

GWh: Gigawatt hours



Our staff help make a difference through their community service.



## CORPORATE GOVERNANCE AND OTHER INFORMATION

Hang Seng Bank Limited (the “Bank”) is committed to high standards of corporate governance with a view to safeguarding the interests of shareholders, customers, staff and other stakeholders. The Bank has followed the module on “Corporate Governance of Locally Incorporated Authorised Institutions” under the Supervisory Policy Manual (“SPM”) issued by the Hong Kong Monetary Authority (“HKMA”) and has fully complied with all the code provisions and most of the recommended best practices as set out in the Code on Corporate Governance Practices contained in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the “Listing Rules”) throughout the year. The Bank also constantly reviews and enhances its corporate governance framework to ensure that it is in line with international and local best practices.

### BOARD OF DIRECTORS

The Board has collective responsibilities for leadership and control of, and for promoting the long-term sustainability and success of, the Bank by directing and supervising the Bank’s affairs; and for performing its corporate governance duties to ensure the Bank’s economic efficiency.

The types of decisions which are to be taken by the Board include those relating to:

- strategic plan and objectives;
- annual operating plans and performance targets;
- annual and interim results;
- capital plans and management;
- risk appetite and profile;
- internal control and risk management governance;
- significant policies such as large credit exposure policy, liquidity management policy and remuneration policy;
- specified senior appointments;
- acquisitions and disposals above predetermined thresholds; and
- significant changes to balance sheet management policies.

### CHAIRMAN AND CHIEF EXECUTIVE

The roles of Chairman of the Board and Chief Executive of the Bank are separate, with a clear division of responsibilities. The Chairman of the Board is an Independent Non-executive Director who is responsible for the leadership and effective running of the Board. The Chief Executive is an Executive Director who exercises all the powers, authorities and discretions of the Executive Committee as may be delegated to her in respect of the Bank and its subsidiaries.

### BOARD COMPOSITION

As at the date of this Annual Report, the Board comprises 16 Directors, of whom two are Executive Directors and 14 are Non-executive Directors. Of the 14 Non-executive Directors, nine are Independent Non-executive Directors. There is a strong independent element on the Board, to ensure the independence and objectivity of the Board’s decision-making process as well as the thoroughness and impartiality of the Board’s oversight of the Management.

All the Independent Non-executive Directors meet the guidelines for assessment of independence as set out in Rule 3.13 of the Listing Rules. The Bank has also received from each of the Independent Non-executive Directors an annual confirmation of his/her independence.

Members of the Board, who come from a variety of different backgrounds, have a diverse range of business, banking and professional expertise. Brief biographical particulars of all the Directors, together with information relating to the relationship among them, are set out in the section “Biographical Details of Directors” in this Annual Report.

### BOARD PROCESS

Regular Board/Board Committee meeting schedules for each year are made available to all Directors/Board Committee members before the end of the preceding year. In addition, notice of meetings will be given to all Directors at least 14 days before each Board meeting.

Other than regular Board meetings, the Chairman also met with Non-executive Directors, including Independent Non-executive Directors, without the presence of Executive Directors, to facilitate an open and frank discussion among the Non-executive Directors on issues relating to the Bank.

Meeting agendas for regular Board meetings are set after consultation with the Chairman and the Chief Executive. All Directors are given an opportunity to include matters in the agenda. Regular reports include the Bank's financial performance, strategic plan, risk appetite and profile, review of internal control and risk management framework, results of stress testings, as well as large credit exposures and connected lendings of the Bank and its subsidiaries.

Minutes of Board/Board Committee meetings with details of the matters discussed by the Board/Board Committee and decisions made, including any concerns or views of the Directors/Board Committee members, are kept by the Company Secretary and are open for inspection by Directors/Board Committee members.

During 2011, the important matters discussed at Board meetings included:

- financial and business performance;
- strategic plan for the period from 2012 to 2014;
- risk appetite statement and profile;
- capital plan and management, and internal capital adequacy assessment process;
- results of stress testings on the Bank's rolling operating plan;
- significant policies such as large credit exposure policy and strategic risk management policy;
- liquidity contingency plan;
- corporate values implementation;
- appointments of Directors and senior executives; and
- pay review for 2011 and variable pay for 2010.

The Board reviews and evaluates its work process and effectiveness annually, with a view to identifying areas for improvement and further enhancement.

All Directors have access to the Executive Directors as and when they consider necessary. They also have access to the Company Secretary who is responsible for ensuring that the Board procedures, and related rules and regulations, are followed.

Under the Articles of Association of the Bank, a Director shall not vote or be counted in the quorum in respect of any contract, arrangement, transaction or other proposal in which he/she or his/her associate(s), is/are materially interested.

### APPOINTMENT, RE-ELECTION AND REMOVAL

The Bank's Articles of Association provide that each Director is required to retire by rotation once every three years and that one-third (or the number nearest to one-third) of the Directors shall retire from office every year at the Bank's Annual General Meeting. A Director's specific term of appointment, therefore, cannot exceed three years. Retiring Directors are eligible for re-election at Annual General Meetings of the Bank.

The Bank uses a formal, considered and transparent procedure for the appointment of new Directors. Before a prospective Director's name is formally proposed, opinions of the existing Directors (including the Independent Non-executive Directors) will be solicited. The appointment will be considered and if thought fit, approved by the Board after due deliberation. In accordance with the requirement under the Banking Ordinance, approval from HKMA will also be obtained. All new Directors are subject to election by shareholders of the Bank at the next Annual General Meeting after their appointments have become effective.

Three new Directors have been appointed since 2011 Annual General Meeting, namely, Mr Andrew H C Fung, Ms Anita Y M Fung and Dr Fred Zulu Hu. The aforesaid Directors will all stand for election by the Bank's shareholders at the Bank's Annual General Meeting to be held on 11 May 2012.

### RESPONSIBILITIES OF DIRECTORS

The Bank regularly reminds all Directors of their role and responsibilities. Through regular Board meetings, all Directors are kept abreast of the conduct, business activities and development of the Bank.

Induction programmes on the following key areas are arranged for newly appointed Directors:

- the Bank's business operations in Hong Kong, including retail banking and wealth management, corporate and commercial banking, treasury and investment services;
- the Bank's business operations on the Mainland; and

- the Bank's financial control, risk management, internal audit, compliance, information technology and support, and human resources.

All Directors are given opportunities to update and develop their skills and knowledge.

All Directors have full and timely access to all relevant information about the Bank so that they can discharge their duties and responsibilities as Directors. There are established procedures for Directors to seek independent professional advice on matters relating to the Bank where appropriate. All costs associated with obtaining such advice will be borne by the Bank. In addition, each Director has separate and independent access to the Bank's senior management.

The Bank has adopted a Code for Securities Transactions by Directors on terms no less exacting than the required standards as set out in the Model Code for Securities Transactions by Directors of Listed Issuers (as set out in Appendix 10 to the Listing Rules). Specific enquiries have been made with all Directors who have confirmed that they have complied with the Bank's Code for Securities Transactions by Directors throughout the year of 2011.

Appropriate Directors' liability insurance cover has also been arranged to indemnify the Directors for liabilities arising out of corporate activities. The coverage and the sum insured under the policy are reviewed annually.

The interests in Group securities, including securities relating to HSBC Holdings plc and the Bank, held by the Directors as at 31 December 2011 are disclosed in the Report of the Directors as set out in this Annual Report.

## DELEGATION BY THE BOARD

### BOARD COMMITTEES

The Board has set up three committees, namely, the Executive Committee, the Audit Committee and the Remuneration Committee, to assist it in carrying out its responsibilities.

Each of these committees has specific written terms of reference which set out in detail their respective authorities and responsibilities. All committees, except the Executive Committee, comprise solely of Independent Non-executive Directors. All committees report back to the Board on their decisions or recommendations on a regular basis.

| BOARD                                     |  |  |
|---|--|--|
| Executive Committee                       | Audit Committee                        | Remuneration Committee                   |
| Members: Mrs Margaret Leung<br>(Chairman) | Members: Dr Eric K C Li*<br>(Chairman) | Members: Dr John C C Chan*<br>(Chairman) |
| Mr Andrew H C Fung                        | Mr Richard Y S Tang*                   | Mr Jenkin Hui*                           |
| Mr Nixon L S Chan                         | Dr Marvin K T Cheung*                  | Dr Raymond K F Ch'ien*                   |
| Mr Andrew W L Leung                       |  |  |
| Mr Christopher H N Ho                     |  |  |
| Mr Donald Y S Lam                         |  |  |
| Mr Nai Pan Tang                           |  |  |

\* Independent Non-executive Directors



## EXECUTIVE COMMITTEE

The Executive Committee meets at least once each month and operates as a general management committee under the direct authority of the Board. It exercises the powers, authorities and discretions as delegated by the Board in so far as they concern the management and day-to-day running of the Bank in accordance with its terms of reference and such other policies and directives as the Board may determine from time to time. The Executive Committee also sub-delegates credit, investment and capital expenditure authorities to its members and senior executives.

To further enhance the Bank's risk management framework and in line with best practices, the Bank has set up a Risk Management Committee to centralise the risk management oversight function of the Bank and its subsidiaries. The Risk Management Committee reports directly to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank, including all the eight types of risks stipulated in the SPM of HKMA, namely, credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal and compliance risk, reputation risk and strategic risk. In addition, the Risk Management Committee also covers insurance risk, pension risk and sustainability risk, and is responsible for approval of all risk management related policies.

## AUDIT COMMITTEE

The Audit Committee meets at least four times a year, with the Bank's executives including, but not limited to, the Chief Financial Officer, the Chief Risk Officer, the Chief Compliance Officer and the Head of Audit, and representatives of the external auditor, to consider, among other things, the Bank's financial reporting, the nature and scope of audit reviews, the effectiveness of the systems of internal control and compliance, and high level risk related matters and risk governance (including, but not limited to, current and forward-looking risk exposures, the Group's risk appetite and future risk strategy; and management of risk within the Group). It is also responsible for making recommendations to the Board on the appointment, re-appointment, removal and remuneration of the Bank's external auditor. In addition, the Audit Committee has also established a "Policy for the Reporting of Improprieties" to provide a secured and confidential channel through which all staff members may report incidents of improprieties to the Chief Executive of the Bank so that appropriate actions can be taken promptly.

The Audit Committee reports to the Board following each Audit Committee meeting, drawing the Board's attention to salient points that the Board should be aware of, identifying any matters in respect of which it considers that action or improvement is needed and making relevant recommendations.

The Audit Committee held five meetings in 2011. The major work performed by the Committee during 2011 included:

- reviewing the Bank's financial statements for the year ended 31 December 2010 and the related documents, and the management letter and audit issues noted by the Bank's external auditor;
- reviewing the Bank's interim financial statements for the six months ended 30 June 2011 and the related documents, and the issues noted by the Bank's external auditor;
- reviewing essential matters or reports relating to financial control, internal audit, compliance and internal control, and discussing the same with the Management;
- reviewing risk-related matters (including, but not limited to, the Bank's risk management framework, risk appetite statement, enterprise stress testing analysis, risk dashboards, risk maps, top and emerging risks, and balance sheet management position), and the adequacy of resources of the risk management function of the Bank;
- reviewing regulatory review reports and internal audit reports, and discussing the same with the Management and Head of Audit;
- reviewing the revised accounting standards and prospective changes to accounting standards, and the impact on the Bank's financial reporting;
- reviewing the internal audit plan for 2012;
- reviewing the remuneration and engagement letters of the Bank's external auditor, and its objectivity and independence;
- reviewing the adequacy of resources, qualifications and experience of the staff of the accounting and financial reporting function of the Bank, and their training programme and budget, and succession planning for key roles of the function;

- reviewing the implementation progress of Sarbanes-Oxley Act;
- reviewing the Bank's capital plan, capital management and internal capital adequacy assessment process;
- reviewing the Bank's progress in implementing Basel III;
- reviewing the effectiveness of the Policy for the Reporting of Improperities and the incidents reported through such channel; and
- exercising oversight over the audit committees and, where applicable, risk committee of the Bank's principal subsidiaries.

The Audit Committee meets with the representatives of the Bank's external auditor and Head of Audit on a regular basis and also meets with them without the presence of the Management at least once a year. Further, the Committee meets with the representatives of HKMA to maintain a regular dialogue with the regulator and to share HKMA's general views on their supervisory focus.

In order to identify areas for further enhancements, the Audit Committee conducts an annual gap analysis as regards the effective discharge of its role and responsibilities pursuant to its terms of reference.

### REMUNERATION COMMITTEE

The Remuneration Committee meets at least twice a year to consider human resources issues and make recommendations to the Board on the Bank's policy and structure for all remuneration and fees of Directors, senior management and key personnel in order to attract, motivate and retain quality personnel. The Committee also determines the remuneration policy of the Bank and its subsidiaries, and the specific remuneration packages of all Executive Directors, senior management and key personnel. In addition, the Committee also reviews annually and independently of the Management, the adequacy and effectiveness of the Bank's remuneration policy and its implementation to ensure that the Bank's remuneration policy is consistent with regulatory requirements and promote effective risk management.

In determining the bank-wide remuneration policy, the Remuneration Committee will take into account the Bank's business objective, people strategy, short-term and long-term performance, business and economic environment conditions, market practices and risk management needs, in order to ensure the remuneration aligns with business and individual performances, promotes effective risk management, facilitates retention of quality personnel and is competitive in the market. The Committee may invite any Director, executive, consultant or other relevant party to provide advice in this respect.

The Remuneration Committee held two meetings in 2011. The major work performed by the Committee during 2011 included:

- reviewing the fees payable to the Directors and Board Committee Chairmen/members of the Bank and its subsidiaries and recommending the same to the Board for approval;
- determining the remuneration packages of the Executive Directors, senior management and key personnel of the Bank; and the Vice Chairman and Chief Executive of Hang Seng Bank (China) Limited;
- reviewing the proposed variable pay for 2010 and recommending the same to the Board for approval; and
- reviewing the pay review proposal for 2011 and recommending the same to the Board for approval.

At the Remuneration Committee meeting held in February 2012, the Committee also reviewed the outcome of a review conducted by the Bank's internal audit function on the Bank's remuneration policy and remuneration system, and the adequacy and effectiveness of its implementation.

In order to identify areas for further enhancements, the Remuneration Committee conducts an annual gap analysis as regards the effective discharge of its role and responsibilities pursuant to its terms of reference.

## ATTENDANCE RECORDS

The attendance records of Board and Board Committee meetings held in 2011 are set out in the following table:

|  | Meetings held in 2011 |                     |                     |                 |                        |
|--|-----------------------|---------------------|---------------------|-----------------|------------------------|
|  | 2011 AGM              | Board               | Executive Committee | Audit Committee | Remuneration Committee |
| Number of Meetings   | 1                     | 9 <sup>Note 1</sup> | 16                  | 6               | 2                      |
| <b>Directors</b>   |                       |                     |                     |                 |                        |
| Dr Raymond K F Ch'ien* ( <i>Chairman</i> )                         | 1/1                   | 9/9                 | –                   | –               | 2/2                    |
| Mrs Margaret Leung<br>( <i>Vice-Chairman and Chief Executive</i> ) | 1/1                   | 9/9                 | 16/16               | –               | –                      |
| Dr John C C Chan*  | 1/1                   | 9/9                 | –                   | –               | 2/2                    |
| Dr Marvin K T Cheung*  | 1/1                   | 7/9                 | –                   | 6/6             | –                      |
| Ms L Y Chiang*   | 1/1                   | 9/9                 | –                   | –               | –                      |
| Mr Andrew H C Fung <sup>Note 2</sup>                               | –                     | 2/2                 | 13/16               | –               | –                      |
| Ms Anita Y M Fung <sup># Note 3</sup>                              | –                     | 1/2                 | –                   | –               | –                      |
| Dr Fred Zulu Hu* <sup>Note 4</sup>                                 | –                     | 5/5                 | –                   | –               | –                      |
| Mr Jenkin Hui*   | 1/1                   | 7/9                 | –                   | –               | 2/2                    |
| Ms Sarah C Legg <sup># Note 5</sup>                                | 1/1                   | 6/8                 | –                   | –               | –                      |
| Mr William W Leung <sup>Note 6</sup>                               | 1/1                   | 5/5                 | 10/11               | –               | –                      |
| Dr Eric K C Li*  | 1/1                   | 8/9                 | –                   | 6/6             | –                      |
| Dr Vincent H S Lo <sup>#</sup>                                     | 1/1                   | 6/9                 | –                   | –               | –                      |
| Mr Mark S McCombe <sup># Note 7</sup>                              | 1/1                   | 4/5                 | –                   | –               | –                      |
| Mrs Dorothy K Y P Sit <sup>#</sup>                                 | 1/1                   | 9/9                 | –                   | –               | –                      |
| Mr Richard Y S Tang*   | 1/1                   | 9/9                 | –                   | 6/6             | –                      |
| Mr Peter T S Wong <sup>#</sup>                                     | 1/1                   | 6/9                 | –                   | –               | –                      |
| Mr Michael W K Wu*   | 1/1                   | 9/9                 | –                   | –               | –                      |
| <b>Senior Executives</b>   |                       |                     |                     |                 |                        |
| Mr Nixon L S Chan  | –                     | –                   | 16/16               | –               | –                      |
| Mr Christopher H N Ho  | –                     | –                   | 14/16               | –               | –                      |
| Mr Donald Y S Lam <sup>Note 8</sup>                                | –                     | –                   | 4/4                 | –               | –                      |
| Mr Andrew W L Leung  | –                     | –                   | 14/16               | –               | –                      |
| Mr David W H Tam <sup>Note 9</sup>                                 | –                     | –                   | 13/16               | –               | –                      |
| <b>Average Attendance Rate</b>                                     | 100%                  | 88%                 | 91%                 | 100%            | 100%                   |

\* Independent Non-executive Directors

# Non-executive Directors

<sup>Note 1</sup> The Board held seven regular meetings, one special meeting and one strategic session in year 2011.

<sup>Note 2</sup> Mr Andrew H C Fung was appointed as Executive Director with effect from 10 October 2011.

<sup>Note 3</sup> Ms Anita Y M Fung was appointed as Non-executive Director with effect from 1 November 2011. She attended the Board's strategic session held in October 2011 in Shanghai as a Director Designate.

<sup>Note 4</sup> Dr Fred Zulu Hu was appointed as Independent Non-executive Director with effect from 30 May 2011.

<sup>Note 5</sup> Ms Sarah C Legg was appointed as Non-executive Director with effect from 14 February 2011.

<sup>Note 6</sup> Mr William W Leung resigned from the Board with effect from 20 August 2011.

<sup>Note 7</sup> Mr Mark S McCombe resigned from the Board with effect from 9 September 2011.

<sup>Note 8</sup> Mr Donald Y S Lam was appointed as a member of the Executive Committee with effect from 7 September 2011.

<sup>Note 9</sup> Mr David W H Tam retired and ceased to be a member of the Executive Committee with effect from 28 January 2012.



## REMUNERATION OF DIRECTORS, SENIOR MANAGEMENT AND KEY PERSONNEL

The Bank's policy on remuneration is to maintain fair and competitive packages based on business needs and industry practice.

### REMUNERATION OF DIRECTORS

The level of fees paid to Non-executive Directors is determined by reference to factors including fees paid by comparable institutions, and Directors' workload and commitments.

The following factors are considered when determining the remuneration packages of Executive Directors:

- business needs;
- general economic situation;
- changes in appropriate markets such as supply/demand fluctuations and changes in competitive conditions;
- individual contributions to results as confirmed in the performance appraisal process; and
- retention consideration and individual potential.

No individual Director will be involved in decisions relating to his/her own remuneration.

The current scales of Director's fees, and additional fees for Chairmen and members of the Audit Committee and Remuneration Committee are set out below:

|                               | Fees<br>(HK\$)             |
|-------------------------------|----------------------------|
| <b>Board of Directors</b>     |                            |
| Chairman                      | 440,000                    |
| Vice-Chairman                 | Nil <sup>Note 10</sup>     |
| Other Directors               | 340,000 <sup>Note 10</sup> |
| <b>Audit Committee</b>        |                            |
| Chairman                      | 260,000                    |
| Members                       | 160,000                    |
| <b>Remuneration Committee</b> |                            |
| Chairman                      | 90,000                     |
| Members                       | 60,000                     |

<sup>Note 10</sup> In line with the remuneration policy of HSBC Group, no Directors' fees are paid to those Directors who are full time employees of the Bank or its subsidiaries.

Information relating to the remuneration of each Director for the year ended 31 December 2011 is set out in Note 19 to the Bank's 2011 Financial Statements.

### REMUNERATION OF SENIOR MANAGEMENT AND KEY PERSONNEL

There were 11 and two employees being classified as Senior Management and Key Personnel respectively during the financial year 2011.

Aggregate amount of remuneration of Senior Management<sup>Note 11</sup> and Key Personnel<sup>Note 12</sup> during the financial year 2011, split into fixed and variable remuneration, is set out below:

| Amount of remuneration for the financial year 2011* (HK\$) | Non-deferred | Deferred  |
|--|--------------|-----------|
| <b>Fixed remuneration</b>                                  |              |           |
| Cash   | 39,004,000   | –         |
| <b>Variable remuneration</b>                               |              |           |
| Cash   | 14,158,000   | 4,672,000 |
| Shares   | 3,115,000    | 7,029,000 |

\* Remuneration refers to all remuneration payments payable to employees during the period between 1 January 2011 and 31 December 2011. For those employees who left the Bank during the financial year 2011, termination payments calculated up to their last employment date are also included.

<sup>Note 11</sup> Senior Management refers to those executives who are the heads of major business lines and functions.

<sup>Note 12</sup> Key Personnel refers to those executives other than Senior Management who are engaged in trading and dealing activities which involve the assumption of material risk or the taking on of material exposures on behalf of the Bank.

Aggregate amount of deferred variable remuneration, split into (i) vested and paid during the financial year 2011 and (ii) outstanding and unvested as at 31 December 2011 is set out below:

| Amount (HK\$)  | Awarded for<br>Performance Year 2011 | Awarded for<br>Prior Performance Years |
|--|--------------------------------------|--|
| <b>Vested and paid during 2011</b>                     |                                      |  |
| Cash   | –                                    | –                                      |
| Shares   | –                                    | 14,770,000                             |
| <b>Outstanding and unvested as at 31 December 2011</b> |                                      |  |
| Cash   | 4,672,000                            | 4,767,000                              |
| Shares   | 7,029,000                            | 29,156,000                             |

There was no deferred variable remuneration being reduced through performance adjustments in 2011.

Quantitative information on employees' exposure to implicit (e.g. fluctuations in the value of shares or performance units) and explicit adjustments (e.g. malus, clawbacks or similar reversals or downward revaluations of awards) of deferred remuneration and retained remuneration is set out below:

|  | Amount (HK\$) |
|--|---------------|
| Total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit/implicit adjustments | 45,624,000    |
| Total amount of reductions during the financial year 2011 due to:  |               |
| – Ex post explicit adjustments   | –             |
| – Ex post implicit adjustments   | (1,924,000)   |

No Senior Management and Key Personnel has been awarded or paid guaranteed bonus, new sign-on or severance payment during the financial year 2011.

## ACCOUNTABILITY AND AUDIT FINANCIAL REPORTING

The Board aims at making a balanced, clear and comprehensive assessment of the Bank's performance, position and prospects. An annual operating plan is reviewed and approved by the Board on a yearly basis. Reports on financial results, business performance and variances against the approved annual operating plan are submitted to the Board for regular discussion and monitoring at Board meetings.

Strategic planning cycles are generally from three to five years. The Bank's strategic plan for 2012 to 2014 was reviewed by the Board in October 2011. Progress on the implementation of the key initiatives in the strategic plan will be reported to and reviewed by the Board on a regular basis.

The annual and interim results of the Bank are announced in a timely manner within the limits of three months and two months respectively after the end of the relevant year or period.

The Directors acknowledge their responsibilities for preparing the accounts of the Bank. As at 31 December 2011, the Directors were not aware of any material uncertainties relating to events or conditions which may cast significant doubt upon the Bank's ability to continue as a going concern. Accordingly, the Directors have prepared the financial statements of the Bank on a going-concern basis.

The responsibilities of the external auditor with respect to financial reporting are set out in the Independent Auditor's Report attached to the Bank's 2011 Financial Statements.

## INTERNAL CONTROLS

### System and Procedures

The Board is responsible for internal control at the Bank and its subsidiaries and for reviewing its effectiveness.

The Bank's internal control system comprises a well-established organisational structure and comprehensive policies and standards. Areas of responsibilities for each business and functional unit are clearly defined to ensure effective checks and balances.

Procedures have been designed for safeguarding assets against unauthorised use or disposition; for maintaining proper accounting records; and for ensuring the reliability of financial information used within the business or for publication. The procedures provide reasonable but not absolute assurance against material errors, losses or fraud. Procedures have also been designed to ensure compliance with applicable laws, rules and regulations.

Systems and procedures are in place in the Bank to identify, control and report on the major types of risks the Bank faces. Business and functional units are responsible for the assessment of individual types of risk arising under their areas of responsibilities, the management of the risks in accordance with risk management procedures and reporting on risk management. The Board maintains an effective risk management framework through the Risk Management Committee which reports to the Executive Committee by setting up of specialised management committees for supervision of major risk areas and the establishment of risk management departments for relevant functions of the Bank. The scope of responsibilities of the Audit Committee has also been expanded to cover risk management oversight. The relevant risk management reports are submitted to Asset and Liability Management Committee, Risk Management Committee, Executive Committee and Audit Committee, and ultimately to the Board for monitoring the respective types of risk. The Bank's risk management policies and major control limits are approved by the Board or its delegated committees, and are monitored and reviewed regularly according to established procedures of the Bank.

More detailed discussions on the policies and procedures for management of each of the major types of risk the Bank faces, including credit, liquidity, market, insurance, operational and reputational risks, are included in the risk management section of the "Financial Review" under the Bank's 2011 Annual Report, and in Note 61 to the Bank's 2011 Financial Statements.

### Annual Assessment

A review of the effectiveness of the Bank's internal control system covering all material controls, including financial, operational, compliance, and risk management controls, is conducted annually. The review at the end of 2011 was conducted with reference to the COSO (The Committee of Sponsoring Organisations of the Treadway Commission) internal control framework, which assesses the Bank's internal control system against the five elements of control environment, risk assessment, control activities, information and communication, and monitoring. The Bank has also conducted an annual review to assess the adequacy of resources, qualifications and experience of staff of the Bank's accounting and financial reporting function, and their training programmes and budget, and succession planning for key roles of the function. The approach, findings, analysis and results of these annual reviews have been reported to the Audit Committee and the Board.

## FRAMEWORK FOR DISCLOSURE OF PRICE-SENSITIVE INFORMATION

The Bank has put in place a robust framework for the disclosure of price-sensitive information in compliance with the Listing Rules and other regulatory requirements in this respect. The framework sets out the procedures and internal controls for the handling and dissemination of price-sensitive information in a timely manner so as to allow the shareholders, customers, staff and other stakeholders to apprehend the latest position of the Bank and its subsidiaries. The framework and its effectiveness are subject to review on a regular basis according to established procedures.

### INTERNAL AUDIT

The internal audit function plays an important role in the Bank's risk management and internal control framework. It provides independent and objective assurance to the Management and the Audit Committee in this respect with a view to adding value and enhancing the Bank's operations. It also facilitates the Management accomplish its objectives through a systematic and disciplined approach to the evaluation and strengthening of the effectiveness of risk management, control, and governance processes. The scope of work of the internal audit function is to determine whether the framework of risk management, control, and governance processes, as designed and represented by the Management, is adequate and effective. Opportunities for reinforcing management control, profitability, best practice and the Bank's corporate image may be identified during audits and will be communicated to the appropriate level of the Management. The Bank's Head of Audit reports to the Chairman and the Audit Committee.



## EXTERNAL AUDITOR

KPMG is the Bank's external auditor. The Audit Committee is responsible for making recommendations to the Board on the appointment, re-appointment, removal and remuneration of the external auditor. The external auditor's independence and objectivity are also reviewed and monitored by the Audit Committee on a regular basis.

During 2011, fees paid to the Bank's external auditor for audit services amounted to HK\$13.3m, same as in 2010. For non-audit services, the fees paid to the Bank's external auditor amounted to HK\$6.7m, compared with HK\$5.8m in 2010. In 2011, the significant non-audit service assignments covered by these fees include the following:

| Nature of service        | Fees paid (HK\$m) |
|--------------------------|-------------------|
| Other assurance services | 6.5               |
| Tax services             | 0.2               |
|                          | <u>6.7</u>        |

## AUDIT COMMITTEE

The Audit Committee assists the Board in meeting its responsibilities for ensuring effective systems of risk management, internal control and compliance, and in meeting its financial reporting obligations.

## COMMUNICATION WITH SHAREHOLDERS

### EFFECTIVE COMMUNICATION

The Bank attaches great importance to communication with shareholders. To this end, a number of means are used to promote greater understanding and dialogue with the investment community. The Bank holds group meetings with analysts in connection with the Bank's annual and interim results. The results announcements are also broadcast live via webcast. Apart from the above, designated senior executives maintain regular dialogue with institutional investors and analysts to keep them abreast of the Bank's development, subject to compliance with the applicable laws and regulations. Including the two results announcements, over a hundred meetings with analysts and fund managers were held in 2011. In addition, the Bank's Vice-Chairman and Chief Executive; and Chief Financial Officer also made presentations and held group meetings with investors at investor forums in Hong Kong and overseas.

Further, the Bank's website ([www.hangseng.com](http://www.hangseng.com)) contains an investor relations section which offers timely access to the Bank's press releases, other business information and information on the Bank's corporate governance structure and practices. For efficient communication with shareholders and in the interest of environmental preservation, shareholders are encouraged to browse the Bank's corporate communications on the Bank's website, in the place of receiving printed copies of the same.

The Annual General Meeting provides a useful forum for shareholders to exchange views with the Board. The Bank's Chairman, Executive Directors, Chairmen of the Board Committees and Non-executive Directors are available at the Annual General Meeting to answer questions from shareholders about the business and performance of the Bank. In addition, the Bank's external auditor is also invited to attend the Annual General Meeting to answer questions about the conduct of the audit, and the preparation and contents of the auditor's report. Separate resolutions are proposed at general meetings for each substantial issue, including the re-election and election (as the case may be) of individual Directors. An explanation of the detailed procedures of conducting a poll will be provided to shareholders at the Annual General Meeting, to ensure that shareholders are familiar with such procedures.

The Bank's last Annual General Meeting was held on Friday, 13 May 2011 at Hang Seng Bank Headquarters, 83 Des Voeux Road Central, Hong Kong. All the resolutions proposed at that meeting were approved by the shareholders by poll voting. Details of the poll results are available under the investor relations section of the Bank's website at [www.hangseng.com](http://www.hangseng.com).

The next Annual General Meeting will be held on Friday, 11 May 2012, the notice of which will be sent to shareholders at least 20 clear business days before the said meeting. Shareholders may refer to the section "Corporate Information and Calendar" in this Annual Report for information on other important dates for shareholders in year 2012.

### CALLING AN EXTRAORDINARY GENERAL MEETING

Shareholder(s) holding not less than 5 percent of the paid-up capital of the Bank may requisition an Extraordinary General Meeting of the Bank.

The requisition must (i) state the objects of the meeting, (ii) be signed by the requisitionist(s) and (iii) be deposited at the Bank's registered office at 83 Des Voeux Road Central, Hong Kong. It may also consist of several documents in like form, each signed by one or more requisitionist(s).

The requisition must also (i) state the name(s) of the requisitionist(s), (ii) the contact details of the requisitionist(s) and (iii) the number of ordinary shares of the Bank held by the requisitionist(s).

The Directors must proceed to convene an Extraordinary General Meeting within 21 days from the date of the deposit of the requisition. Such meeting should be held on a day not more than 28 days after the date on which the notice convening the meeting is given.

If the Directors fail to convene the Extraordinary General Meeting as aforesaid, the requisitionist(s), or any of them representing more than one-half of the total voting rights of all of them, may themselves convene the meeting. Any meeting so convened shall not be held after the expiration of three months from the date of the deposit of the requisition.

A meeting so convened by the requisitionist(s) shall be convened in the same manner, as nearly as possible, as that in which meetings are to be convened by the Directors.

Any reasonable expenses incurred by the requisitionist(s) by reason of the failure of the Directors duly to convene a meeting shall be repaid to the requisitionist(s) by the Bank.

#### **PUTTING FORWARD PROPOSALS AT GENERAL MEETINGS**

Shareholders holding not less than 2.5 percent of the paid-up capital of the Bank, or, not less than 50 shareholders each holding specified number of shares in the Bank, may :

- put forward proposal at general meeting;
- circulate to other shareholders written statement with respect to matter to be dealt with at general meeting.

For further details on the shareholder qualifications, and the procedures and timeline, in connection with the above, shareholders are kindly requested to refer to Section 115A of the Companies Ordinance (Chapter 32 of the Laws of Hong Kong).

Further, a shareholder may propose a person other than a retiring Director of the Bank for election as a Director of the Bank at a general meeting. For such purpose, the shareholder must send to the Bank's registered address (for the attention of the Bank's Company Secretary) a written notice which identifies the candidate and includes a notice in writing by that candidate of his/her willingness to be so elected. Such notice must be sent within a period of not less than seven days commencing no earlier than the day after the despatch of the notice of the meeting appointed for such election and ending no later than seven days prior to the date of such meeting.

#### **PUTTING ENQUIRIES TO THE BOARD**

Shareholders may send their enquiries requiring the Board's attention to the Bank's Company Secretary at the Bank's registered address. Questions about the procedures for convening or putting forward proposals at an Annual General Meeting or Extraordinary General Meeting may also be put to the Company Secretary by the same means.

#### **SHAREHOLDERS COMMUNICATION POLICY**

The Bank has established a Shareholders Communication Policy to set out the Bank's processes to provide shareholders and the investment community with ready, equal and timely information on the Bank for them to make informed assessments of the Bank's strategy, operations and financial performance, and to encourage them to take active interest in the Bank.

#### **MATERIAL RELATED PARTY TRANSACTIONS AND CONNECTED TRANSACTIONS**

##### **MATERIAL RELATED PARTY TRANSACTIONS AND CONTRACTS OF SIGNIFICANCE**

The Bank's material related party transactions are set out in Note 60 to the 2011 Financial Statements. These transactions include those that the Bank has entered into with its immediate holding company and fellow subsidiary companies in the ordinary course of its interbank activities, including the acceptance and placement of interbank deposits, corresponding banking transactions, off-balance sheet transactions, and the provision of other banking and financial services.

The Bank uses the information technology services of, and shares an automated teller machine network with, The Hongkong and Shanghai Banking Corporation Limited, its immediate holding company. The Bank also shares information technology and certain processing services with fellow subsidiaries on a cost recovery basis. In 2011, the Bank's share of the costs included HK\$231m for system development, HK\$240m for data processing, and HK\$165m for administrative services.

The Bank maintains a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. As part of its ordinary course of business with other financial institutions, the Bank also markets Mandatory Provident Fund products and distributes retail investment funds for fellow subsidiaries, with a fee income of HK\$194m and HK\$53m respectively in 2011. Hang Seng Investment Management Limited, a wholly owned subsidiary of the Bank, manages in the ordinary course of its business a fund administered by a fellow subsidiary, to which management fee rebates were made. The rebate for 2011 amounted to HK\$70m.

These transactions were entered into by the Bank in the ordinary and usual course of business on normal commercial terms, and in relation to those which constituted connected transactions under the Listing Rules, they also complied with applicable requirements under the Listing Rules. The Bank regards its usage of the information technology services of The Hongkong and Shanghai Banking Corporation Limited (amount of information technology services cost incurred for 2011: HK\$473m) as contracts of significance for 2011.

### CONTINUING CONNECTED TRANSACTIONS

On 22 June 2010, Hang Seng Insurance Company Limited ("HSIC"), a wholly-owned subsidiary of the Bank, entered into the following agreements :

- (i) a management services agreement ("Management Services Agreement") with HSBC Life (International) Limited ("INHK") for a term of three years commencing from 22 June 2010, pursuant to which INHK, directly or through one or more of its affiliates, would provide to HSIC certain management services.

INHK would charge HSIC for the provision of the services on a fully absorbed cost basis plus a mark-up of 5%. These charges have been determined following negotiation on an arm's length basis and in accordance with the policy of the HSBC Group, which has taken into account the transfer pricing guidelines of UK and the Organisation for Economic Co-operation and Development.

- (ii) an investment management agreement ("Investment Management Agreement") with HSBC Global Asset Management (Hong Kong) Limited ("AMHK") for a term of three years commencing from 22 June 2010, pursuant to which AMHK would act as investment manager in respect of certain of HSIC's assets held from time to time.

HSIC would pay, on a quarterly basis, to AMHK a fee of between 0.17% and 0.375% per annum of the mean value of the assets under management, which has been determined on an arm's length basis.

Details of the terms of and the caps under the Management Services Agreement and the Investment Management Agreement for the period from 22 June to 31 December 2010, and for the years ending 31 December 2011 and 2012, and for the period from 1 January to 21 June 2013, were announced by the Bank on 22 June 2010.

The Directors believed that the Management Services Agreement would enable HSIC to run at a reasonably low cost structure by leveraging the shared infrastructure and expertise

of INHK. The resulting cost efficiency has contributed to increased competitiveness of HSIC's manufactured products in the market, which the Directors considered to be essential to the future business growth of HSIC.

The Investment Management Agreement was based on the commercial terms set out in the previous investment management agreement which expired on 21 June 2010 and the Directors (including the Independent Non-executive Directors) believed that these terms should remain in place.

INHK and AMHK are both indirect wholly-owned subsidiaries of HSBC Holdings plc, the ultimate controlling shareholder of the Bank and therefore are connected persons of the Bank. Accordingly, the Management Services Agreement and the Investment Management Agreement constituted continuing connected transactions of the Bank. The Bank has complied with the disclosure requirements in accordance with Chapter 14A of the Listing Rules.

For the year ended 31 December 2011, the aggregate amount paid under the Management Services Agreement was HK\$83m, whereas the aggregate amount paid under the Investment Management Agreement was HK\$61m.

In respect of the Management Services Agreement and the Investment Management Agreement which constituted the Bank's continuing connected transactions, all the Independent Non-executive Directors of the Bank have reviewed the said transactions and confirmed that the said transactions have been entered into:

- (i) in the ordinary and usual course of business of the Group;
- (ii) on normal commercial terms; and
- (iii) in accordance with the relevant agreements governing them on terms that are fair and reasonable and in the interests of the Bank and its shareholders as a whole.

Further, the Bank has engaged its external auditor to report on the Group's continuing connected transactions in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" issued by the Hong Kong Institute of Certified Public Accountants. The auditor has issued an unqualified letter containing their findings and conclusions in respect of the continuing connected transactions set out in the preceding paragraphs in accordance with Listing Rule 14A.38. A copy of the auditor's letter has been provided by the Bank to The Stock Exchange of Hong Kong Limited.



## HUMAN RESOURCES

The human resources policies of the Bank are designed to attract people of the highest calibre and to motivate them to excel in their careers, as well as uphold the Bank's brand equity and culture of quality service.

### EMPLOYEE STATISTICS

As at 31 December 2011, the Bank's total headcount was 9,834, representing an increase by 192, or 2.0%, compared with a year earlier. The total headcount comprised 1,407 executives, 4,048 officers and 4,379 clerical and non-clerical staff.

### EMPLOYEE REMUNERATION

The Remuneration Committee oversees the Bank's overall reward strategy and ensures all the reward policies are carefully considered in the context of business objective, people strategy, commercial competitiveness and regulatory guidance during their formulation. The Committee may invite any Director, executive, consultant or other relevant party to provide advice in this respect. The fundamental principles, philosophies and processes are documented in the Bank's remuneration policy.

The Bank adopts a Total Reward Approach. In determining the total remuneration for employees, the Bank will make reference to individual's responsibility, capability and risk profile of the job to ensure an appropriate balance between the fixed pay and variable pay.

Fixed pay is determined by taking into account relevant level and composition of pay in the markets in which the Bank operates. Salaries are reviewed in the context of business performance, individual performance and potential, market practice, internal relativities, risk management requirements and competitiveness compared to peers.

Bank-wide variable remuneration budgets are formulated in consideration of the Bank's business performance, people strategy and the relevant operational and financial risks; and is subject to a periodic review and adjustment by the Bank's Asset and Liability Management Committee against the Bank's latest business performance, financial position and risk appetite profile.

Variable pay is determined with respect to individual's performance against respective financial and non-financial goals and measures, and the relevant governance criteria. This consists of deferred and non-deferred components in the forms of cash and share award. Deferred awards will be granted if the total variable remuneration amount of the relevant employee exceeds the

prescribed thresholds. The deferred award has a vesting period of three years and is subject to adjustment or clawback under certain specific circumstances with respect to the awardee's individual performance or the Bank's overall performance.

The principles of the remuneration policy are applicable to the Bank and its subsidiaries, subject to the local legislative requirements and market practices and proportional to the scope and complexity of the local business.

### EMPLOYEE ENGAGEMENT

The Bank continues to build a best place to work by promoting employee engagement and by driving a diversity and inclusive culture.

The Global People Survey 2011 was completed and follow up actions were taken as a continuous effort to gauge and improve staff engagement. The results showed that our staff's engagement was sustained at a level well above the Best in Class. To foster an engaging, inclusive environment for employees, the Bank advocates appreciation and inclusion across all levels of staff through mass communication and training initiatives.

### GROWTH AND DEVELOPMENT

The Bank is committed to sustain a culture of competence and ethical behaviour with due regard to the principles set out in the SPM CG-6 "Competence and Ethical Behaviour" module issued by HKMA. The Bank has established policies and procedures for monitoring, developing and maintaining the competence levels and ethical behaviour of staff members. These include clear competence criteria for staff members and strong commitment to staff training and development.

In order to fully develop staff competence and potential, the Bank has a comprehensive induction programme that provides new staff with an understanding of the Bank's history, culture, values and corporate governance. To equip staff members to meet future challenges and professional requirements, including those for regulated businesses and activities, the Bank offers a wide range of training and development programmes in the areas of sales and relationship management, product, operations, compliance, credit and risk. The Bank also offers Professional Qualifications and Education Award Scheme to support staff members to pursue professional or academic qualifications. On average, our staff members received six days of training in 2011.

To strengthen the leadership pipeline and help staff members fulfill their personal career goals, the Bank has developed a Leadership and Management Development framework which offers a broad range of leadership and management skills training. To ensure sustainability, the Bank has strategy, measures and metrics to plan and manage succession to critical roles, and to facilitate talent feed to the succession pipeline. Line businesses and the HR function are connected to accelerate the development of talents and high potential staff through a mix of on-the-job training, coaching and learning interventions.

### RECRUITMENT AND RETENTION

Vigorous recruitment activities continued in the first half of year 2011, especially for front-line sales positions, experienced professionals and specialists to meet business needs and for replacement of staff turnover. In view of the uncertain economic outlook since the second half of year 2011, headcount has been closely monitored and external recruitment was restricted only to cases justified by business needs.

Young talents are constantly recruited and groomed through well-structured, intensive development programmes. Further, trainee programmes have been provided for jobs in selected functional areas in order to build pipeline for succession. There were also conscious efforts on retention of talents and key staff through review of career advancement opportunities and remuneration package to ensure market competitiveness.

## OTHER INFORMATION

### BUSINESS PRINCIPLES AND VALUES

The Bank has a set of well-founded business principles and corporate values guiding staff to keep the highest personal standards of integrity as well as to comply with the spirit and letter of all laws and regulations when conducting business. "Courageous Integrity" is the guiding principle whereby every employee has the courage to do the right thing without compromising the ethical standards and integrity, and behaves in a dependable, open and connected way in everyday work. The Bank advocates the living of values by all staff, promotes their awareness and commitment, and empowers leaders and managers to drive values behaviour in the workplace.

### CODE OF CONDUCT

To ensure the Bank operates according to the highest standards of ethical conduct and professional competence, all staff are required to strictly follow the Code of Conduct contained in the Bank's Staff Handbook. With reference to the applicable regulatory guidelines and other industry best practices, the

Code sets out ethical standards and values to which all the Bank's staff are required to adhere and covers various legal, regulatory and ethical issues. These include topics such as prevention of bribery, dealing in securities, personal benefits, outside employment and anti-discrimination policies.

The Bank uses various communication channels to periodically remind staff of the requirement to adhere to the rules and ethical standards set out in the Code of Conduct.

### HEALTH AND SAFETY

The Bank acknowledges and accepts its responsibilities for securing safety and health of its employees, of contractors working at premises over which it has control, and of visiting members of the public. By successfully implementing the certified BS OHSAS 18001:2007-compliant Safety Management System, the Bank marks its achievement to be the first bank world-wide to conform to this internationally acclaimed best practice aiming at reducing the exposure of the Bank's staff, contractors and customers to occupational safety and health risks associated with its business activities.

The Bank provides a range of training and activities to enhance the knowledge of its staff in occupational safety and health, fire safety, manual handling, and office safety. A number of staff have acquired Qualified First Aider status so as to offer prompt assistance to their colleagues and customers in the event of a medical emergency or accident whilst awaiting the arrival of the ambulance.

The Bank implements a Contingency Plan for Communicable Disease, which sets out the key issues to be addressed and the actions to be taken by various units in response to the occurrence of a serious communicable disease, and the keeping of adequate stock of Face Masks and Tamiflu to cater for the needs of its staff in case of an outbreak of influenza pandemic. Staff have been made aware through various communication channels of the importance of personal hygiene and health, and the contingency measures to be adopted, to enable the Bank to continue with its services to the community during an outbreak of a serious communicable disease.

The Bank operates a Staff Recreation Centre at Kowloon Bay with various facilities for health enhancement and leisure activities to foster work life balance among its staff and their family members.







# RIDING THE WAVES

DETERMINATION

## MANAGEMENT DISCUSSION AND ANALYSIS

# BUSINESS IN HONG KONG

In 2011, our ingrained culture of customer service and time-to-market capabilities allowed us to react quickly to meet changing customer needs, especially amid the global economic uncertainties of the second half of the year.



We built on our large customer franchise, maintained prudent risk management and capitalised on new opportunities to achieve long-term growth.

Given the growing economic integration of Hong Kong and mainland China, we introduced more renminbi-related financial services for personal and business customers.

## RETAIL BANKING AND WEALTH MANAGEMENT

Retail Banking and Wealth Management reported operating profit excluding loan impairment charges of HK\$6,441m, a decrease of 18.1% from 2010. Profit before tax fell by 15.9% to HK\$6,623m. Performance was affected by the drop in wealth management income in the second half of 2011.

Net interest income recorded a year-on-year decline of 3.9%. Intense market competition levied pressure on our deposit income, while unsecured lending and insurance were able to achieve moderate growth in their respective net interest income.

# 18.7 %

Market share of new mortgage registrations in HK (Dec 2011)

# 2.23 MILLION

Credit cards issued





## Our credit card business delivered a strong performance.

We leveraged our leading market position, convenient distribution network and personalised value-added solutions.

As part of our efforts to cater for the needs of e-savvy customers and improve operational efficiency, we continued to invest in technology. Our online and mobile banking capabilities were strengthened to improve the customer experience.

In September 2011, we launched a new generation of e-Banking services, providing a unified interface for different mobile devices accessing our Personal e-Banking. Other enhancements included the introduction of online account opening for integrated accounts and the provision of free basic real-time securities quotes.

At the end of 2011, the number of Personal e-Banking customers was up 11.7% to 1.2 million, compared with a year earlier.

### CONSUMER FINANCE

Income from unsecured lending grew by 10.9% year-on-year. Personal loan balances were up 15.2%.

Our credit card business delivered a strong performance and we grew our market share in terms of card base. We remained the second and third largest issuer of VISA and MasterCard



# 1.2

MILLION  
Personal e-Banking  
customers

# +34.2 %

Commercial Banking  
profit before tax







We built on our wealth management strengths to help customers achieve their financial goals.

cards respectively. At the year-end, total cards issued had grown by 9.7% to 2.23 million. The Hang Seng Hong Kong dollar China UnionPay (CUP) credit card continued to generate strong interest, with the number of cards issued more than doubling to 206,000 during the year. Effective marketing efforts continued to boost card usage, with card spending and card receivables growing by 16.1% and 17.6% year-on-year respectively.

During the year, the Bank celebrated the 10th anniversary of its popular credit card Cash Dollars scheme.

Excluding Government Home Ownership Scheme mortgages, mortgage lending decreased by 2.0% to HK\$131.9bn as a result of the Bank's switch in focus to prime-based mortgage lending, intense market competition and government cooling measures. The Bank switched its focus from HIBOR-based lending to prime-based loans in early 2011. This affected our market share initially but as many competitors followed suit and rationalised their mortgage pricing, our market share in Hong Kong in terms of new registrations rebounded to reach 18.7% in December 2011.

To further strengthen our mortgage positioning, a dedicated 690-square-metre Mortgage Centre was established in Mongkok to provide customised one-stop financial planning solutions to home buyers.

### WEALTH MANAGEMENT

We continued to build on our wealth management strengths to help customers achieve their financial goals in changing market conditions. However, as a result of the weakened investor sentiment in the second half of 2011, income from wealth management declined overall.

In our insurance business, we enhanced our comprehensive range of protection propositions and leveraged our effective distribution channels, including telemarketing. Life insurance annualised new premiums increased by 12.1% and total policies in force grew by 8.5%, compared with 2010. Despite the strong sales, income from insurance fell as market conditions led to lower investment returns on the life insurance fund portfolios.

Income from investment services fell by 10.6% year-on-year in the volatile market. The sales momentum of investment funds slowed down in the second half as global uncertainties intensified. As part of our efforts to widen our product range, we launched the Hang Seng Corporate Sustainability Index Fund, the first fund of its kind in Hong Kong in August 2011.

Income from securities broking decreased in the second half of the year, reflecting a decline in stock market trading turnover.

In order to cater for the increasing wealth management needs of individuals on the Mainland, we reached out to affluent Mainlanders looking for services in Hong Kong through our strong customer referral mechanisms.

We also continued to take advantage of the growing demand for investment exposure to the renminbi. During the year, we reopened the Hang Seng RMB Bond Fund for subscription after its debut launch in 2010. IPO subscription and trading services for renminbi-denominated securities were made available upon the listing of the first such stock outside the Mainland.





## COMMERCIAL BANKING

Commercial Banking achieved an increase of 28.9% in operating profit excluding loan impairment charges to HK\$3,442m. Profit before tax grew by 34.2% to HK\$5,031m.

The growth was driven mainly by net interest income from advances and non-interest income. Net interest income from advances increased by 36.0%, whereas non-interest income grew by 13.0%.

Amid intense competition, growth of 5.1% was achieved in customer deposits during the year.

Net interest income from our trade finance business grew by 93.6% year-on-year. As a market leader in cross-border trade finance and supported by our strong balance sheet, we moved quickly to meet the increased demand in this area. Besides close collaboration between colleagues in Hong Kong and the Mainland, we also cooperate with strategic partners on the Mainland to enhance our cross-border trade proposition. This proved to be a valuable source of referral business.

In 2011, the number of our commercial renminbi accounts in Hong Kong grew by 20.1% to over 70,000 and the renminbi cross-border trade-related business routed through the Bank increased.

Initiatives to grow fee income from corporate wealth management sales achieved satisfactory results. Enhanced corporate investment, insurance and treasury products were marketed to customers through different platforms to capture the shift in investment sentiment. Income from corporate wealth management increased by 14.9% and contributed to 13.3% of Commercial Banking's total net operating income.

With the widening scope of the renminbi financial services market, we strengthened our suite of products and services for commercial and corporate banking customers to reinforce our leadership in this area. Our cash management and payment capabilities were further enhanced to offer greater convenience to business customers. Renminbi-related services launched included bill payment, inter-bank autopay and direct debit, cashier's order issuance and cheque deposits into HKD accounts. The renminbi MaxiInterest Investment Deposit and an online renminbi exchange service were also offered.

Three more Business Banking Centres were opened during the year to reach out to more customers, including SMEs, taking the total to seven. The Centres facilitated account acquisition and the Commercial Banking customer base increased by 13.4% over 2010.

With prudent risk management, a high quality portfolio was maintained and the loan impairment provision against Commercial Banking's total portfolio remained low at 0.77%.

Our efforts to help our customers grow won us industry recognition. We received an Achievement Award for Cash Management in Hong Kong from *The Asian Banker* for the second consecutive year and an SME's Best Partner Award from the Hong Kong General Chamber of Small and Medium Business for the sixth consecutive year.

Further enhancements to our online platform included the introduction of investment account activation and an e-Statement service on Business e-Banking services. The number of customers using Business e-Banking increased by 16.2% to over 74,000 while the number of online business transactions grew by 13.8%, compared with 2010.



Three more Business Banking Centres were opened in 2011 to reach out to more customers, taking the total to seven.





## CORPORATE BANKING

Corporate Banking recorded growth of 41.9% in operating profit excluding loan impairment charges to HK\$1,794m. Profit before tax grew by 45.6% to HK\$1,843m.

Net interest income rose by 38.8%. Advances to customers rose by 10.2% as we selectively grew quality loans.

Against a backdrop of tightening market liquidity, we took the opportunity to improve our loan margins by repricing. We also proactively managed our loan book to capitalise on the increased cross-border loan demand.

Property-related financing remained a major component of Corporate Banking lending. However, given the tighter regulatory environment in Hong Kong and the Mainland, we

strengthened efforts to diversify our loan exposure and revenue base, leveraging strong customer relationships and good industry knowledge to capture new business opportunities. We focused on large corporates in Hong Kong with strong financial standing and well-established Mainland enterprises. We also targeted Mainland businesses with high growth potential in key industries, in particular those supported under China's 12th Five-Year Plan.

By delivering total cash management solutions to customers and capitalising on an efficient cross-border relationship management system, customer deposits increased by 29.0% despite intense competition.

Non-interest income rose by 14.3% as Corporate Banking offered a wide spectrum of tailor-made treasury, wealth management and insurance solutions to corporates.



We strengthened our suite of renminbi products for commercial and corporate banking customers to reinforce our leadership in this area.

## TREASURY

Treasury recorded a 23.7% increase in operating profit to HK\$2,729m while profit before tax rose by 25.8% to HK\$4,227m. The growth in total operating income was mainly the result of an increase in net interest income which was partly offset by lower trading income.

In spite of persistently low interest rates and flat yield curves in various investment markets, net interest income rose by 50.2% to reach HK\$2,108m. The increase was attributed to a larger commercial surplus for investment as the Bank's balance sheet grew, more positioning taken in balance sheet management and better margins for inter-bank lending in both Hong Kong and the Mainland.

Leveraging opportunities in foreign exchange markets for funding swap activities also contributed to the increase in net interest income, although this was partly offset by the loss on foreign exchange arising from funding swap activities grouped under trading income.

Trading income fell by 13.9% to HK\$1,001m. Overall trading income was impacted by the decline in income from funding swap activities. However, foreign exchange trading income recorded encouraging growth, boosted in part by the increasing demand for renminbi-denominated products following the further liberalisation of the renminbi business in Hong Kong.

The customer referral mechanism with other business units was strengthened to encourage the cross-selling of treasury products.



## HANG SENG INDEXES

Wholly owned subsidiary Hang Seng Indexes Company Limited (Hang Seng Indexes) continued to strengthen its position as a leading index compiler in the region through enriching its index profile and expanding its overseas exposure with the launch of new indexes and the listing of a new index-linked fund.

In January 2011, Hang Seng Indexes announced the launch of the HSI Volatility Index and the Hang Seng Risk Adjusted Index Series. The HSI Volatility Index is a useful indicator that reflects investor sentiment towards the stock market and facilitates the development of volatility products such as futures and options, allowing investors to diversify their portfolio and hedge against volatility exposure. The Hang Seng Risk Adjusted Index Series provides a tool for investors with a medium-to-long term perspective to gain exposure to the stock market while controlling the level of risk.

With the number of foreign companies listed in Hong Kong increasing rapidly in the past year, Hang Seng Indexes launched the Hang Seng Foreign Companies Composite Index and the

Hang Seng Global Composite Index in September 2011 to provide benchmarks to the market reflecting the overall performance of Hong Kong listed foreign companies and all Hong Kong listed companies (including foreign companies) respectively.

The Hang Seng Corporate Sustainability Index Series was expanded in August 2011 with the addition of two new benchmark indexes: the Hang Seng Corporate Sustainability Benchmark Index and the Hang Seng (China A) Corporate Sustainability Benchmark Index. The new benchmark indexes include more MidCap and SmallCap companies that have strong sustainability performance.

A new mutual fund tracking the Hang Seng Corporate Sustainability Index was launched in Hong Kong in August 2011 by Hang Seng Investment Management Limited (a wholly owned subsidiary of Hang Seng Bank Limited). In September 2011, Hang Seng Indexes increased its exposure in Europe with the listing of XACT China, an exchange-traded fund (ETF) tracking the Hang Seng China Enterprises Index (HSCEI), on NASDAQ OMX Stockholm, Sweden.

Hang Seng Indexes now compiles 302 publicly available indexes – 47 real-time price indexes and 255 daily indexes – of which 73 track the Mainland segment (including cross market indexes) of the market. In addition to its publicly available indexes, Hang Seng Indexes also compiles customised indexes to serve the specific indexing needs of various clients.

The total number of futures and options contracts traded on the Hang Seng Index and the Hang Seng China Enterprises Index in 2011 increased by 15.0% and 23.3% respectively, compared with 2010. At 31 December 2011, the total size of ETFs tracking all indexes in the Hang Seng Family of Indexes was over US\$13bn.





Hang Seng Indexes compiles  
302 publicly available indexes.





DIRECTION



# EXPANDING HORIZONS



## MANAGEMENT DISCUSSION AND ANALYSIS

# BUSINESS ON THE MAINLAND

Our mainland China business recorded encouraging growth in 2011 as we successfully leveraged our proven wealth management and cross-border service capabilities.



Through our Mainland subsidiary, Hang Seng Bank (China) Limited, we advanced our strategic positioning in this important market and deepened key alliances to expand our product delivery. We were able to increase our customer base and strengthen existing customer relationships by offering quality services.

In a significant brand-building development, Hang Seng China moved in May 2011 into new headquarters in Lujiazui, Shanghai's financial district. The move signifies our long-term commitment to the Mainland market.

Reflecting our efforts to take advantage of the further opening-up of the Mainland market, our wholly owned subsidiary Hang Seng Securities Limited partnered with Guangzhou Securities Company Limited to apply to set up the first joint venture securities investment advisory company under CEPA VI in Guangdong province.

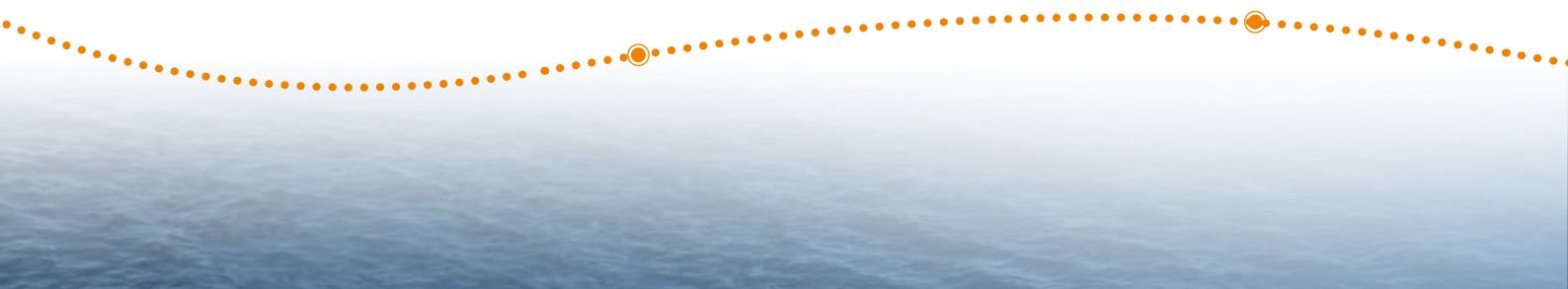
The Mainland business contributed 21.9% to the Bank's total profit before tax, compared with 14.9% in 2010. This includes the share of profit from our Mainland investments, where our share of profit from Industrial Bank increased by about 40% during the year.

## 21.9 %

Contribution to Bank's  
total profit before tax

## +45.7 %

Total operating income







## FINANCIAL PERFORMANCE

Hang Seng China recorded an encouraging increase in profit before tax to HK\$482m. Total operating income grew by 45.7%, underpinned by strong growth in net interest income and other operating income.

Government measures to control high inflation resulted in a tighter regulatory environment, particularly for property-related lending. We continued to focus on prudent credit risk management, growing our customer base of high-quality

borrowers. Advances to customers rose by 23.0% during the year. Residential mortgage lending increased by 5.5%, reflecting the impact of the government measures.

In the keenly competitive market, we were able to increase total deposits by 34.1%, leading to further improvement in our advances-to-deposits ratio. At 70.6%, the advances-to-deposits ratio met the timeline for implementing the regulatory requirement in this area ahead of schedule. Net interest income rose by 19.3%.

**+21.1 %**

Personal customer base

**+34.1 %**

Deposits







Mrs Dorothy K Y P Sit, Vice-Chairman and Chief Executive of Hang Seng Bank (China) Limited, with members of the Hang Seng China management team.

We continued to diversify our income streams by growing our Mainland wealth management and renminbi trade settlement capabilities, resulting in a 117.8% rise in non-interest income.

## SERVICES

In the challenging and highly competitive banking environment, we built on our strengths to provide customised wealth management products, cross-border trade solutions and renminbi-related services.

We enhanced total wealth management financial solutions, targeting high net worth and mass-affluent individuals with our Prestige Banking services. Our first VIP Prestige Banking Centre was opened in Shanghai in May 2011.

By capitalising on our wealth management strength in Hong Kong, we were able to provide tailor-made products to meet changing customer risk appetites. This reinforced our growing reputation as a market leader among foreign banks.

## We will capitalise on our competitive advantages to capture new opportunities.

During the year, we achieved a 25.6% increase in the Mainland Prestige Banking account base, which supported a 44.7% rise in deposits in the Mainland's Retail Banking and Wealth Management business. The overall personal customer base grew by 21.1% year on year.

Collaboration with both domestic and foreign insurance companies was strengthened to offer a larger range of insurance products to customers.

The synergies between our Hong Kong and Mainland operations strengthened our cross-border renminbi propositions in trade services and other areas. Trade settlement services remained a pillar of our corporate and commercial banking services.

Our cross-border customer referral process was enhanced to expand our client base of business customers with high growth potential in key industries, in particular those supported under China's 12th Five-Year Plan.

Counter services were extended to all Hang Seng China outlets for corporate and commercial banking customers.

The Mainland corporate and commercial banking customer base grew by 8.3% year on year. Corporate and commercial customer advances and deposits were up 26.8% and 25.9% respectively.

In its treasury business, Hang Seng China adhered to prudent risk management in asset and liability management, focusing on exploring low risk, high return investment channels in response to the uncertainties in the market environment. Meanwhile, collaboration among business units in Hong Kong and the

Mainland was strengthened to develop treasury products that met different customer needs, particularly in cross-border renminbi trade.

We leveraged strong business ties with domestic banks on the Mainland to expand our product coverage and launched products such as renminbi bill rediscounting.

Our achievements on the Mainland were recognised during the year when Hang Seng China was named China's Best Foreign Retail Bank by *Money Week* and Outstanding Risk Management Bank of the Year by *The Economic Observer*. Hang Seng China also received the Best Cross-Border Trade Settlement Service Award from *CFO World*.



## NETWORK

Given Hang Seng China's focus on the economically significant Pearl River Delta, Yangtze River Delta and Bohai Rim, we are well-positioned to meet the wealth management needs of Mainlanders with rapidly rising incomes and capture a growing share of commercial business flows.

At the end of December 2011, Hang Seng China operated a strategically located network of 11 branches and 28 sub-branches covering 14 cities across the Mainland.

During the year, Hang Seng China opened its third cross-city sub-branch in Huizhou.

Applications to establish a new branch in Xiamen, a sub-branch each in Beijing and Tianjin, and a cross-city sub-branch each in Guangdong's Shunde, Zhuhai and Jiangmen respectively have been approved.



Mainland Headquarters

Highlighting our long-term commitment to the Mainland market and to providing quality services to Mainland customers, in May 2011, Hang Seng China celebrated the opening of its new headquarters at Hang Seng Bank Tower in the Lujiazui financial district in Shanghai. The premises, comprising about 7,000 square metres of office and retail space in the Tower, were purchased in 2010 for RMB510m. Hang Seng China's Shanghai branch was also relocated to the same building.

Improvements in service delivery included the introduction of new online functions to facilitate customer convenience and generate more sales.

Hang Seng China debit cards continued to be well-received by the market. At the end of 2011, the number of its issued debit cards had increased by 31.2% compared with a year earlier. Hang Seng China also operated 65 ATMs at the year-end.

In order to support growth and deepen customer relationships, Hang Seng China increased its staff number by 9.8% to 1,772 in 2011.

Our partnership with Industrial Bank continued to yield good results. In March 2011, the Bank signed a memorandum of understanding with Industrial Bank to further strengthen bilateral cooperation in various areas of business including credit facilities, product development and distribution, asset management and private banking. In addition, more branch-level cooperation initiatives have been launched between the two banks.

## FUTURE GROWTH

Given regulatory changes broadening the scope of renminbi financial services, the gradual internationalisation of the renminbi and the closer economic integration of Hong Kong and the Mainland, we aim to capitalise on our competitive advantages to capture new opportunities.

We will step up our focus on the increasing wealth management needs of Mainlanders and intend to extend our VIP Prestige Banking services to other key cities. We will continue to reach







out to corporate and commercial banking customers in key industries supported under China's 12th Five-Year Plan, develop cross-border renminbi products and provide value propositions in trade services. Collaboration between our Hong Kong and Mainland teams will be further strengthened to enhance cross-border services.

Our network of operations will continue to expand. The acquisition of deposits will remain key to sustainable expansion of our business, helping to strengthen our balance sheet. Revenue diversification and the optimisation of distribution channels will remain crucial as we provide total solutions to customers across all businesses.

We will actively promote our cross-border capabilities by strengthening our relationships with referral partners.

We are confident of  
reinforcing our leadership  
among foreign banks.

Given our strong brand, service excellence and strong cross-border banking proposition, we are confident of reinforcing our leadership in wealth management, corporate and commercial banking services among foreign banks.



TRUST





**SOLID**  
PERFORMANCE



## MANAGEMENT DISCUSSION AND ANALYSIS

## FINANCIAL REVIEW

## FINANCIAL PERFORMANCE

## INCOME STATEMENT

## Summary of Financial Performance

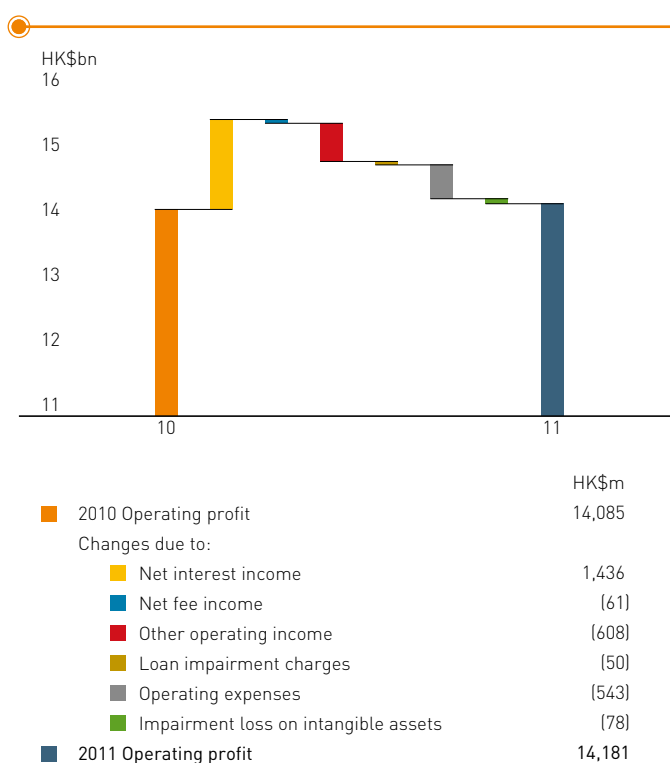
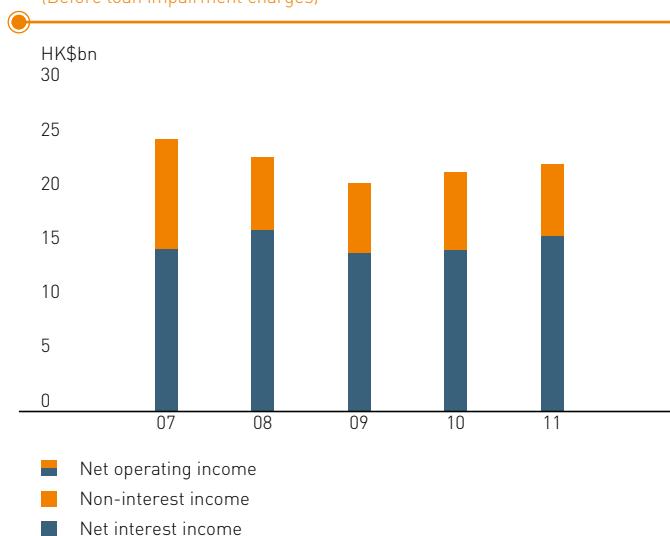
| Figures in HK\$m                               | 2011          | 2010   |
|--|---------------|--------|
| Total operating income                         | <b>34,207</b> | 34,417 |
| Operating expenses                             | <b>7,898</b>  | 7,355  |
| Operating profit after loan impairment charges | <b>14,181</b> | 14,085 |
| Profit before tax                              | <b>19,213</b> | 17,345 |
| Profit attributable to shareholders            | <b>16,680</b> | 14,917 |
| Earnings per share (in HK\$)                   | <b>8.72</b>   | 7.80   |

Hang Seng Bank Limited ("the Bank") and its subsidiaries ("the Group") reported an audited profit attributable to shareholders of HK\$16,680m for 2011, up 11.8% compared with 2010. Earnings per share were HK\$8.72, up HK\$0.92 from 2010. Profit attributable to shareholders for the second half of 2011 increased by HK\$566m, or 7.0%, compared with the first half.

*Operating profit excluding loan impairment charges grew by HK\$146m, or 1.0%, to HK\$14,621m.*

The Bank continues to navigate a challenging environment and delivered a solid operating result. Net interest income grew by 10.0%, primarily due to average loan growth coupled with higher loan spreads and increased balance sheet management income. The increasingly uncertain and volatile market as a result of the evolving eurozone sovereign debt concerns and slow recovery of the US economy led to an unfavourable investment climate which did not favour the wealth management business. Non-interest income declined by 8.9% compared with last year. While the Bank remains prudent in managing costs, investment for future growth, in particular business expansion in mainland China, led to a 7.4% rise in operating expenses compared with 2010. Riding on the Bank's business momentum and leveraging its core strengths, the Bank registered a 0.6% increase in operating profit excluding loan impairment charges in the second half of the year compared with the first half.

## OPERATING PROFIT ANALYSIS

NET OPERATING INCOME  
(Before loan impairment charges)

*Net interest income rose by HK\$1,436m, or 10.0%, with a 10.4% increase in average interest-earning assets.*

| Figures in HK\$m  | 2011           | 2010    |
|---|----------------|---------|
| Net interest income/ (expense) arising from:  |                |         |
| – financial assets and liabilities that are not at fair value through profit and loss | <b>16,525</b>  | 14,459  |
| – trading assets and liabilities  | <b>(848)</b>   | (238)   |
| – financial instruments designated at fair value                                      | <b>59</b>      | 79      |
|   | <b>15,736</b>  | 14,300  |
| Average interest-earning assets   | <b>886,156</b> | 802,464 |
| Net interest spread   | <b>1.68%</b>   | 1.72%   |
| Net interest margin   | <b>1.78%</b>   | 1.78%   |

The increase in net interest income was primarily due to the growth in average customer advances with strong loan growth from the latter part of 2010, improved balance sheet management income and loan spreads. This was partly offset by the narrowed deposit spreads under keen market competition on deposit acquisition and the persistently low interest rate environment.

Net interest margin remained intact at 1.78% for 2011, and net interest spread fell by four basis points to 1.68%. The reduction in net interest spread was driven by the combination of the low interest rate environment and narrowing deposit spreads, resulting from keen market competition. There was an improvement in balance sheet management portfolio income as Treasury grasped opportunities in the interbank market and successfully enhanced the portfolio yield on new and existing assets with a larger commercial surplus for investment. The average volume growth in corporate and commercial lending and credit cards also helped to support net interest income revenue streams. The Group also grew its life insurance funds investment portfolio and increased its interest income by 10.0% compared with last year. Despite the growth in renminbi business, the dilutive effect of the increase in lower yielding renminbi funds placed with the local clearing bank adversely affected the net interest spread. The contribution from net free funds grew by four basis points to 0.10%.

Net interest income in the second half of 2011 grew by HK\$462m, or 6.0%, compared with the first half, due mainly to fewer days in the first half of the year and a 1.7% increase in average interest-earning assets. Net interest margin in the second half was 1.80%, up five basis points compared with the first half.

The HSBC Group reports interest income and interest expense arising from financial assets and financial liabilities held for trading as “Net trading income”. Income arising from financial instruments designated at fair value through profit and loss is reported as “Net income from financial instruments designated at fair value” (other than for debt securities in issue and subordinated liabilities, together with derivatives managed in conjunction with them).

The table below presents the net interest income of Hang Seng, as included within the HSBC Group accounts:

| Figures in HK\$m                | 2011           | 2010    |
|---------------------------------|----------------|---------|
| Net interest income             | <b>16,525</b>  | 14,456  |
| Average interest-earning assets | <b>840,064</b> | 756,110 |
| Net interest spread             | <b>1.89%</b>   | 1.86%   |
| Net interest margin             | <b>1.97%</b>   | 1.91%   |

*Net fee income decreased slightly by HK\$61m, or 1.2%, to HK\$4,836m compared with 2010.*

With the weak investment sentiment in Hong Kong in the second half of the year, income from stockbroking and related services decreased by 12.5%, reflecting the decline in stock market trading turnover. Income from retail investment funds fell by 12.9%, as the demand for wealth management products decreased in the second half. The increasingly uncertain and volatile equities market and an unfavourable investment sentiment led to a decline in retail investment funds sales. As a result, subscription fees and commissions decreased. Insurance agency fee income and private banking service fee income fell by 5.5% and 19.4% respectively.

Card services income increased by 14.6%, which was in line with the growth in average credit card balances. The 9.8% growth in the card base resulted in rising merchant and interchange fee income. Credit facilities fee income rose by 29.7%, due mainly to higher fees from increased corporate lending.

On the back of increased trade activity and the expansion of renminbi cross-border trade settlement volumes, remittances and trade-related fee income grew by 5.4% and 2.0% respectively.

Compared with the first half of 2011, net fee income in the second half fell by HK\$236m, or 9.3%, mainly reflecting decreases in income from stockbroking and related services, the sales of retail investment funds and private banking services. Fee income from credit facilities and card services registered growth in the second half of the year.

*Trading income fell by HK\$263m, or 12.8%, to HK\$1,796m.*

Foreign exchange income rose by HK\$75m, or 4.2%, contributed by higher customer demand for foreign exchange-linked structured products and the Bank's efforts to meet the growing demand for renminbi-denominated products. The Bank was also successful in capturing higher customer driven activity and achieving wider spreads as volatility increased. This was offset partly by reduced net interest income from funding swap\* activities and increased losses on the revaluation of certain US dollar capital funds – maintained in Hang Seng China and subject to regulatory controls – against the renminbi. Excluding the above offsetting items, foreign exchange trading income grew by HK\$285m, or 17.8%.

Income from securities, derivatives and other trading activities fell by HK\$338m. This was primarily related to the losses on equity options backing a life endowment product due to unfavourable movements in the underlying equity indices, which resulted in a corresponding decrease in "Net insurance claims incurred and movement in policyholder liabilities".

\* Treasury from time to time employs foreign exchange swaps for its funding activities, which in essence involve swapping a currency ("original currency") into another currency ("swap currency") at the spot exchange rate for short-term placement and simultaneously entering into a forward exchange contract to convert the funds back to the original currency on maturity of the placement. In accordance with HKAS 39, the exchange difference of the spot and forward contracts is required to be recognised as a foreign exchange gain/loss, while the corresponding interest differential between the original and swap funding is reflected in net interest income.

*Net income/(loss) from financial instruments designated at fair value reported a revaluation loss of HK\$160m, compared with a revaluation gain of HK\$282m in 2010.*

This was mainly due to the fair value changes of assets supporting the linked insurance contracts with offsetting movements in the value of those contracts reported under "net insurance claims incurred and movement in policyholders' liabilities".

*Net earned insurance premiums fell by HK\$246m, or 2.2%. Net insurance claims incurred and movement in policyholders' liabilities fell by HK\$977m, or 7.8%.*

#### Analysis of income from wealth management business

| Figures in HK\$m                    | 2011  | 2010  |
|-------------------------------------|-------|-------|
| Investment income:                  |       |       |
| – retail investment funds           | 905   | 1,039 |
| – structured investment products*   | 661   | 448   |
| – private banking service fee**     | 172   | 196   |
| – stockbroking and related services | 1,285 | 1,468 |
| – margin trading and others         | 134   | 129   |
|                                     | 3,157 | 3,280 |
| Insurance income:                   |       |       |
| – life insurance                    | 2,018 | 2,282 |
| – general insurance and others      | 364   | 342   |
|                                     | 2,382 | 2,624 |
| Total                               | 5,539 | 5,904 |

\* Income from structured investment products includes income reported under net fee income on the sales of third-party structured investment products. It also includes profit generated from the selling of structured investment products in issue, reported under trading income.

\*\* Income from private banking includes income reported under net fee income on investment services and profit generated from selling of structured investment products in issue, reported under trading income.



Eurozone sovereign debt concerns affected the stock market in general and weakened investment sentiment in the second half of 2011. Against this backdrop, wealth management business income decreased by 6.2% compared with 2010. Investment and insurance income fell by 3.8% and 9.2% respectively.

The volatility in the stock market and unfavourable investment sentiment led to a 12.9% decline in income from sales of retail investment funds. Stockbroking and related services income fell by 12.5% as a result of lower stock market turnover recorded by the Bank.

The Bank continued to make good progress in distributing competitive structured products to customers, primarily related to renminbi-denominated products, and recorded a 47.5% growth in structured investment products income. Private banking service income fell by 12.2%, reflecting weaker investment sentiment.

Life insurance income decreased by HK\$264m, or 11.6%, to HK\$2,018m. Hang Seng continued to launch new products catering for customers' investment and protection needs. This included the launch of the "RewardYou Life Insurance Plan" and "3-Year Target Life Insurance Plan" which were well received. Total policies in-force at 31 December 2011 rose by 8.5% year-on-year.

Net interest income and fee income from the life insurance funds investment portfolio rose by 8.1%, due mainly to growth in the size of the life insurance investment portfolio, which held bond investments as its major assets.

The investment return on life insurance investment funds reported a loss of HK\$361m, compared with a gain of HK\$287m in 2010, reflecting changes in the fair value of assets supporting

insurance contracts and reported under "trading income" and "net income/(loss) from financial instruments designated at fair value", with offsetting movements in policyholders' liabilities. The movement in PVIF decreased by 47.2%, representing the net effect of the unfavourable experience variance of the investment return assumption, offset by a refinement of the calculation of the PVIF asset to bring greater comparability and consistency across the Group's insurance operations and higher sales in 2011 compared with last year.

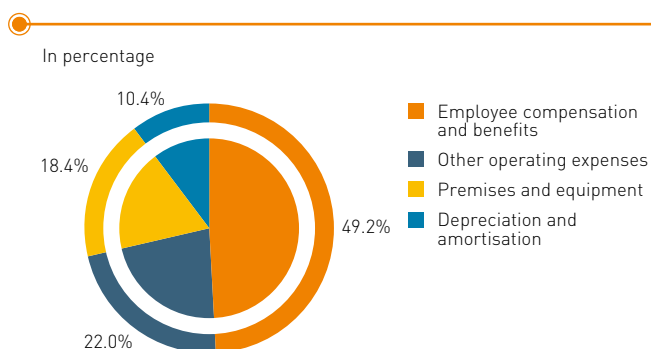
General insurance income increased by 6.4% to HK\$364m.

| Figures in HK\$m  | 2011     | 2010     |
|---|----------|----------|
| Life insurance:   |          |          |
| – net interest income and fee income  | 2,576    | 2,382    |
| – investment returns on life insurance funds                                | (361)    | 287      |
| – net earned insurance premiums   | 10,723   | 10,966   |
| – net insurance claims incurred and movement in policyholders' liabilities* | (11,515) | (12,479) |
| – movement in present value of in-force long-term insurance business        | 595      | 1,126    |
|   | 2,018    | 2,282    |
| General insurance and others  | 364      | 342      |
| Total   | 2,382    | 2,624    |

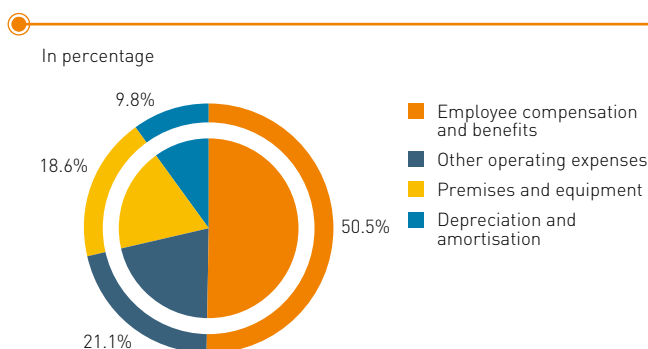
\* Including premium and investment reserves

Operating expenses rose by HK\$543m, or 7.4%, to HK\$7,898m.

#### OPERATING EXPENSES FOR 2011



#### OPERATING EXPENSES FOR 2010



While carefully managing costs, the Bank continued to make investments in support of long-term business growth. Operating expenses of our Hong Kong operations rose by 5.2%.

Employee compensation and benefits increased by HK\$171m, or 4.6%. Salaries and other related costs increased by 3.4%, reflecting the annual salary increment and higher average headcount. General and administrative expenses were up 9.4%, mainly due to the increase in processing charges and marketing expenditure as more branding and promotional activities were conducted during the year to support business growth. Rental expenses rose as a result of increased rents for branches in Hong Kong and new branches on the Mainland. Depreciation charges rose by 13.1%, mainly reflecting higher depreciation charges on business premises following upward property revaluation in Hong Kong.

#### Full time equivalent staff numbers by region

|           | 2011         | 2010  |
|-----------|--------------|-------|
| Hong Kong | <b>7,993</b> | 7,960 |
| Mainland  | <b>1,784</b> | 1,623 |
| Others    | <b>57</b>    | 59    |
| Total     | <b>9,834</b> | 9,642 |

At 31 December 2011, the Group's staff numbers had increased by 192 compared with the end of 2010.

With the increase in operating expenses outpacing the growth in net operating income before impairment charges, the cost efficiency ratio rose by 1.3 percentage points, compared with 2010, to 35.0%. The Bank continues to focus on improving operational efficiency while maintaining growth momentum and market leadership.

*Impairment loss on intangible assets* of HK\$78m related to certain IT projects.

*Operating profit* rose slightly by HK\$96m, or 0.7%, to HK\$14,181m after accounting for the increase in *loan impairment charges*.

*Loan impairment charges increased by HK\$50m, or 12.8%, to HK\$440m* compared with a year earlier.

| Figures in HK\$m         | 2011         | 2010  |
|--------------------------|--------------|-------|
| Loan impairment charges: |              |       |
| – individually assessed  | <b>(103)</b> | (186) |
| – collectively assessed  | <b>(337)</b> | (204) |
|                          | <b>(440)</b> | (390) |
| of which:                |              |       |
| – new and additional     | <b>(740)</b> | (609) |
| – releases               | <b>222</b>   | 157   |
| – recoveries             | <b>78</b>    | 62    |
|                          | <b>(440)</b> | (390) |

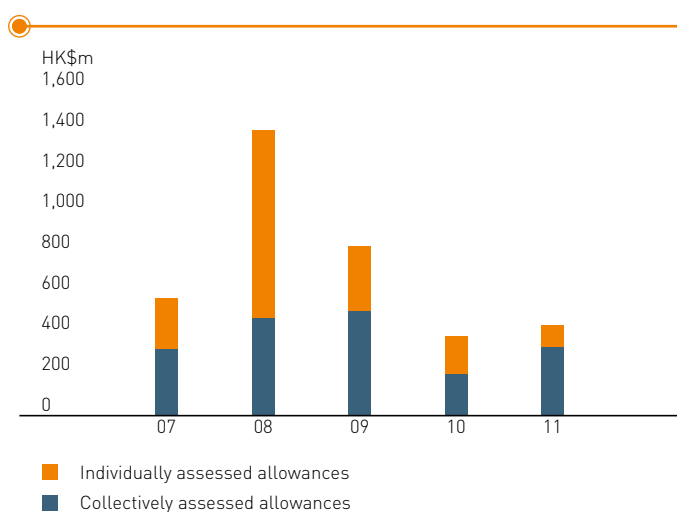
Individually assessed impairment charges fell by HK\$83m, or 44.6%, mainly due to higher releases and recoveries from commercial and corporate banking customers which offset the increase in new impairment. The increase in new impairment charges was primarily due to a specific impairment charge provided in 2011.

Collectively assessed impairment charges rose by HK\$133m, due largely to the rise in impairment allowances for loans not individually identified as impaired. Impairment allowances for credit card and personal loans portfolios were also higher as a result of portfolio growth.

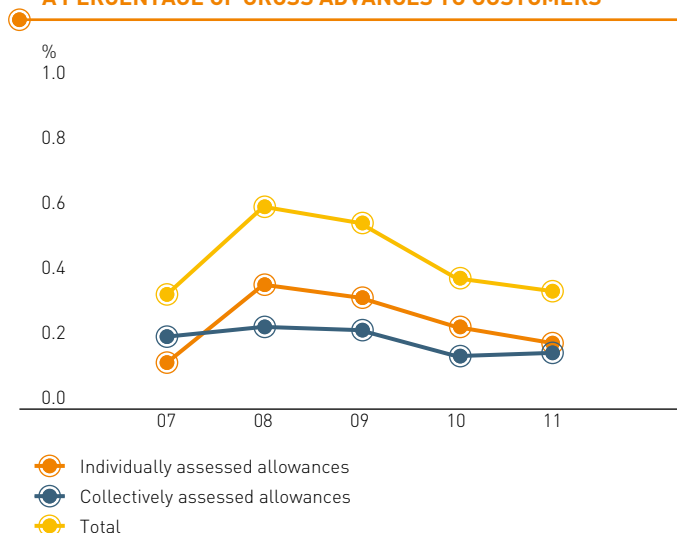
Total loan impairment allowances as a percentage of gross advances to customers are as follows:

|                                  | 2011<br>%   | 2010<br>% |
|----------------------------------|-------------|-----------|
| Loan impairment allowances:      |             |           |
| – individually assessed          | <b>0.19</b> | 0.24      |
| – collectively assessed          | <b>0.16</b> | 0.15      |
| Total loan impairment allowances | <b>0.35</b> | 0.39      |

## NET CHARGES FOR LOAN IMPAIRMENT ALLOWANCES



## LOAN IMPAIRMENT ALLOWANCES AS A PERCENTAGE OF GROSS ADVANCES TO CUSTOMERS



**Profit before tax** increased by 10.8% to HK\$19,213m after taking into account a 55.4% (or HK\$62m) fall in **gains less losses from financial investments and fixed assets**; a 103.7% (or HK\$505m) increase in **net surplus on property revaluation**;

and a 49.9% (or HK\$1,329m) increase in **share of profits from associates**, mainly from Industrial Bank and a property investment company.

*Gains less losses from financial investments and fixed assets fell by HK\$62m, or 55.4%, compared with 2010.*

Net gains from the disposal of available-for-sale equity securities rose by HK\$32m while net gains from the disposal of available-for-sale debt securities fell by HK\$84m compared with 2010.

*Net surplus on property revaluation rose by 103.7% to HK\$992m.*

| Figures in HK\$m                                | 2011       | 2010       |
|---|------------|------------|
| Surplus of revaluation on investment properties | 982        | 474        |
| Surplus of revaluation on assets held for sale  | 8          | 10         |
| Reversal of revaluation deficit on premises     | 2          | 3          |
|   | <b>992</b> | <b>487</b> |

The Group's premises and investment properties were revalued at 30 November 2011 and updated for any material changes at 31 December 2011 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use and the basis of valuation for investment properties was open market value. The net revaluation surplus for Group premises amounted to HK\$3,731m, of which HK\$3,729m was credited to premises revaluation reserve and HK\$2m was credited to the income statement. Revaluation gains of HK\$982m on investment properties were recognised through the income statement. The related deferred tax provisions for Group premises and investment properties were HK\$610m and HK\$162m respectively.

The revaluation exercise also covered business premises/ investment properties reclassified as properties held for sale. The revaluation gain of HK\$8m was recognised through the income statement.



## CUSTOMER GROUP PERFORMANCE

The table below sets out the profit before tax contributed by the customer groups for the years stated.

| Figures in HK\$m                   | Retail Banking and Wealth Management | Commercial Banking | Corporate Banking | Treasury | Other | Total reportable segments |
|------------------------------------|--------------------------------------|--------------------|-------------------|----------|-------|---------------------------|
| <b>Year ended 31 December 2011</b> |                                      |                    |                   |          |       |                           |
| Profit before tax                  | 6,623                                | 5,031              | 1,843             | 4,227    | 1,489 | 19,213                    |
| Share of profit before tax         | 34.5%                                | 26.2%              | 9.6%              | 22.0%    | 7.7%  | 100.0%                    |
| <b>Year ended 31 December 2010</b> |                                      |                    |                   |          |       |                           |
| Profit before tax                  | 7,872                                | 3,748              | 1,266             | 3,361    | 1,098 | 17,345                    |
| Share of profit before tax         | 45.4%                                | 21.6%              | 7.3%              | 19.4%    | 6.3%  | 100.0%                    |

**Retail Banking and Wealth Management ("RBWM")** reported a profit before tax of HK\$6,623m in 2011, down 15.9% from 2010. Operating profit excluding loan impairment charges reached HK\$6,441m, representing a drop of 18.1% compared with 2010.

Net interest income recorded a year-on-year decline. Intense market competition levied pressure on RBWM's deposit income, while unsecured lending and insurance were able to achieve moderate growth in their respective net interest income. Intense market competition and the resulting high cost of funds hit deposit income. To grow the Bank's deposit base, increased interest rates were offered to customers. As a result, net interest income from deposits dropped by 15.8% compared with the same period in 2010.

The Bank switched its focus from HIBOR-based lending to Prime-based loans in early 2011 in its mortgage business. The Bank's mortgage market share dropped initially, but as many competitors followed suit and rationalised their mortgage pricing, our market share in terms of new registrations rebounded to reach 18.7% in December 2011. Net interest income from our Hong Kong mortgage business improved in the second half of the year over the first half.

With a quality credit card customer base, total operating income from unsecured lending remained a key income driver and grew by 10.9% year-on-year. The Bank grew its market share in terms of card base and remained the second and third largest issuer of VISA and MasterCard cards respectively. As of 31 December 2011, total cards in issue reached 2.23 million and over 342,000 new cards were acquired during the year. The Hang Seng Hong Kong dollar China UnionPay ("CUP") credit card continued to generate strong interest, with the number of cards issued more than doubling since the end of 2010. Effective marketing efforts continued to boost card usage with card spending and card receivables growing by 16.1% and 17.6% year-on-year respectively. Personal loan balances were up by 15.2% year-on-year to HK\$5.3bn.

Income from investments declined by 10.6% year-on-year as the investment business experienced volatile markets in 2011. Investment fund subscriptions deteriorated in the second half due to the economic uncertainties around the globe. As a result, the income from both retail investment funds and securities broking declined compared with the previous year.

The diversification strategy of offering new life insurance plans with improved protection propositions proved to be effective in driving sales momentum later in the year. Annualised new premiums grew by 12.1% compared with 2010 while total policies in force also grew steadily. However, net insurance premium

income fell by 2.2% compared to 2010. Income from non-linked insurance business fell as unfavourable market conditions led to lower investment returns. Insurance income was also affected by the decline in the present value of in-force long-term insurance business, representing the net effect of the unfavourable experience variance of the investment return assumption, offset by a refinement of the calculation of the PVIF asset to bring greater comparability and consistency across the Group's insurance operation and higher sales in 2011 compared with 2010.

Service quality was never compromised and Hang Seng Bank continued to receive recognition in the banking industry. The Bank was named "Best Local Private Bank in Hong Kong" in the *Euromoney* Private Banking Survey 2011 based on the assessment of business performance and peer nominations. *Asiamoney* also named Hang Seng Bank the "Best Domestic Bank in Hong Kong" again in 2011.

**Commercial Banking ("CMB")** achieved a 34.2% increase in profit before tax to HK\$5,031m, contributing to more than a quarter of the Bank's total. Operating profit excluding loan impairment charges was up 28.9% to HK\$3,442m.

Against a backdrop of buoyant consumer demand, CMB achieved encouraging growth driven mainly by net interest income from advances and non-interest income. With a strong asset base and strategic re-pricing, net interest income from advances increased by 36.0%, whereas non-interest income grew by 13.0%. Amidst intense competition, healthy growth was achieved in customer deposits of 5.1% compared with 31 December 2010.

Various initiatives to grow fee income achieved satisfactory results, notably from loan-related fees and remittances. CMB also provided timely and competitive corporate wealth management products for its customers, focusing particularly on those in the top-end segment. A wide range of products including corporate investment, insurance and treasury products were marketed to customers through different platforms to capture the shift in investment sentiment as well as to meet customers' expectations on yield enhancement or hedging needs. Income from the corporate wealth management business increased by 14.9% and contributed to 13.3% of CMB's net operating income.

To assist commercial customers in growing their cross-border business and to establish a dynamic customer referral channel, CMB closely collaborated with Hang Seng China and strategic partners on the Mainland. This collaboration has enhanced the Bank's cross-border service proposition and has proven to be a valuable source of referral business.

At 31 December 2011, the number of commercial renminbi accounts in Hong Kong exceeded 70,000 and the renminbi cross-border trade-related business routed through the Bank had increased. As Hong Kong develops into an important renminbi offshore centre, the Bank will capitalise on its growth capabilities by further enhancing renminbi services, especially through the provision of customised renminbi trade solutions and wealth management services as well as capturing the potential of renminbi lending in Hong Kong.

Cash management capabilities were further enhanced to offer speedy China remittance services to customers. The Express China remittance service was enhanced to provide "within 3 hours credit" for remittances to beneficiary accounts of Hang Seng China. Hang Seng was one of the pioneer banks to offer a renminbi bill payment service providing a one-stop solution to merchants for collecting renminbi payments from their customers via the Bank's automated channels.

Seven Business Banking Centres located in areas of high commercial traffic are in operation, enhancing the network and providing high quality and convenient services to customers and referral partners. Those Centres facilitated account acquisition and Commercial Banking customer numbers increased by 13.4% over 2010.

There were also continuous efforts to encourage customers to use online and automated banking channels. The activation of online investment accounts and e-Statement services were launched on the Business e-Banking platform in July 2011. An online renminbi exchange service was launched in August 2011. As a result, the number of customers using Business e-Banking services increased by 16.2% while the number of online business transactions grew by 13.8%.

With prudent risk management, a high quality asset portfolio was maintained and loan impairment allowances against CMB's total portfolio remained at a low level of 0.77%.

**Corporate Banking (“CIB”)** achieved a 45.6% growth in profit before tax to HK\$1,843m compared with 2010. Operating profit excluding loan impairment charges was HK\$1,794m, up 41.9%. The strong profit growth was mainly attributable to a rise in net interest income and non-interest income which increased by 38.8% and 14.3% respectively.

CIB encountered a challenging operating environment in 2011. On the Mainland, market liquidity tightened significantly following a series of increases in interest rates and the required deposit reserve ratio. Strong loan demand prompted an increasing number of Mainland enterprises to come to Hong Kong for bank financing. To meet the loan demand, competition for customer deposits intensified and hence raised funding costs.

Against a backdrop of tightening market liquidity, CIB leveraged its strong industry knowledge, effective risk management as well as dedicated business teams in Hong Kong and on the Mainland to achieve strong financial results through selective growth in customer advances, which increased by 10.2% compared with the end of 2010. By offering total cash management solutions to customers and capitalising on an efficient cross-border relationship management system, CIB’s customer deposits grew by 29.0% amid intense competition.

The return on renminbi deposits and lending also showed positive growth as we took advantage of the increase in cross-border loan demand and the relaxation of foreign direct investment restrictions.

Leveraging its well-established business infrastructure, CIB also stepped up efforts to grow non-interest income, offering a wide spectrum of services encompassing treasury, hedging, trade services, cash management, wealth management and insurance.

**Treasury (“TRY”)** recorded a 25.8% increase in profit before tax to HK\$4,227m, while operating profit increased by 23.7% to HK\$2,729m. The growth was mainly driven by increases in net interest income and TRY’s share of profits from associates.

In spite of persistently low interest rates, net interest income surged by 50.2% to reach HK\$2,108m. The increase was attributed to a number of factors including more commercial surplus for investment as the Bank’s balance sheet grew, more positioning taken in balance sheet management and more opportunities and better margins for inter-bank lending in both Hong Kong and mainland China. Leveraging opportunities in foreign exchange markets for funding swap activities also contributed to the increase though this was partly offset by the loss on foreign exchange arising from funding swap activities grouped under trading income.

Trading income fell by HK\$161m, or 13.9%, to HK\$1,001m. Foreign exchange trading income recorded encouraging growth, boosted in part by rising demand for renminbi-denominated products following further liberalisation of renminbi business in Hong Kong. However, overall trading income was impacted by the decline in income from funding swap activities.

## MAINLAND BUSINESS

With the opening of the third cross-city sub-branch in Huizhou under CEPA VI in August 2011, Hang Seng China currently operates a network of 11 branches and 28 sub-branches, covering 14 cities in mainland China. The Bank maintains a wholesale branch in Shenzhen for foreign currency business. Applications to establish a new branch in Xiamen, a sub-branch each in Beijing and Tianjin, and a cross-city sub-branch each in Guangdong’s Shunde, Zhuhai and Jiangmen respectively have been approved. The establishment of the new outlets will further strengthen Hang Seng’s strategic presence in focused areas on the Mainland.

Since late 2010, inflationary pressure became the government’s major concern and a series of tightening measures was adopted in the first half of 2011. This was followed by transitions in macro-economic policies from credit tightening to selective monetary easing after the consumer price index (“CPI”) peaked and worries over international economic conditions that weakened domestic growth surfaced in the latter half of 2011. In the banking sector, competition for deposits remained intense among all banks and costs to attract and retain talent with local experience stayed high.



Against such a challenging and highly competitive environment, Hang Seng China continued to target corporate customers with renminbi cross-border trade-related business needs and align credit policies with China's 12th Five-Year Plan. On the retail front, Hang Seng China's leading position in the wealth management business was boosted with the launch of the VIP Prestige Centre in Shanghai to provide tailor-made services for high net worth individuals.

Hang Seng China's strategy has been to grow in both scale and value and this has delivered encouraging results. In 2011, the total number of Corporate and Commercial Banking customers

increased by 8.3% while the total number of Retail Banking and Wealth Management customers grew by 21.1% (the number of Prestige Banking customers increased by 25.6%) over December 2010.

Driven by the expanded customer base, gross advances to customers rose by 23.0% whereas total deposits increased by 34.1% over the end of 2010. Total operating income was 45.7% higher than 2010, underpinned by strong growth in net interest income and other operating income. Profit before tax recorded an increase of 821.8% compared with 2010.

|                             | 2011 compared with 2010 |                    |
|-----------------------------|-------------------------|--------------------|
|                             | As reported             | Constant currency* |
| Total operating income      | <b>45.7%</b>            | <b>38.8%</b>       |
| Profit before tax           | <b>821.8%</b>           | <b>778.2%</b>      |
| Gross advances to customers | <b>23.0%</b>            | <b>17.6%</b>       |
| Customer deposits           | <b>34.1%</b>            | <b>28.3%</b>       |

The partnership with Industrial Bank continued to support the Bank's long-term growth on the Mainland. In March 2011, the Bank signed a memorandum of understanding with Industrial Bank to further strengthen bilateral cooperation in various business areas. Moreover, more branch-level cooperation initiatives have been launched between Hang Seng and Industrial Bank.

In October 2011, Hang Seng Securities Limited ("Hang Seng Securities"), a wholly owned subsidiary of the Bank, signed a memorandum of understanding with Guangzhou Securities Company Limited ("Guangzhou Securities") to take an important step in their application to set up Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company Limited. This is the first ever application to set up a joint venture securities investment advisory company in Guangdong province under

CEPA VI. Subject to regulatory approval for its establishment, the joint venture aims to become a showcase for cross-border securities investment advisory co-operation under CEPA by combining the strengths of both partners, paving the way for Hang Seng to expand its business on the Mainland.

\* When reference is made to "constant currency" in commentaries, comparative data reported in the functional currency of Hang Seng's operations on the Mainland have been translated at the appropriate exchange rates applied in the current year in respect of the income statement or balance sheet. Constant currency comparatives in respect of 2010 and 2009 used in the 2011 and 2010 commentaries respectively are computed by translating into HK Dollars:

- the income statement for 2010 and 2009 of renminbi at the average rates of exchange for 2011 and 2010 respectively; and
- the balance sheet at 31 December 2010 and 2009 for renminbi at the prevailing rates of exchange on 31 December 2011 and 2010 respectively.

## ECONOMIC PROFIT

Economic profit is calculated from post-tax profit, adjusted for any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill and takes into account the cost of capital invested by the Bank's shareholders.

For the year 2011, economic profit was HK\$10,312m, an increase of HK\$904m, or 9.6%, compared with 2010. Return on invested capital (post-tax profit, adjusted for the property revaluation surplus net of deferred tax, depreciation attributable to the revaluation and impairment of purchased goodwill), rose by HK\$1,318m.

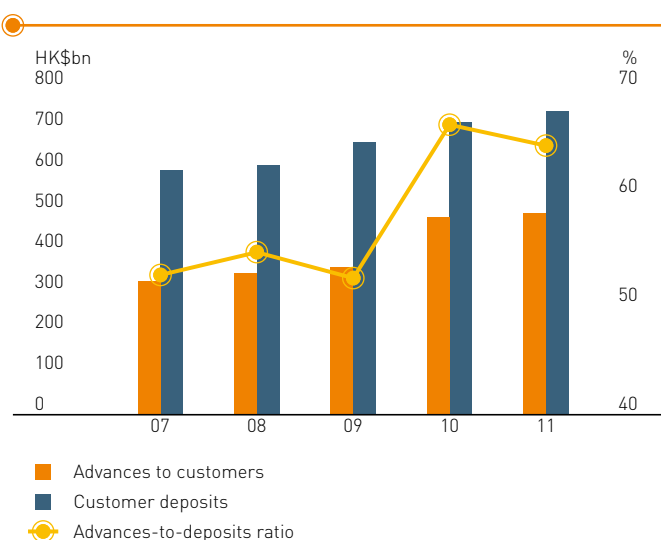
|                             | 2011           |              | 2010    |       |
|-----------------------------|----------------|--------------|---------|-------|
|                             | HK\$m          | %            | HK\$m   | %     |
| Average invested capital    | <b>62,837</b>  |              | 57,616  |       |
| Return on invested capital* | <b>16,008</b>  | <b>25.5</b>  | 14,690  | 25.5  |
| Cost of capital             | <b>(5,696)</b> | <b>(9.1)</b> | (5,282) | (9.2) |
| Economic profit             | <b>10,312</b>  | <b>16.4</b>  | 9,408   | 16.3  |

\* Return on invested capital is based on post-tax profit excluding any surplus/deficit arising from property revaluation, depreciation attributable to the revaluation surplus and impairment of purchased goodwill.

## BALANCE SHEET

**Total assets** rose by HK\$58.5bn, or 6.4%, to HK\$975.4bn. Customer advances increased by HK\$7.9bn, or 1.7%, with growth in the commercial and corporate lending businesses, largely in mainland China. The trade finance business declined as certain trade finance loans matured in the second half of the year. The Bank was strongly positioned to capture cross-border opportunities and prudently grew its Mainland lending during the year while maintaining sound loan quality. Under the vigorous deposit acquisition strategy in both Hong Kong and the Mainland during the year, customer deposits, including certificates of deposit and other debt securities in issue, increased by HK\$32.9bn, or 4.6%, to HK\$743.2bn, driven in part by strong growth in renminbi deposits. At 31 December 2011, the advances-to-deposits ratio was 64.7%, compared with 66.5% at 31 December 2010. Financial investments and trading assets increased by 4.9% and 146.3% respectively, reflecting the deployment of the commercial surplus to high-quality treasury bills and debt securities.

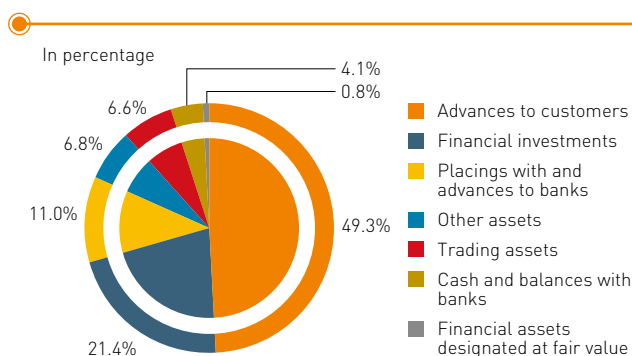
## ADVANCES TO CUSTOMERS AND CUSTOMER DEPOSITS



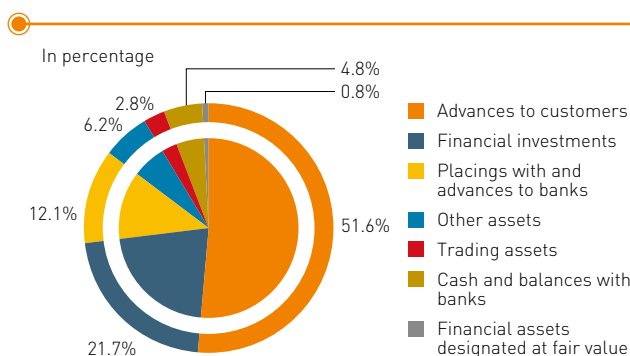
## Assets Deployment

| Figures in HK\$m   | 2011    | %     | 2010    | %     |
|--|---------|-------|---------|-------|
| Cash and balances with banks and other financial institutions        | 39,533  | 4.1   | 44,411  | 4.8   |
| Placings with and advances to banks and other financial institutions | 107,742 | 11.0  | 110,564 | 12.1  |
| Trading assets   | 64,171  | 6.6   | 26,055  | 2.8   |
| Financial assets designated at fair value                            | 8,096   | 0.8   | 7,114   | 0.8   |
| Advances to customers  | 480,574 | 49.3  | 472,637 | 51.6  |
| Financial investments  | 209,190 | 21.4  | 199,359 | 21.7  |
| Other assets   | 66,139  | 6.8   | 56,771  | 6.2   |
| Total assets   | 975,445 | 100.0 | 916,911 | 100.0 |

### ASSETS DEPLOYMENT FOR 2011



### ASSETS DEPLOYMENT FOR 2010



## Advances to Customers

At 31 December 2011, gross advances to customers were up HK\$7.8bn, or 1.6%, at HK\$482.2bn compared with the end of 2010.

Loans for use in Hong Kong decreased by HK\$4.1bn, or 1.2%. Lending to industrial, commercial and financial sectors declined marginally by 0.9%. New financing to corporate customers remained active, reflecting strong growth in property investment lending against the backdrop of the buoyant commercial property market during the year. Stronger partnerships with Commercial Banking customers helped grow lending to the manufacturing industry by 11.3%. Advances to the information technology sector fell by 54.1% mainly due to loan repayments.

Trade finance declined substantially as certain trade finance loans matured during the second half of the year.

Lending to individuals fell by HK\$2.3bn, or 1.5%. Residential mortgage lending to individuals declined by 4.3%, as a result of the Bank's focus towards Prime-based mortgage lending. The decrease was also affected by the intense market competition and new government measures to cool the residential property market. The uncertain economic conditions also led to a decline in residential property market activity towards the latter part of the year.

The credit card business registered strong growth, with card advances growing by 17.9%. This was supported by a rise of 9.8% in the number of cards in issue and a 16.5% increase in card spending, mainly due to successful card customer acquisition and card utilisation campaigns.



Loans for use outside Hong Kong increased strongly by HK\$26.0bn, or 41.6%, compared with the end of 2010. This was due largely to the 23.0% expansion of Mainland loan portfolios, which reached HK\$44.7bn at 31 December 2011. Strong growth was recorded in corporate lending, driven mainly by renminbi loans. The Group remained vigilant in assessing credit risk in increasing lending on the Mainland.

### Customer Deposits

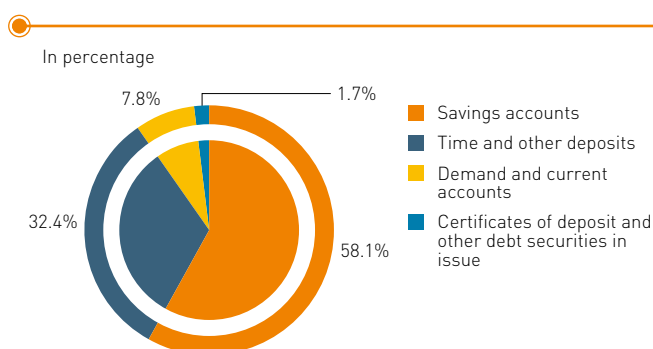
Customer deposits, including current, savings and other deposit accounts and certificates of deposit and other debt securities in issue, stood at HK\$743.2bn at 31 December 2011, an increase of

4.6% over the end of 2010. In the low interest rate environment with keen market competition, most customers shifted deposits from savings accounts to time deposits. Certificates of deposit and structured deposit instruments with yield enhancement features also gained popularity. Hang Seng China achieved deposit growth of 34.1%, mainly in renminbi deposits.

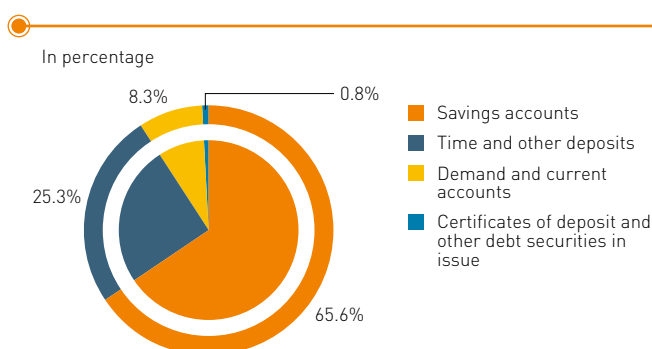
### Subordinated Liabilities

The outstanding subordinated notes, which qualify as supplementary capital, help the Bank maintain a balanced capital structure and support business growth.

CUSTOMER DEPOSITS FOR 2011



CUSTOMER DEPOSITS FOR 2010



### Shareholders' funds

| Figures in HK\$m                      | 2011   | 2010   |
|---------------------------------------|--------|--------|
| Share capital                         | 9,559  | 9,559  |
| Retained profits                      | 48,640 | 42,966 |
| Premises revaluation reserve          | 12,280 | 9,426  |
| Cash flow hedging reserve             | 6      | 72     |
| Available-for-sale investment reserve |        |        |
| – on debt securities                  | (756)  | (25)   |
| – on equity securities                | 195    | 227    |
| Capital redemption reserve            | 99     | 99     |
| Other reserves                        | 5,099  | 4,055  |
| Total reserves                        | 65,563 | 56,820 |
| Proposed dividends                    | 75,122 | 66,379 |
| Shareholders' funds                   | 3,633  | 3,633  |
|                                       | 78,755 | 70,012 |
| Return on average shareholders' funds | 22.6%  | 22.8%  |

Shareholders' funds (excluding proposed dividends) grew by HK\$8,743m, or 13.2%, to HK\$75,122m at 31 December 2011. Retained profits rose by HK\$5,674m, mainly reflecting growth as a result of the 2011 profit after the appropriation of interim dividends. The premises revaluation reserve increased by HK\$2,854m, or 30.3%, attributable to the buoyant commercial property market.

The available-for-sale investment reserve for debt securities recorded a deficit of HK\$756m compared with a deficit of HK\$25m at the end of 2010, reflecting the general widening of the credit spread. The Group assessed that there were no impaired debt securities during the year, and accordingly, no impairment loss has been recognised.

The return on average shareholders' funds was 22.6%, compared with 22.8% for 2010.

Excluding the redemption of all the US\$450m floating rate subordinated notes due 2016 at par on 6 July 2011, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities during 2011.

## RISK MANAGEMENT

The effectiveness of the Group's risk management policies and strategies is a key success factor. Operating in the financial services industry, the most important types of risks the Group is exposed to are credit, liquidity, market, legal, operational, reputational and strategic. The Group has established policies and procedures to identify, measure, analyse and actively manage the risks and to set appropriate risk limits to control this broad spectrum of risks. In line with best practices, the Bank's Risk Management Committee exercises oversight of the risk

management framework for the Bank. The Risk Management Committee is constituted by the Board and accountable to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank and is responsible for approval of all risk management related policies and major control limits. Risk limits are monitored and controlled continually by dedicated departments by means of reliable and up-to-date management information systems. The management of various types of risks is well coordinated at the level of the Bank's Board and various Management committees, such as, the Executive Committee, Risk Management Committee and Asset and Liability Management Committee.

Note 61 "Financial risk management" to the financial statements provides a detailed discussion and analysis of the Group's credit risk, liquidity risk, market risk, insurance risk, operational risk and capital management. The management of reputational risk is set out as follows:

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events. Standards are set and policies and procedures are established in all areas of reputational risk and are communicated to staff at all levels. These include fair and transparent dealings with customers, conflicts of interest, money laundering deterrence, environmental impact and anti-corruption measures. The reputational downside to the Group is fully appraised before any strategic decision is taken.

The Group is a socially and environmentally responsible organisation. Its corporate responsibility policies and practices are discussed in the corporate responsibility section of this annual report.

## BIOGRAPHICAL DETAILS OF DIRECTORS



**\* Dr Raymond CH' IEN Kuo Fung**  
GBS, CBE, JP

**Chairman**  
**Aged 60**

**Joined the Board since August 2007**

**Other position held within Hang Seng Group**

- ^ Hang Seng Bank Limited – Member of Remuneration Committee

**Other major appointments**

- Ascendas China Commercial Fund Management Limited – Chairman (Note 1)
- ^ China.com Inc – Chairman
- ^ China Resources Power Holdings Company Limited – Independent Non-executive Director
- ^ Convenience Retail Asia Limited – Independent Non-executive Director
- Federation of Hong Kong Industries – Honorary President
- Hong Kong Mercantile Exchange Limited – Independent Non-executive Director
- ^ MTR Corporation Limited – Non-executive Chairman
- ^ Swiss Reinsurance Company Limited – Independent Non-executive Director
- The Hongkong and Shanghai Banking Corporation Limited – Independent Non-executive Director
- The Tianjin Municipal Committee of the Chinese People's Political Consultative Conference – Member of Standing Committee
- ^ The Wharf (Holdings) Limited – Independent Non-executive Director
- University of Pennsylvania, USA – Trustee
- Past major appointments**
- ^ CDC Corporation – Chairman (1999-2011) (Note 1)
- ^ CDC Software Corporation – Director (2009-2012) (Note 1)
- Executive Council of HKSAR Government – Member (1997-2002)
- Executive Council of Hong Kong, then under British Administration – Member (1992-1997)
- ^ HSBC Holdings plc – Independent Non-executive Director (1998-2007)
- HSBC Private Equity (Asia) Limited – Chairman (1997-2010)
- ^ Inchcape plc – Independent Non-executive Director (1997-2009)
- Independent Commission Against Corruption – Chairman of Advisory Committee on Corruption (1998-2006)
- The APEC Business Advisory Council – Hong Kong Member (2004-2009)
- The Hong Kong/European Union Business Cooperation Committee – Chairman (2005-2012) (Note 1)

**Qualification**

Doctoral Degree in Economics – University of Pennsylvania, USA

**Major awards**

Chevalier de l'Ordre du Merite Agricole of France (2008)

Gold Bauhinia Star (1999)

Commander in the Most Excellent Order of the British Empire (1994)

Justice of the Peace (1993)

**Mrs Margaret LEUNG KO May Yee**  
JP

**Vice-Chairman and Chief Executive**

**Aged 59**

**Joined the Board since April 2009**

**Other positions held within Hang Seng Group**

- ^ Hang Seng Bank Limited – Chairman of Executive Committee
- Hang Seng Bank (China) Limited – Chairman
- Hang Seng Indexes Company Limited – Chairman of Hang Seng Index Advisory Committee
- Hang Seng Insurance Company Limited – Chairman
- Chairman of other subsidiaries in Hang Seng Group
- Other major appointments**
- Chinese Bankers Club, Hong Kong – Honorary President
- Hang Seng Management College – Chairman of the Board of Governors
- Hang Seng School of Commerce – Chairman of the Board; Supervisor
- HKSAR Commission on Strategic Development – Member
- Ho Leung Ho Lee Foundation – Member of Board of Trustees
- Hong Kong Baptist University – Member of the Court
- Hong Kong University Alumni Association – Honorary Vice-President
- ^ HSBC Holdings plc – Group General Manager
- ^ Hutchison Whampoa Limited – Independent Non-executive Director
- Securities and Futures Commission – Member of Advisory Committee
- ^ Swire Pacific Limited – Independent Non-executive Director
- The Community Chest of Hong Kong – Board Member; First Vice President; Executive Committee Chairman





The Guangzhou Municipal Committee of the Chinese People's Political Consultative Conference – Member  
 The Henan Provincial Committee of the Chinese People's Political Consultative Conference – Member of Standing Committee  
 The Hongkong and Shanghai Banking Corporation Limited – Director  
 The University of Hong Kong – Member of the Council

#### Past major appointments

Hong Kong Export Credit Insurance Corporation – Member of Advisory Board (2005-2010)  
 HSBC Group – Global Co-Head Commercial Banking (2003-2009)  
 The Community Chest of Hong Kong – Chairman of Campaign Committee (2009-2011)  
 Wells Fargo HSBC Trade Bank, NA – Director (2007-2010)

#### Qualification

Bachelor's Degree in Economics, Accounting and Business Administration – The University of Hong Kong

#### Major award

Justice of the Peace (2009)

### \* Dr John CHAN Cho Chak

GBS, JP

Director

Aged 68

Joined the Board since August 1995

#### Other position held within Hang Seng Group

- ^ Hang Seng Bank Limited – Chairman of Remuneration Committee

#### Other major appointments

- ^ Guangdong Investment Limited – Independent Non-executive Director
- Long Win Bus Company Limited – Non-executive Director
- ^ RoadShow Holdings Limited – Chairman and Non-executive Director
- ^ Swire Properties Limited – Independent Non-executive Director
- Sir Edward Youde Memorial Fund – Chairman of the Council
- The Community Chest of Hong Kong – Board Member
- Hong Kong Monetary Authority – Member of The Exchange Fund Advisory Committee
- The Hong Kong University of Science and Technology – Chairman of the Court

The Kowloon Motor Bus Company (1933) Limited – Non-executive Director

- ^ Transport International Holdings Limited – Independent Non-executive Director (Note 1)

#### Past major appointments

HKSAR Commission on Strategic Development – Non-Official Member (2005-2009)

- ^ Hong Kong Exchanges and Clearing Limited – Independent Non-executive Director (2000-2003)

Hong Kong Civil Service – Private Secretary to the Governor; Deputy Secretary (General Duties); Director of Information Services; Deputy Chief Secretary; Secretary for Trade and Industry; Secretary for Education and Manpower (1964-1978; 1980-1993)

The Community Chest of Hong Kong – Vice Patron (2004-2011) (Note 1)

The Hong Kong Jockey Club – Chairman (2006-2010)

#### Qualifications

Degree of Doctor of Social Sciences (honoris causa) – The University of Hong Kong and The Hong Kong University of Science and Technology

Degree of Doctor of Business Administration (honoris causa) – International Management Centres

Diploma in Management Studies – The University of Hong Kong  
 Honours Degree in English Literature – The University of Hong Kong

#### Major awards

Gold Bauhinia Star (1999)  
 Justice of the Peace (1994)

### \* Dr Marvin CHEUNG Kin Tung

GBS, OBE, JP

Director

Aged 64

Joined the Board since May 2004

#### Other position held within Hang Seng Group

- ^ Hang Seng Bank Limited – Member of Audit Committee

#### Other major appointments

Airport Authority Hong Kong – Chairman  
 Barristers Disciplinary Tribunal – Member  
 Executive Council of HKSAR Government – Non-official Member

- ^ HKR International Limited – Independent Non-executive Director  
Hong Kong University of Science and Technology – Chairman of the Council
- ^ HSBC Holdings plc – Independent Non-executive Director;  
Audit Committee member  
The Tracker Fund of Hong Kong – Chairman of the Supervisory Committee

#### Past major appointments

- ^ Hong Kong Exchanges and Clearing Limited – Independent Non-executive Director (2005-2011)
- ^ Sun Hung Kai Properties Limited – Independent Non-executive Director (2007-2009)  
Independent Commission Against Corruption – Member of Operations Review Committee (2004-2009)  
KPMG Hong Kong – Chairman and Chief Executive Officer (1996-2003)

#### Qualifications

Fellow – Hong Kong Institute of Certified Public Accountants  
Fellow – Institute of Chartered Accountants in England and Wales  
Doctor of Business Administration (Honours) – Hong Kong Baptist University

#### Major awards

Gold Bauhinia Star (2008)  
Silver Bauhinia Star (2000)  
Officer of the Most Excellent Order of the British Empire (1993)  
Justice of the Peace (1991)

### \* Ms CHIANG Lai Yuen

#### Director

Aged 46

Joined the Board since September 2010

#### Other major appointments

- ^ Chen Hsong Holdings Limited – Executive Director;  
Chief Executive Officer  
Chen Hsong Investments Limited – Director  
China Shenzhen Machinery Association – Vice-President  
Directorate Salaries and Conditions of Service of HKSAR Government – Member of Standing Committee  
Shenzhen Federation of Industrial Economics – Vice-Chairman  
The Hong Kong University of Science and Technology – Member of the Council  
The Open University of Hong Kong – Member of the Council  
The Shenzhen Committee of the Chinese People's Political Consultative Conference – Member of Standing Committee  
The Toys Manufacturers' Association of Hong Kong – Vice-President

#### Past major appointment

Disciplined Services Salaries and Conditions of Service of HKSAR Government – Member of Standing Committee (retired in December 2010)

#### Qualification

Bachelor Degree of Arts – Wellesley College, USA

#### Major award

"Young Industrialist Awards of Hong Kong" by the Federation of Hong Kong Industries (2004)

### Mr Andrew FUNG Hau Chung

JP

Executive Director and Head of Treasury and Investment  
Aged 54

Joined the Board since October 2011

#### Other positions held within Hang Seng Group

- ^ Hang Seng Bank Limited – Member of Executive Committee  
Hang Seng Asset Management Pte Ltd – Director  
Hang Seng Bullion Company Limited – Director

Hang Seng Insurance Company Limited – Director  
Hang Seng Investment Management Limited – Director and General Manager  
Hang Seng Investment Services Limited – Director  
Hang Seng Life Limited – Director  
Hang Seng Securities Limited – Director

#### Other major appointments

- Business Facilitation Advisory Committee – Non-official member  
Central Policy Unit – Pan-Pearl River Delta Panel – Member  
Hong Kong Institute of Certified Public Accountants – Lay Member of the Council (Note 1)  
Hong Kong Trade Development Council – Member of the Financial Services Advisory Committee
- ^ Industrial Bank Co., Ltd. – Director; Member of Executive Committee; Member of Remuneration and Examination Committee  
Securities and Futures Commission – Member of Process Review Panel; Member of Products Advisory Committee  
The Community Chest of Hong Kong – Board member  
The Federation of Hong Kong Industries – Member of General Committee  
The Hong Kong Mortgage Corporation Limited – Director  
Treasury Markets Association – Member of the Executive Board

#### Past major appointments

- ^ Hang Seng Bank Limited –  
General Manager and Head of Treasury and Investment (2009-2011);  
General Manager and Head of Investment and Insurance (2008-2009);  
Deputy General Manager and Head of Investment and Insurance (2006-2008)  
DBS Bank (Hong Kong) Limited – Managing Director, Advisory Sales, Greater China, Wholesale Banking – Global Financial Markets (2002-2006)
- ^ Commonwealth Bank of Australia, Hong Kong Branch – Treasurer and Head of Capital Markets, Asia (1996-2002)  
The Hongkong and Shanghai Banking Corporation Limited – Head of Hong Kong Dollar Markets (1991-1996)

#### Qualifications

Bachelor of Arts Degree – The University of Hong Kong  
Honorary Fellowship – Lingnan University

### # Ms Anita FUNG Yuen Mei

#### Director

Aged 51

Joined the Board since November 2011

#### Other major appointments

- ^ Bank of Communications Co., Ltd. – Director  
Hong Kong Airport Authority – Member of the Board  
Hong Kong Housing Authority – Member of the Finance Committee  
Hong Kong Monetary Authority – Member of the Currency Board Sub-committee of the Exchange Fund Advisory Committee (Note 1); Member of the Financial Infrastructure Sub-committee of the Exchange Fund Advisory Committee  
HSBC Bank (China) Company Limited – Deputy Chairman  
HSBC Global Asset Management (Hong Kong) Limited – Chairman and Director (Note 1)
- ^ HSBC Holdings plc – Group General Manager  
The Community Chest of Hong Kong – Board Member (Note 1)  
The Financial Services and the Treasury Bureau – Non-official member of the Advisory Committee on Bond Market Development  
The Hongkong and Shanghai Banking Corporation Limited – Chief Executive Officer, Hong Kong  
The Hong Kong Association of Banks – Chairman (Note 1)  
The Hong Kong Trade Development Council – Ex-officio Member (Note 1); Member of the Financial Services Advisory Committee

The Hong Kong University of Science and Technology – Member of the Council  
Treasury Markets Association – Member of the Executive Board, and the Chairman of the Market Development Committee

#### Past major appointments

The Hongkong and Shanghai Banking Corporation Limited – joined as Head of HKD Bond Markets (1996-1998), and was appointed Head of Asian Fixed Income Trading (1998-2001), Head of Trading, Asia-Pacific (2001-2003), Treasurer and Co-Head of Global Markets, Asia-Pacific (2003-2004), Treasurer and Head of Global Markets, Asia-Pacific (2005-2010) and Head of Global Banking and Markets, Asia-Pacific (2010-2011)

#### Qualifications

Bachelor Degree of Social Science – The University of Hong Kong  
Master Degree of Applied Finance – Macquarie University, Australia

### \* Dr HU Zulu, Fred

#### Director

Aged 48

Joined the Board since May 2011

#### Other major appointments

China Huarong Asset Management Company – Member of the advisory board  
China Medical Board – Trustee  
HKSAR Commission on Strategic Development – Member  
National Center for Economic Research at Tsinghua University – Director and Professor  
Primavera Capital Limited – Founder and Chairman  
^ SCMP Group Limited – Independent Non-executive Director  
^ Shanghai Pudong Development Bank Co., Ltd. – External Supervisor  
The Nature Conservancy China Board – Co-Chairman  
Yale-China Association – Trustee

#### Past major appointments

Goldman Sachs Group Inc. – Managing Director (2000 – March 2010); Chairman of Greater China (2008 – March 2010)  
Securities and Futures Commission – Member of Advisory Committee (2009-2011) (Note 1)  
^ Shanghai Pudong Development Bank Co., Ltd. – Independent Director (2002-2008)

#### Qualifications

Master of Arts and Doctor of Philosophy in Economics – Harvard University  
Master of Science in Engineering Science – Tsinghua University

### \* Mr Jenkin HUI

#### Director

Aged 68

Joined the Board since August 1994

#### Other position held within Hang Seng Group

^ Hang Seng Bank Limited – Member of Remuneration Committee

#### Other major appointments

Central Development Limited – Director  
Hongkong Land Holdings Limited – Director  
Jardine Matheson Holdings Limited – Director  
Jardine Strategic Holdings Limited – Director  
Point Piper Investment Limited – Chief Executive

### # Ms Sarah Catherine LEGG

#### Director

Aged 44

Joined the Board since February 2011

#### Other major appointments

The Hongkong and Shanghai Banking Corporation Limited – Chief Financial Officer  
HSBC Bank (Taiwan) Limited – Director (Note 1)  
HSBC Asia Holdings BV – Director  
HSBC Bank Bahamas Limited – President  
HSBC Markets (Bahamas) Limited – President  
HSBC Securities Investments (Asia) Limited – Director  
The Hong Kong Society for Rehabilitation – Honorary Treasurer  
Director of other subsidiaries in HSBC Group

#### Past major appointments

The Hongkong and Shanghai Banking Corporation Limited – Chief Accounting Officer (2006-2010)  
^ HSBC Holdings plc – Senior Manager, Finance Transformation (2003-2006)  
HSBC Bank plc – Head of Product Control, Global Banking and Markets (1999-2003)

#### Qualifications

Master of Arts – King's College, Cambridge University  
Fellow – Chartered Institute of Management Accountants  
Member – Association of Corporate Treasurers

### \* Dr Eric LI Ka Cheung GBS, OBE, JP

#### Director

Aged 58

Joined the Board since February 2000

#### Other position held within Hang Seng Group

^ Hang Seng Bank Limited – Chairman of Audit Committee

#### Other major appointments

^ Bank of Communications Co., Ltd. – Independent Non-executive Director; Chairman of Audit Committee  
^ China Resources Enterprise, Limited – Independent Non-executive Director; Chairman of Audit Committee  
HKSAR Commission on Strategic Development – Member  
Li, Tang, Chen & Co, Certified Public Accountants – Senior Partner  
Long Win Bus Company Limited – Independent Non-executive Director  
^ RoadShow Holdings Limited – Independent Non-executive Director; Chairman of Audit Committee  
^ SmarTone Telecommunications Holdings Limited – Independent Non-executive Director; Chairman of Audit Committee  
^ Sun Hung Kai Properties Limited – Independent Non-executive Director; Chairman of Audit Committee  
The Financial Reporting Council – Convenor of Financial Reporting Review Committee  
The Hong Kong Jockey Club – Steward  
The Hong Kong Institute of Education – Treasurer of the Council  
The Kowloon Motor Bus Company (1933) Limited – Independent Non-executive Director; Chairman of Audit Committee  
The Eleventh National Committee of Chinese People's Political Consultative Conference – Member  
^ Transport International Holdings Limited – Independent Non-executive Director; Chairman of Audit Committee  
^ Wong's International (Holdings) Limited – Independent Non-executive Director; Chairman of Audit Committee



**Past major appointments**

Hong Kong Monetary Authority – Chairman of Process Review Committee (2007-2010)  
 The International Federation of Accountants – Board Member (2004-2006)  
 The Legislative Council of Hong Kong – Member (1991-2004);  
 Chairman of Public Accounts Committee (1995-2004)  
 Meadville Holdings Limited – Independent Non-executive Director;  
 Chairman of Remuneration Committee (2007-2010)

**Qualifications**

BA (Economics) Honours Degree – University of Manchester, UK  
 Fellow – Hong Kong Institute of Certified Public Accountants (Practising)  
 Hon Doctor of Laws – University of Manchester, UK  
 Hon Doctor of Social Sciences – Hong Kong Baptist University  
 Hon Fellow – The Chinese University of Hong Kong  
 Hon Fellow – The Hong Kong Polytechnic University

**Major awards**

Gold Bauhinia Star (2003)  
 Officer of the Most Excellent Order of the British Empire (1996)  
 Justice of the Peace (1991)

## # Dr Vincent LO Hong Sui

GBS, JP

**Director****Aged 63****Joined the Board since February 1999****Other major appointments**

- APEC Business Advisory Council – Hong Kong's Representative Business and Professionals Federation of Hong Kong – Honorary Life President
- Chongqing Municipal Government – Economic Adviser
- ^ Great Eagle Holdings Limited – Non-executive Director
- Yangtze Council – President
- Shanghai Tongji University; Shanghai University – Advisory Professorship
- Shui On Group – Chairman
- ^ Shui On Land Limited – Chairman
- ^ SOCAM Development Limited (formerly known as: Shui On Construction and Materials Limited) – Chairman
- The Eleventh National Committee of the Chinese People's Political Consultative Conference – Member
- The Hong Kong University of Science and Technology – Honorary Court Chairman

**Past major appointments**

- ^ China Telecom Corporation Limited – Independent Non-executive Director (retired in 2008)
- ^ New World China Land Limited – Non-executive Director (retired in 2004)
- ^ Shui On Land Limited – Chief Executive Officer (2004-2011)

**Qualification**

Doctorate in Business Administration (honoris causa) –  
 The Hong Kong University of Science and Technology

**Major awards**

"Ernst & Young Entrepreneur Of The Year 2009" in the China Real Estate Sector (2009)  
 Ernst & Young China Entrepreneur Of The Year 2009 (2009)  
 Chevalier des Arts et des Lettres by the French Government (2005)  
 Director of the Year in the category of Listed Company Executive Directors by The Hong Kong Institute of Directors in 2002 (2002)  
 Businessman of the Year award in the Hong Kong Business Awards 2001 (2001)  
 Justice of the Peace (1999)  
 Gold Bauhinia Star (1998)

## # Mrs Dorothy SIT KWAN Yin Ping

**Director****Aged 60****Joined the Board since August 2009****Other positions held within Hang Seng Group**

Hang Seng Bank (China) Limited – Vice Chairman; Chief Executive;  
 Chairman of Executive Committee

**Past major appointments**

- The Banking Industry Training Advisory Committee – Member (2006-2009); Ex-officio Member of its Sub-committee on Specification of Competency Standards Development (2007-2009)
- ^ Hang Seng Bank Limited – General Manager (2005-2009); Chief Operating Officer (2006-2009)
- The Hongkong and Shanghai Banking Corporation Limited – joined as management trainee and held various managerial positions in retail banking, operations and systems, mainland China project finance, internal audit, marketing, channel development and management, wealth management and retail investments (1976-2003) and was Head of Personal Financial Services, Hong Kong (2004-2005)
- Bank of Shanghai – Director (2004-2005)
- EPS Company (Hong Kong) Limited – Chairman (2004-2005)

**Qualification**

Master's Degree in Business Administration – The Chinese University of Hong Kong

## \* Mr Richard TANG Yat Sun

**BBS, JP****Director****Aged 59****Joined the Board since August 1995****Other positions held within Hang Seng Group**

- ^ Hang Seng Bank Limited – Member of Audit Committee
- Hang Seng Bank (China) Limited – Supervisor
- Other major appointments**
- Correctional Services Children's Education Trust Investment Advisory Board – Chairman
- Customs and Excise Service Children's Education Trust Fund Committee – Chairman
- Hong Kong Commercial Broadcasting Company Limited – Director
- Hong Kong Institute of Certified Public Accountants – Member of Disciplinary Panel A
- ^ King Fook Holdings Limited – Vice Chairman
- ^ Miramar Hotel & Investment Company, Limited – Director
- Richcom Company Limited – Chairman and Managing Director
- Tang Shiu Kin and Ho Tim Charitable Fund – Advisor

**Qualifications**

Bachelor of Science Degree in Business Administration –  
 Menlo College, California, USA  
 Master's Degree in Business Administration – University of Santa Clara, California, USA

**Major awards**

Bronze Bauhinia Star (2000)  
 Justice of the Peace (1997)

## # Mr Peter WONG Tung Shun

JP

**Director****Aged 60****Joined the Board since May 2005****Other major appointments**

- ^ Bank of Communications Co., Ltd. – Non-executive Director
- ^ Cathay Pacific Airways Limited – Independent Non-executive Director

Chongqing Mayor's International Economic Advisory Council – Member  
 Greater Pearl River Delta Business Council – Member  
 Hong Kong General Chamber of Commerce – Director; member of General Committee  
 Hong Kong Monetary Authority – Member of Exchange Fund Advisory Committee  
 HSBC Bank (China) Company Limited – Chairman and Non-executive Director  
 HSBC Bank Malaysia Berhad – Chairman and Non-executive Director  
 ^ HSBC Holdings plc – Group Managing Director; member of Group Management Board  
 International Advisor to the Mayor of Tianjin  
 ^ Ping An Insurance (Group) Company of China, Ltd. – Non-executive Director  
 The Hongkong and Shanghai Banking Corporation Limited – Chief Executive; Executive Director  
 The Hong Kong Institute of Bankers – President  
 The Tenth Hubei Provincial Committee of the Chinese People's Political Consultative Conference – Member

#### Past major appointments

- ^ Hong Kong Exchanges and Clearing Limited – Member of Risk Management Committee (2010)
- Hong Kong Institute for Monetary Research – Member of the Board of Directors (2010-2011)
- Hong Kong Monetary Authority – Member of Banking Advisory Committee (2005-2010)
- Hong Kong Trade Development Council – Chairman of Financial Services Advisory Committee (2006-2010)
- HSBC Bank Australia Limited – Non-executive Director (2010-2011)
- HSBC Bank (Vietnam) Ltd – Vice-Chairman and Non-executive Director (2010-2012) (Note 1)
- The Hong Kong Association of Banks – Chairman (2009)

#### Qualifications

Bachelor's Degree in Computer Science; MBA in Marketing and Finance; MSc in Computer Science – Indiana University, USA

#### Major Award

Justice of the Peace (2002)

### \* Mr Michael WU Wei Kuo

Director

Aged 41

Joined the Board since September 2010

#### Other major appointments

Hongkong Caterers Limited – Executive Director and Company Secretary  
 Hong Kong Retail Management Association – Executive Committee Member  
 Maxim's Caterers Limited – Chairman and Managing Director  
 The Community Chest of Hong Kong – Board Member  
 The Hong Kong University of Science and Technology – Council Member

#### Qualification

Bachelor of Science in Applied Mathematics and Economics – Brown University, USA

#### Major Award

"Executive Award" of the DHL/SCMP Hong Kong Business Awards (2008)

#### Notes:

- 1 New appointments, re-designation or cessation of appointments since the date of the Bank's 2011 Interim Report or (as the case may be) the date(s) of announcement(s) for the appointment of Director(s) issued by the Bank subsequent to the date of the Bank's 2011 Interim Report.
- 2 The interests of Directors in shares of the Bank, if any, within the meaning of Part XV of the Securities and Futures Ordinance ("SFO") as at 31 December 2011 are disclosed in the section "Directors' and Alternate Chief Executives' Interests" of the Report of the Directors attached to the Bank's 2011 Annual Report.
- 3 Some Directors (as disclosed in the section "Biographical Details of Directors" of the Bank's 2011 Annual Report) are also Directors of HSBC Holdings plc ("HSBC") and/or its subsidiaries. HSBC, through its wholly owned subsidiaries, has an interest in the shares of the Bank under the provisions of Divisions 2 and 3 of Part XV of the SFO, the details of which are disclosed in the section "Substantial Interests in Share Capital" of the Report of the Directors attached to the Bank's 2011 Annual Report.
- 4 Save as disclosed in the section "Biographical Details of Directors" of the Bank's 2011 Annual Report, the Directors (a) have not held any directorships in other publicly listed companies, whether in Hong Kong or overseas, during the last 3 years; (b) do not hold any other positions in the Bank and its subsidiaries; and (c) do not have any other relationships with any Directors, senior management or substantial or controlling shareholders of the Bank, except that Mr Michael W K Wu's spouse is the niece of Dr Vincent H S Lo, a Non-executive Director of the Bank.
- 5 All Directors (except those Directors who are full time employees of the Bank or its subsidiaries) will receive Directors' fees in the amounts approved from time to time by shareholders at the Annual General Meetings of the Bank. The current amounts of Directors' fees have been determined with reference to market rates, directors' workload and required commitment. A Director will also receive a fee for duties assigned to and services provided by him/her as Chairman or member of various Committees of the Bank. Such fees have been determined with reference to the remuneration policy of the Bank.
- 6 Commencing from 1 January 2008, no Directors' fees will be paid to those Directors who are full time employees of the Bank or its subsidiaries. The salary packages of such Directors have been determined with reference to the remuneration policy of the Bank. Such Directors are also entitled to discretionary bonus.
- 7 The details of the emoluments of the Directors on a named basis are disclosed in Note 19 of the Bank's Financial Statements as contained in the Bank's 2011 Annual Report.
- 8 None of the Directors, except Mr Andrew H C Fung has signed service contracts with the Bank. However, the Bank's Articles of Association provide that each Director is required to retire by rotation once every three years and that one-third (or the number nearest to one-third) of the Directors shall retire from office every year at the Bank's Annual General Meeting. A Director's specific term of appointment, therefore, cannot exceed three years. Every retiring Director shall be eligible for re-election or election at the Annual General Meetings of the Bank.
- 9 Biographical details of Directors of the Bank are also available on the website of the Bank ([www.hangseng.com](http://www.hangseng.com)).

\* Independent Non-executive Directors

# Non-executive Directors

^ The securities of these companies are listed on a securities market in Hong Kong or overseas.

## BIOGRAPHICAL DETAILS OF SENIOR MANAGEMENT

**Mrs Margaret LEUNG KO May Yee**

JP

**Vice-Chairman and Chief Executive**

(Biographical details are set out on pages 80 and 81)

**Mr Andrew FUNG Hau Chung**

JP

**Executive Director and Head of Treasury and Investment**

(Biographical details are set out on page 82)

**Mr Nixon CHAN Lik Sang****Head of Retail Banking and Wealth Management**

Aged 59

Joined the Bank since October 2009

**Major positions held within Hang Seng Group**

Hang Seng Bank Limited – Head of Retail Banking and Wealth Management; member of Executive Committee

Hang Seng Indexes Company Limited – Member of Hang Seng Index Advisory Committee

Hang Seng Insurance Company Limited – Director

**Other major appointments**

Hang Seng Management College – Member of the Board of Governors

Hang Seng School of Commerce – Director

Small and Medium Enterprises Committee – Member

**Past major positions**

The Hongkong and Shanghai Banking Corporation Limited – Senior Executive, Commercial Banking (2005 – 2009)

Held various senior positions in commercial banking and personal financial services (1993 – 2005)

**Qualification**

Bachelor Degree in Business Administration – University of Hawaii, USA

**Mr Christopher HO Hing Nin****Chief Technology and Services Officer**

Aged 59

Joined the Bank since July 2009

**Major positions held within Hang Seng Group**

Hang Seng Bank Limited – Chief Technology and Services Officer; member of Executive Committee

Hang Seng Real Estate Management Limited – Director

Hang Seng Security Management Limited – Director

**Other major appointments**

Urban Renewal Authority – Member of Central Oasis Community Advisory Committee

Education Bureau of HKSAR Government – Member of Banking Industry Training Advisory Committee

**Past major positions**

The Hongkong and Shanghai Banking Corporation Limited – Head of Service Delivery Asia Pacific (2009)

Held various senior positions in banking operations and personal financial services (1992 – 2008)

**Qualification**

MSc in Management Information Systems – Sheffield Hallam University, UK

**Mr Donald LAM Yin Shing****Head of Corporate and Commercial Banking**

Aged 48

Joined the Bank since March 2003

**Major positions held within Hang Seng Group**

Hang Seng Bank Limited – Head of Corporate and Commercial Banking; member of Executive Committee

Hang Seng General Insurance (Hong Kong) Company Limited – Director

Hang Seng Insurance Company Limited – Director

**Past major positions**

Hang Seng Bank Limited –

Head of Commercial Banking (2007-2011)

Head of Commercial Banking Relationship Management (2005-2006)

Deputy Head of Commercial Banking Relationship Management (2004-2005)

Senior Relationship Manager of Commercial Banking Relationship Management Department A (2003-2004)

Playmates Holdings Limited – Executive Director and Chief Financial Officer (2001-2003)

The Hongkong and Shanghai Banking Corporation Limited –

Senior Marketing and Planning Manager (1999-2001)

Senior Corporate Relationship Manager, Commercial Banking (1997-1999)

Held various senior positions in Corporate and Commercial Banking (1987-1997)

**Qualifications**

Associate – The Hong Kong Institute of Bankers

Bachelor of Social Science (1st Class Honor) – The University of Hong Kong

Master of Business Administration – The Chinese University of Hong Kong

Master of Science in e-Commerce – The Chinese University of Hong Kong

**Mr Andrew LEUNG Wing Lok****Chief Financial Officer**

Aged 49

Joined the Bank in July 1997 (left in 2006) and rejoined in July 2009

**Major positions held within Hang Seng Group**

Hang Seng Bank Limited – Chief Financial Officer; member of Executive Committee

Hang Seng Bank (China) Limited – Director

Hang Seng Insurance Company Limited – Director

**Other major appointment**

Industrial Bank Co., Ltd. – Member of Credit Card Centre Management Committee

**Past major positions**

Hang Seng Bank Limited –

Senior Manager and Deputy Head of China Business (2005-2006)

Senior Manager and Deputy Head of Greater China Business (2003-2005)

Senior Manager of Corporate Banking (2001-2003)

Senior Manager and Deputy Head of Financial Control (1997-2001)





From left to right: Mr Nixon L S Chan, Mrs Dorothy K Y P Sit (Vice-Chairman and Chief Executive of Hang Seng Bank (China) Limited), Mrs Margaret Leung, Mr Andrew H C Fung, Mr Donald Y S Lam

#### Qualifications

Associate – The Hong Kong Institute of Chartered Secretaries  
 Associate – The Institute of Chartered Secretaries and Administrators  
 Bachelor of PRC Law – Peking University, PRC  
 Bachelor of Social Sciences (Major in Management) – The University of Hong Kong  
 Certified Member – Certified Management Accountants Society of British Columbia, Canada  
 Fellow – Chartered Association of Certificated Accountants  
 Fellow – Hong Kong Institute of Certified Public Accountants  
 Master of Science, Data processing – University of Ulster, UK  
 Master of Science in Electronic Commerce and Internet Computing – The University of Hong Kong

#### Mr TANG Nai Pan

##### Chief Risk Officer

Aged 50

Joined the Bank since August 2011

##### Major positions held within Hang Seng Group

Hang Seng Bank Limited – Chief Risk Officer; member of Executive Committee

#### Past major positions

Shanghai Pudong Development Bank Co., Ltd., Shanghai – General Manager/Advisor, Global Markets and Corporate Treasury (2006-2011)  
 DBS Bank Limited, Singapore – Managing Director, Treasury and Risk Management (2001-2006)  
 Citibank (Hong Kong) Limited – Head of Market Risk, North Asia  
 The Chinese University of Hong Kong – Assistant Professor in Finance  
 McGill University, Canada – Assistant Professor in Finance

#### Qualifications

Bachelor of Arts – University of Minnesota, Minneapolis, USA  
 Master of Science – University of Chicago, USA  
 Doctor of Philosophy Candidate in Finance – Kellogg School, Northwestern University, USA

## REPORT OF THE DIRECTORS

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2011.

### PRINCIPAL ACTIVITIES

The Bank and its subsidiaries and associates are engaged in the provision of banking and related financial services.

### PROFITS

The consolidated profit of the Bank and its subsidiaries and associates for the year and the particulars of dividends which have been paid or declared are set out on pages 97 and 133 of this Annual Report respectively.

### MAJOR CUSTOMERS

The Directors believe that the five largest customers of the Bank accounted for less than 30% of the total interest income and other operating income of the Bank for the year.

### SUBSIDIARIES

Particulars of the Bank's principal subsidiaries as at 31 December 2011 are set out in note 37 to the financial statements for the year ended 31 December 2011.

### SHARE CAPITAL

No change in either the authorised or issued share capital took place during the year.

### DONATIONS

Charitable donations made by the Bank and its subsidiaries during the year amounted to HK\$7.0m. For further details of the Bank's corporate social responsibility activities and expenditures, please refer to the section "Corporate Responsibility" of this Annual Report.

### RESERVES

Profit attributable to shareholders, before dividends, of HK\$16,680m (2010: HK\$14,917m) have been transferred to reserves. Distributable reserve of the Bank as at 31 December 2011 amounted to HK\$20,642m (2010: HK\$20,556m). Other movements in reserves are set out in the consolidated statement of changes in equity.

### DIRECTORS

The Directors of the Bank who were in office as at the end of the year were Dr Raymond K F Ch'ien, Mrs Margaret Leung, Dr John C C Chan, Dr Marvin K T Cheung, Ms L Y Chiang, Mr Andrew H C Fung, Ms Anita Y M Fung, Dr Fred Zulu Hu, Mr Jenkin Hui, Ms Sarah C Legg, Dr Eric K C Li, Dr Vincent

H S Lo, Mrs Dorothy K Y P Sit, Mr Richard Y S Tang, Mr Peter T S Wong and Mr Michael W K Wu.

After appointment as Directors of the Bank with effect from 14 February 2011, Mr Mark S McCombe and Ms Sarah C Legg were elected Directors at the Bank's 2011 Annual General Meeting ("AGM") held on 13 May 2011. Subsequently, Mr McCombe resigned from the Board with effect from 9 September 2011.

Mr William W Leung resigned from the Board with effect from 20 August 2011.

Dr Fred Zulu Hu, Mr Andrew H C Fung and Ms Anita Y M Fung were appointed Directors of the Bank with effect from 30 May 2011, 10 October 2011 and 1 November 2011, respectively. They will retire under the provisions of the Bank's Articles of Association and, being eligible, offer themselves for election at the Bank's forthcoming AGM to be held on 11 May 2012 ("2012 AGM").

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Mrs Margaret Leung, Mrs Dorothy K Y P Sit, Mr Richard Y S Tang and Mr Peter T S Wong. Mrs Margaret Leung has informed the Board of her intention of not seeking re-election at the 2012 AGM for the reason set out below. All the other above-mentioned Directors will offer themselves for re-election at the 2012 AGM.

Mrs Margaret Leung will retire as Vice-Chairman and Chief Executive of the Bank and from the Board with effect from the conclusion of the 2012 AGM. Ms Rose W M Lee will be appointed a Non-executive Director and Chief Executive Designate of the Bank with effect from the date of receipt of the approval of Hong Kong Monetary Authority of her appointment until the conclusion of the 2012 AGM and being eligible, will offer herself for election by shareholders at the 2012 AGM. Subject to being elected by the shareholders, Ms Lee will become Vice-Chairman and Chief Executive of the Bank with effect from the conclusion of the 2012 AGM.

The Board announces the above changes to the Board composition on 27 February 2012. For further details of the above changes to the Board composition, shareholders may refer to the announcement issued by the Bank and uploaded on the Bank's website at [www.hangseng.com](http://www.hangseng.com).

No Director proposed for re-election or election, as the case may be, at the forthcoming AGM has a service contract with the Bank which is not determinable by the Bank within one year without payment of compensation (other than statutory compensation).

The biographical details of the Directors of the Bank are set out in the section "Biographical Details of Directors" of this Annual Report.

## STATUS OF INDEPENDENT NON-EXECUTIVE DIRECTORS

The Bank has received from each Independent Non-executive Director an annual confirmation of his/her independence pursuant to Rule 3.13 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Stock Exchange") (the "Listing Rules") and the Bank still considers the Independent Non-executive Directors to be independent.

## DIRECTORS' AND ALTERNATE CHIEF EXECUTIVES' INTERESTS

### INTERESTS IN SHARES

As at 31 December 2011, the interests of the Directors and Alternate Chief Executives in the shares, underlying shares of equity derivatives and debentures of the Bank and its associated corporations (all within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) disclosed in accordance with the Listing Rules were detailed below.

|  | Personal<br>Interests<br>(held as<br>beneficial<br>owner) | Family<br>Interests<br>(interests<br>of spouse<br>or child<br>under 18) | Corporate<br>Interests<br>(interests of<br>controlled<br>corporation) | Other<br>Interests       | Total<br>Interests | Total<br>Interests<br>as % of the<br>relevant<br>issued<br>share capital |
|--|---|---|---|--------------------------|--------------------|--|
| <b>Number of<br/>Ordinary Shares<br/>of HK\$5 each in the Bank</b>                 |   |   |   |                          |                    |  |
| <b>Directors:</b>  |   |   |   |                          |                    |  |
| Mrs Margaret Leung   | 21,000  | –   | –   | –                        | 21,000             | 0.00   |
| Dr John C C Chan   | –   | –   | –   | 1,000 <sup>(1)</sup>     | 1,000              | 0.00   |
| <b>Number of<br/>Ordinary Shares of<br/>US\$0.50 each in<br/>HSBC Holdings plc</b> |   |   |   |                          |                    |  |
| <b>Directors:</b>  |   |   |   |                          |                    |  |
| Dr Raymond K F Ch'ien  | 57,237  | –   | –   | –                        | 57,237             | 0.00   |
| Mrs Margaret Leung   | 243,889   | –   | –   | 375,502 <sup>(5)</sup>   | 619,391            | 0.00   |
| Dr John C C Chan   | 20,234  | –   | –   | 4,371 <sup>(1)</sup>     | 24,605             | 0.00   |
| Ms L Y Chiang  | 12,000  | –   | 6,000 <sup>(2)</sup>  | –                        | 18,000             | 0.00   |
| Mr Andrew H C Fung   | 20,585  | –   | –   | 41,668 <sup>(5)</sup>    | 62,253             | 0.00   |
| Ms Anita Y M Fung  | –   | –   | –   | 1,299,729 <sup>(5)</sup> | 1,299,729          | 0.00   |
| Mr Jenkin Hui  | 17,915  | –   | 1,985,170 <sup>(3)</sup>  | –                        | 2,003,085          | 0.01   |
| Ms Sarah C Legg  | 37,270  | 2,008   | –   | 57,359 <sup>(5)</sup>    | 96,637             | 0.00   |
| Dr Eric K C Li   | –   | 41,040  | –   | –                        | 41,040             | 0.00   |
| Mrs Dorothy K Y P Sit  | 57,343 <sup>(4)</sup>                                     | 1,031   | –   | 37,143 <sup>(5)</sup>    | 95,517             | 0.00   |
| Mr Peter T S Wong  | 410,767   | 17,599  | –   | 406,683 <sup>(5)</sup>   | 835,049            | 0.00   |
| <b>Alternate Chief Executives:</b>   |   |   |   |                          |                    |  |
| Mr Nixon L S Chan  | 16,816  | –   | –   | 32,007 <sup>(5)</sup>    | 48,823             | 0.00   |
| Mr Christopher H N Ho  | 79,457  | 44,324  | –   | 15,075 <sup>(5)</sup>    | 138,856            | 0.00   |
| Mr Donald Y S Lam  | 22,699  | –   | –   | 20,804 <sup>(5)</sup>    | 43,503             | 0.00   |
| Mr Andrew W L Leung  | 4,710   | –   | –   | 1,668 <sup>(5)</sup>     | 6,378              | 0.00   |
| Mr David W H Tam   | 22,171  | 9,014   | –   | 14,928 <sup>(5)</sup>    | 46,113             | 0.00   |



## Notes:

- (1) 1,000 shares in the Bank and 4,371 shares in HSBC Holdings plc were held by a trust of which Dr John C C Chan and his wife were beneficiaries.
- (2) Ms L Y Chiang was entitled to fully control the voting power at general meetings of Happy Boom Enterprises Limited, a private company, which beneficially held all of those shares referred to above as her corporate interests.
- (3) Mr Jenkin Hui was entitled to fully control the voting power at general meetings of Parc Palais Incorporated, a private company, which beneficially held all of those shares referred to above as his corporate interests.
- (4) 8,046 shares were jointly held by Mrs Dorothy K Y P Sit and her husband.
- (5) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives, as set against their respective names below:

|                                    | Options<br>(please refer to<br>the options table<br>below for details) | Conditional awards of<br>shares under the<br>HSBC Share Plans<br>(please refer to the<br>awards table below<br>for further information) | Total     |
|------------------------------------|--|---|-----------|
| <b>Directors:</b>                  |  |   |           |
| Mrs Margaret Leung                 | 4,197  | 371,305   | 375,502   |
| Mr Andrew H C Fung                 | 4,197  | 37,471  | 41,668    |
| Ms Anita Y M Fung                  | 4,197  | 1,295,532   | 1,299,729 |
| Ms Sarah C Legg                    | 20,021   | 37,338  | 57,359    |
| Mrs Dorothy K Y P Sit              | 2,375  | 34,768  | 37,143    |
| Mr Peter T S Wong                  | –  | 406,683   | 406,683   |
| <b>Alternate Chief Executives:</b> |  |   |           |
| Mr Nixon L S Chan                  | 11,476   | 20,531  | 32,007    |
| Mr Christopher H N Ho              | 5,961  | 9,114   | 15,075    |
| Mr Donald Y S Lam                  | 11,082   | 9,722   | 20,804    |
| Mr Andrew W L Leung                | –  | 1,668   | 1,668     |
| Mr David W H Tam                   | 13,770   | 1,158   | 14,928    |

## OPTIONS

As at 31 December 2011, the Directors and Alternate Chief Executives mentioned below held unlisted physically settled options to acquire the number of ordinary shares of US\$0.50 each in HSBC Holdings plc set against their respective names. These options were granted for nil consideration by HSBC Holdings plc.

|                    | Options<br>held<br>as at<br>31 December<br>2011 | Options<br>exercised/<br>cancelled<br>during the<br>Director's/<br>Alternate Chief<br>Executive's<br>term of office<br>in 2011 | Exercise<br>price<br>per share | Date<br>granted | Exercisable<br>from | Exercisable<br>until |
|--------------------|---|--|--------------------------------|-----------------|---------------------|----------------------|
| <b>Directors:</b>  |   |  |                                |                 |                     |                      |
| Mrs Margaret Leung | 4,197   | –  | HK\$37.8797                    | 29 Apr 2009     | 1 Aug 2014          | 31 Jan 2015          |
| Mr Andrew H C Fung | 4,197   | –  | HK\$37.8797                    | 29 Apr 2009     | 1 Aug 2014          | 31 Jan 2015          |
| Ms Anita Y M Fung  | 4,197   | –  | HK\$37.8797                    | 29 Apr 2009     | 1 Aug 2014          | 31 Jan 2015          |
| Ms Sarah C Legg    | –   | 5,738  | £7.5919                        | 23 Apr 2001     | 23 Apr 2004         | 22 Apr 2011          |
|                    | 3,656   | –  | £7.3244                        | 7 May 2002      | 7 May 2005          | 7 May 2012           |
|                    | 3,803   | –  | £7.3244                        | 7 May 2002      | 7 May 2005          | 7 May 2012           |
|                    | 2,295   | –  | £6.0216                        | 2 May 2003      | 2 May 2006          | 2 May 2013           |
|                    | 5,738   | –  | £7.2181                        | 30 Apr 2004     | 30 Apr 2009         | 30 Apr 2014          |
|                    | 4,529   | –  | £3.6361                        | 29 Apr 2009     | 1 Aug 2014          | 31 Jan 2015          |
|                    | 20,021  |  |                                |                 |                     |                      |

|                                    | Options held as at 31 December 2011 | Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2011 | Exercise price per share | Date granted | Exercisable from | Exercisable until |
|------------------------------------|-------------------------------------|--|--------------------------|--------------|------------------|-------------------|
| <b>Directors:</b>                  |                                     |  |                          |              |                  |                   |
| Mrs Dorothy K Y P Sit              | –                                   | 3,443  | £7.5919                  | 23 Apr 2001  | 23 Apr 2004      | 22 Apr 2011       |
|                                    | 2,375                               | –  | HK\$37.8797              | 29 Apr 2009  | 1 Aug 2012       | 31 Jan 2013       |
|                                    | <u>2,375</u>                        |  |                          |              |                  |                   |
| <b>Alternate Chief Executives:</b> |                                     |  |                          |              |                  |                   |
| Mr Nixon L S Chan                  | –                                   | 4,820  | £7.5919                  | 23 Apr 2001  | 23 Apr 2004      | 22 Apr 2011       |
|                                    | 3,328                               | –  | £7.3244                  | 7 May 2002   | 7 May 2005       | 6 May 2012        |
|                                    | 3,615                               | –  | £6.0216                  | 2 May 2003   | 2 May 2006       | 1 May 2013        |
|                                    | 4,533                               | –  | £7.2181                  | 30 Apr 2004  | 30 Apr 2009      | 29 Apr 2014       |
|                                    | –                                   | 592 <sup>(1)</sup>   | HK\$62.9770              | 21 Apr 2010  | 1 Aug 2011       | 31 Oct 2011       |
|                                    | <u>11,476</u>                       |  |                          |              |                  |                   |
| Mr Christopher H N Ho              | 3,443                               | –  | £7.2181                  | 30 Apr 2004  | 30 Apr 2009      | 29 Apr 2014       |
|                                    | 2,518                               | –  | HK\$37.8797              | 29 Apr 2009  | 1 Aug 2012       | 31 Jan 2013       |
|                                    | <u>5,961</u>                        |  |                          |              |                  |                   |
| Mr Donald Y S Lam                  | 6,885                               | –  | £7.2181                  | 30 Apr 2004  | 30 Apr 2009      | 30 Apr 2014       |
|                                    | 4,197                               | –  | HK\$37.8797              | 29 Apr 2009  | 1 Aug 2014       | 31 Jan 2015       |
|                                    | <u>11,082</u>                       |  |                          |              |                  |                   |
| Mr David W H Tam                   | –                                   | 5,738  | £7.5919                  | 23 Apr 2001  | 23 Apr 2004      | 22 Apr 2011       |
|                                    | 6,311                               | –  | £7.3244                  | 7 May 2002   | 7 May 2005       | 6 May 2012        |
|                                    | 7,459                               | –  | £7.2181                  | 30 Apr 2004  | 30 Apr 2009      | 29 Apr 2014       |
|                                    | <u>13,770</u>                       |  |                          |              |                  |                   |

Note:

[1] At the date of exercise, 1 August 2011, the market value per share was £6.0750.

## CONDITIONAL AWARDS OF SHARES

As at 31 December 2011, the interests of the Directors and Alternate Chief Executives in the conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc made in favour of them under the HSBC Share Plans were as follows:

|                                    | Awards held as at 1 January 2011 | Awards made during the Director's/Alternate Chief Executive's term of office in 2011 | Awards released during the Director's/Alternate Chief Executive's term of office in 2011 | Awards held as at 31 December 2011 |
|------------------------------------|----------------------------------|--|--|------------------------------------|
| <b>Directors:</b>                  |                                  |  |  |                                    |
| Mrs Margaret Leung                 | 396,274                          | 110,657  | 150,534  | 371,305 <sup>(1)</sup>             |
| Mr Andrew H C Fung                 | 38,776                           | 13,665   | 16,521   | 37,471 <sup>(1)</sup>              |
| Ms Anita Y M Fung                  | 1,295,532 <sup>(2)</sup>         | –  | –  | 1,295,532                          |
| Ms Sarah C Legg                    | 36,889 <sup>(3)</sup>            | 12,557   | 13,351   | 37,338 <sup>(1)</sup>              |
| Mrs Dorothy K Y P Sit              | 42,602                           | 11,819   | 21,217   | 34,768 <sup>(1)</sup>              |
| Mr Peter T S Wong                  | 308,025                          | 241,631  | 156,545  | 406,683 <sup>(1)</sup>             |
| <b>Alternate Chief Executives:</b> |                                  |  |  |                                    |
| Mr Nixon L S Chan                  | 20,055                           | 4,924  | 5,263  | 20,531 <sup>(1)</sup>              |
| Mr Christopher H N Ho              | 8,153                            | 1,723  | 1,101  | 9,114 <sup>(1)</sup>               |
| Mr Donald Y S Lam                  | 9,722 <sup>(4)</sup>             | –  | –  | 9,722                              |
| Mr Andrew W L Leung                | 848                              | 1,046  | 282  | 1,668 <sup>(1)</sup>               |
| Mr David W H Tam                   | 1,663                            | –  | 553  | 1,158 <sup>(1)</sup>               |

Notes:

(1) This includes additional shares arising from scrip dividends.

(2) This represented the awards held by Ms Anita Y M Fung on 1 November 2011 when she was appointed a Director of the Bank.

(3) This represented the awards held by Ms Sarah C Legg on 14 February 2011 when she was appointed a Director of the Bank.

(4) This represented the awards held by Mr Donald Y S Lam on 18 October 2011 when he was appointed an Alternate Chief Executive of the Bank.

All the interests stated above represent long positions. As at 31 December 2011, no short positions were recorded in the Register of Directors' and Alternate Chief Executives' Interests and Short Positions required to be kept under section 352 of the SFO.

Save as disclosed in the preceding paragraphs, at no time during the year was the Bank or any of its holding companies or its subsidiaries or fellow subsidiaries a party to any arrangement to enable the Directors of the Bank to acquire benefits by means of the acquisition of shares in or debentures of the Bank or any other body corporate.

No right to subscribe for equity or debt securities of the Bank has been granted by the Bank to, nor have any such rights been exercised by, any person during the year ended 31 December 2011.

## DIRECTORS' INTERESTS IN CONTRACTS

No contract of significance, to which the Bank or any of its holding companies or any of its subsidiaries or fellow subsidiaries was a party and in which a Director of the Bank had a material interest, subsisted as at the end of the year or at any time during the year.



## DIRECTORS' INTERESTS IN COMPETING BUSINESSES

Pursuant to Rule 8.10 of the Listing Rules, as at the date of this report, the following Directors had declared interests in the following entities which compete or are likely to compete, either directly or indirectly, with the businesses of the Bank:

Mr Andrew H C Fung is Director, a member of Executive Committee and a member of Remuneration and Examination Committee of Industrial Bank Co., Ltd. ("Industrial Bank"), in which the Bank holds a 12.8% stake. Industrial Bank conducts general banking business in mainland China.

Ms Anita Y M Fung is a Group General Manager of HSBC Holdings plc and the Chief Executive Officer, Hong Kong of The Hongkong and Shanghai Banking Corporation Limited. She is also the Deputy Chairman of HSBC Bank (China) Company Limited and the Chairman and Director of HSBC Global Asset Management (Hong Kong) Limited, subsidiaries of The Hongkong and Shanghai Banking Corporation Limited, and a Director of various HSBC Group subsidiaries.

Ms Sarah C Legg is the Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited and a Director of various HSBC Group subsidiaries.

Mrs Margaret Leung is a Group General Manager of HSBC Holdings plc and a Director of The Hongkong and Shanghai Banking Corporation Limited.

Mr Peter T S Wong is a Group Managing Director of HSBC Holdings plc. He is also the Chief Executive and Executive Director of The Hongkong and Shanghai Banking Corporation Limited; and Chairman and Non-executive Director of HSBC Bank Malaysia Berhad and HSBC Bank (China) Company Limited. He is a Non-executive Director of Bank of Communications Co., Ltd., which conducts general banking business. He is also a Non-executive Director of Ping An Insurance (Group) Company of China, Ltd., which conducts life insurance, property and casualty insurance and other financial services.

HSBC Holdings plc, through its subsidiaries and associated undertakings, including The Hongkong and Shanghai Banking Corporation Limited, the immediate holding company of the Bank, is engaged in providing a comprehensive range of banking, insurance and related financial services.

The entities in which the Directors have declared interests are managed by separate Boards of Directors and management, which are accountable to their respective shareholders.

Further, Industrial Bank has an Audit and Related Party Transaction Control Committee which is responsible for considering all matters concerning audit as well as connected party transactions to be entered into by Industrial Bank as required by the laws of mainland China. The majority of members of Industrial Bank's Audit and Related Party Transaction Control Committee are independent Directors.

The Board of the Bank includes nine Independent Non-executive Directors whose views carry significant weight in the Board's decisions. The Audit Committee of the Bank, which consists of three Independent Non-executive Directors, meets regularly to assist the Board of Directors in reviewing the financial performance, internal control and compliance systems of the Bank and its subsidiaries. The Bank is, therefore, capable of carrying on its businesses independently of, and at arm's length from, the businesses in which Directors have declared interests.

## DIRECTORS' EMOLUMENTS

The emoluments of the Directors of the Bank (including Executive Directors and Independent Non-executive Directors) on a named basis are set out in note 19 to the financial statements for the year ended 31 December 2011.

## SUBSTANTIAL INTERESTS IN SHARE CAPITAL

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2011, the following corporations had interests or short positions in the shares or underlying shares (as defined in the SFO) in the Bank set opposite their respective names:

| Name of Corporation                                   | Number of Ordinary Shares of HK\$5 each in the Bank (Percentage of total) |
|---|---|
| The Hongkong and Shanghai Banking Corporation Limited | 1,188,057,371 (62.14%)  |
| HSBC Asia Holdings BV                                 | 1,188,057,371 (62.14%)  |
| HSBC Asia Holdings (UK) Limited                       | 1,188,057,371 (62.14%)  |
| HSBC Holdings BV                                      | 1,188,057,371 (62.14%)  |
| HSBC Finance (Netherlands)                            | 1,188,057,371 (62.14%)  |
| HSBC Holdings plc                                     | 1,188,057,371 (62.14%)  |

The Hongkong and Shanghai Banking Corporation Limited is a wholly-owned subsidiary of HSBC Asia Holdings BV, which is a wholly-owned subsidiary of HSBC Asia Holdings (UK) Limited, which in turn is a wholly-owned subsidiary of HSBC Holdings BV. HSBC Holdings BV is a wholly-owned subsidiary of HSBC Finance (Netherlands), which in turn is a wholly-owned subsidiary of HSBC Holdings plc. Accordingly, The Hongkong and Shanghai Banking Corporation Limited's interests are recorded as the interests of HSBC Asia Holdings BV, HSBC Asia Holdings (UK) Limited, HSBC Holdings BV, HSBC Finance (Netherlands) and HSBC Holdings plc.

The Directors regard HSBC Holdings plc to be the beneficial owner of 1,188,057,371 ordinary shares in the Bank (62.14%).

All the interests stated above represent long positions. As at 31 December 2011, no short positions were recorded in the Register of Interests in Shares and Short Positions required to be kept under section 336 of the SFO.

## PURCHASE, SALE OR REDEMPTION OF THE BANK'S LISTED SECURITIES

Save for the redemption of all the US\$450,000,000 floating rate subordinated notes due 2016 at par on 6 July 2011, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's listed securities during the year.

## PUBLIC FLOAT

As at the date of this report, the Bank has maintained the prescribed public float under the Listing Rules, based on the information that is publicly available to the Bank and within the knowledge of the Directors of the Bank.

## CODE ON CORPORATE GOVERNANCE PRACTICES

Details of the Bank's corporate governance practices are set out in the "Corporate Governance and Other Information" section in this Annual Report.

## AUDITOR

KPMG retire and, being eligible, offer themselves for re-appointment. A resolution for the re-appointment of KPMG as auditor of the Bank will be proposed at the forthcoming Annual General Meeting.

On behalf of the Board

**Raymond Ch'ien**

Chairman

Hong Kong, 27 February 2012



**2011**

FINANCIAL  
STATEMENTS

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| 8          | Interest income/interest expense   | 33 | Financial assets designated at fair value                            | 61         | Financial risk management  |
| 9          | Net fee income   | 34 | Derivative financial instruments                                     | 62         | Fair value of financial instruments                                |
| 10         | Trading income   | 35 | Advances to customers  | 63         | Comparative figures  |
| 11         | Net (loss)/income from financial instruments designated at fair value  | 36 | Financial investments  | 64         | Immediate and ultimate holding companies                           |
| 12         | Dividend income  | 37 | Investments in subsidiaries  | 65         | Approval of financial statements                                   |
| 13         | Net earned insurance premiums  | 38 | Interest in associates   | <b>251</b> | <b>INDEPENDENT AUDITOR'S REPORT</b>                                |
| 14         | Other operating income   | 39 | Investment properties  | <b>252</b> | <b>SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (unaudited)</b> |
| 15         | Net insurance claims incurred and movement in policyholders' liabilities   | 40 | Premises, plant and equipment  | <b>273</b> | <b>ANALYSIS OF SHAREHOLDERS</b>                                    |
| 16         | Loan impairment charges  | 41 | Intangible assets  | <b>274</b> | <b>SUBSIDIARIES</b>  |
| 17         | Operating expenses   | 42 | Other assets   | <b>275</b> | <b>CORPORATE INFORMATION AND CALENDAR</b>                          |
| 18         | The emoluments of the five highest paid individuals  | 43 | Current, savings and other deposit accounts                          |            |  |
|            |  | 44 | Trading liabilities  |            |  |
|            |  | 45 | Financial liabilities designated at fair value                       |            |  |
|            |  | 46 | Certificates of deposit and other debt securities in issue           |            |  |



## CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)

|  |      | 2011           | 2010           |
|--|------|----------------|----------------|
|  | note |                |                |
| Interest income  | 8    | 19,845         | 16,507         |
| Interest expense   | 8    | (4,109)        | (2,207)        |
| <b>Net interest income</b>   |      | <b>15,736</b>  | <b>14,300</b>  |
| Fee income   |      | 5,923          | 5,895          |
| Fee expense  |      | (1,087)        | (998)          |
| <b>Net fee income</b>  | 9    | <b>4,836</b>   | <b>4,897</b>   |
| Trading income   | 10   | 1,796          | 2,059          |
| Net (loss)/income from financial instruments designated at fair value    | 11   | (160)          | 282            |
| Dividend income  | 12   | 17             | 14             |
| Net earned insurance premiums  | 13   | 11,061         | 11,307         |
| Other operating income   | 14   | 921            | 1,558          |
| <b>Total operating income</b>  |      | <b>34,207</b>  | <b>34,417</b>  |
| Net insurance claims incurred and movement in policyholders' liabilities | 15   | (11,610)       | (12,587)       |
| <b>Net operating income before loan impairment charges</b>               |      | <b>22,597</b>  | <b>21,830</b>  |
| Loan impairment charges  | 16   | (440)          | (390)          |
| <b>Net operating income</b>  |      | <b>22,157</b>  | <b>21,440</b>  |
| Employee compensation and benefits                                       |      | (3,888)        | (3,717)        |
| General and administrative expenses                                      |      | (3,191)        | (2,917)        |
| Depreciation of premises, plant and equipment                            |      | (700)          | (619)          |
| Amortisation of intangible assets  |      | (119)          | (102)          |
| <b>Operating expenses</b>  | 17   | <b>(7,898)</b> | <b>(7,355)</b> |
| Impairment loss on intangible assets                                     |      | (78)           | –              |
| <b>Operating profit</b>  |      | <b>14,181</b>  | <b>14,085</b>  |
| Gains less losses from financial investments and fixed assets            | 21   | 50             | 112            |
| Net surplus on property revaluation                                      | 22   | 992            | 487            |
| Share of profits from associates   |      | 3,990          | 2,661          |
| <b>Profit before tax</b>   |      | <b>19,213</b>  | <b>17,345</b>  |
| Tax expense  | 23   | (2,533)        | (2,428)        |
| <b>Profit for the year</b>   |      | <b>16,680</b>  | <b>14,917</b>  |
| Profit attributable to shareholders                                      |      | <b>16,680</b>  | <b>14,917</b>  |
| <i>(Figures in HK\$)</i>   |      |                |                |
| Earnings per share   | 25   | 8.72           | 7.80           |

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)

|  | 2011          | 2010   |
|--|---------------|--------|
| <b>Profit for the year</b>   | <b>16,680</b> | 14,917 |
| <b>Other comprehensive income</b>  |               |        |
| Premises:  |               |        |
| – unrealised surplus on revaluation of premises                          | 3,729         | 2,102  |
| – deferred taxes   | (610)         | (343)  |
| Available-for-sale investment reserve:                                   |               |        |
| – fair value changes taken to equity:                                    |               |        |
| – on debt securities   | 255           | 774    |
| – on equity shares   | 8             | (5)    |
| – fair value changes transferred to the income statement:                |               |        |
| – on hedged items  | (538)         | (272)  |
| – on disposal  | (53)          | (105)  |
| – share of changes in equity of associates:                              |               |        |
| – fair value changes   | (646)         | 120    |
| – deferred taxes   | 221           | (53)   |
| Cash flow hedging reserve:   |               |        |
| – fair value changes taken to equity                                     | 119           | 291    |
| – fair value changes transferred to the income statement                 | (197)         | (414)  |
| – deferred taxes   | 13            | 21     |
| Defined benefit plans:   |               |        |
| – actuarial (losses)/gains on defined benefit plans                      | (1,600)       | 11     |
| – deferred taxes   | 264           | (2)    |
| Exchange differences on translation of:                                  |               |        |
| – financial statements of overseas branches, subsidiaries and associates | 971           | 687    |
| Others   | 8             | 13     |
| <b>Other comprehensive income for the year, net of tax</b>               | <b>1,944</b>  | 2,825  |
| <b>Total comprehensive income for the year</b>                           | <b>18,624</b> | 17,742 |
| Total comprehensive income for the year attributable to shareholders     | 18,624        | 17,742 |

## CONSOLIDATED BALANCE SHEET

at 31 December 2011

(Expressed in millions of Hong Kong dollars)

|  |      | 2011           | 2010    |
|--|------|----------------|---------|
|  | note |                |         |
| <b>ASSETS</b>  |      |                |         |
| Cash and balances with banks and other financial institutions        | 30   | <b>39,533</b>  | 44,411  |
| Placings with and advances to banks and other financial institutions | 31   | <b>107,742</b> | 110,564 |
| Trading assets   | 32   | <b>64,171</b>  | 26,055  |
| Financial assets designated at fair value                            | 33   | <b>8,096</b>   | 7,114   |
| Derivative financial instruments                                     | 34   | <b>4,710</b>   | 5,593   |
| Advances to customers  | 35   | <b>480,574</b> | 472,637 |
| Financial investments  | 36   | <b>209,190</b> | 199,359 |
| Interest in associates   | 38   | <b>19,407</b>  | 15,666  |
| Investment properties  | 39   | <b>4,314</b>   | 3,251   |
| Premises, plant and equipment  | 40   | <b>17,983</b>  | 14,561  |
| Intangible assets  | 41   | <b>5,962</b>   | 5,394   |
| Other assets   | 42   | <b>13,763</b>  | 12,306  |
| <b>Total assets</b>  |      | <b>975,445</b> | 916,911 |
| <b>LIABILITIES AND EQUITY</b>  |      |                |         |
| <b>Liabilities</b>   |      |                |         |
| Current, savings and other deposit accounts                          | 43   | <b>699,857</b> | 683,628 |
| Deposits from banks  |      | <b>14,004</b>  | 15,586  |
| Trading liabilities  | 44   | <b>59,712</b>  | 42,581  |
| Financial liabilities designated at fair value                       | 45   | <b>434</b>     | 457     |
| Derivative financial instruments                                     | 34   | <b>4,848</b>   | 4,683   |
| Certificates of deposit and other debt securities in issue           | 46   | <b>9,284</b>   | 3,095   |
| Other liabilities  | 47   | <b>20,138</b>  | 17,018  |
| Liabilities to customers under insurance contracts                   | 48   | <b>72,225</b>  | 64,425  |
| Current tax liabilities  | 49   | <b>305</b>     | 344     |
| Deferred tax liabilities   | 49   | <b>4,037</b>   | 3,234   |
| Subordinated liabilities   | 50   | <b>11,846</b>  | 11,848  |
| <b>Total liabilities</b>   |      | <b>896,690</b> | 846,899 |
| <b>Equity</b>  |      |                |         |
| Share capital  | 51   | <b>9,559</b>   | 9,559   |
| Retained profits   |      | <b>48,640</b>  | 42,966  |
| Other reserves   |      | <b>16,923</b>  | 13,854  |
| Proposed dividends   | 26   | <b>3,633</b>   | 3,633   |
| Shareholders' funds  |      | <b>78,755</b>  | 70,012  |
| <b>Total equity and liabilities</b>                                  |      | <b>975,445</b> | 916,911 |

**Raymond K F Ch'ien** *Chairman*

**Margaret Leung** *Vice-Chairman and Chief Executive*

**Eric K C Li** *Director*

**Andrew W L Leung** *Chief Financial Officer*

## BALANCE SHEET

at 31 December 2011

(Expressed in millions of Hong Kong dollars)

|  |      | 2011           | 2010           |
|--|------|----------------|----------------|
|  | note |                |                |
| <b>ASSETS</b>  |      |                |                |
| Cash and balances with banks and other financial institutions        | 30   | 36,475         | 41,062         |
| Placings with and advances to banks and other financial institutions | 31   | 47,724         | 52,131         |
| Trading assets   | 32   | 60,526         | 25,232         |
| Financial assets designated at fair value                            | 33   | 140            | 148            |
| Derivative financial instruments                                     | 34   | 4,436          | 5,026          |
| Advances to customers  | 35   | 425,629        | 423,074        |
| Amounts due from subsidiaries  |      | 85,222         | 93,445         |
| Financial investments  | 36   | 105,142        | 103,106        |
| Investments in subsidiaries  | 37   | 14,434         | 11,584         |
| Interest in associates   | 38   | 5,172          | 5,172          |
| Investment properties  | 39   | 2,806          | 2,100          |
| Premises, plant and equipment  | 40   | 13,249         | 10,588         |
| Intangible assets  | 41   | 408            | 442            |
| Other assets   | 42   | 9,182          | 8,787          |
| <b>Total assets</b>  |      | <b>810,545</b> | <b>781,897</b> |
| <b>LIABILITIES AND EQUITY</b>  |      |                |                |
| <b>Liabilities</b>   |      |                |                |
| Current, savings and other deposit accounts                          | 43   | 661,012        | 649,144        |
| Deposits from banks  |      | 11,989         | 15,585         |
| Trading liabilities  | 44   | 36,077         | 30,106         |
| Financial liabilities designated at fair value                       | 45   | –              | –              |
| Derivative financial instruments                                     | 34   | 4,102          | 4,528          |
| Certificates of deposit and other debt securities in issue           | 46   | 9,284          | 3,095          |
| Amounts due to subsidiaries  |      | 10,797         | 8,899          |
| Other liabilities  | 47   | 16,960         | 15,434         |
| Current tax liabilities  | 49   | 270            | 320            |
| Deferred tax liabilities   | 49   | 1,801          | 1,617          |
| Subordinated liabilities   | 50   | 11,846         | 11,848         |
| <b>Total liabilities</b>   |      | <b>764,138</b> | <b>740,576</b> |
| <b>Equity</b>  |      |                |                |
| Share capital  | 51   | 9,559          | 9,559          |
| Retained profits   | 52   | 22,818         | 19,637         |
| Other reserves   | 52   | 10,397         | 8,492          |
| Proposed dividends   | 26   | 3,633          | 3,633          |
| Shareholders' funds  |      | 46,407         | 41,321         |
| <b>Total equity and liabilities</b>                                  |      | <b>810,545</b> | <b>781,897</b> |

**Raymond K F Ch'ien** *Chairman*

**Margaret Leung** *Vice-Chairman and Chief Executive*

**Eric K C Li** *Director*

**Andrew W L Leung** *Chief Financial Officer*



# CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)

|  | 2011           | 2010    |
|--|----------------|---------|
| <b>Share capital</b>                                   |                |         |
| At beginning and end of the year                       | <b>9,559</b>   | 9,559   |
| <b>Retained profits (including proposed dividends)</b> |                |         |
| At beginning of the year                               | <b>46,599</b>  | 41,385  |
| Dividends to shareholders                              |                |         |
| – dividends approved in respect of the previous year   | <b>(3,633)</b> | (3,633) |
| – dividends declared in respect of the current year    | <b>(6,309)</b> | (6,309) |
| Transfer   | <b>264</b>     | 218     |
| Total comprehensive income for the year                | <b>15,352</b>  | 14,938  |
|  | <b>52,273</b>  | 46,599  |
| <b>Other reserves</b>                                  |                |         |
| Premises revaluation reserve                           |                |         |
| At beginning of the year                               | <b>9,426</b>   | 7,885   |
| Transfer   | <b>(268)</b>   | (218)   |
| Total comprehensive income for the year                | <b>3,122</b>   | 1,759   |
|  | <b>12,280</b>  | 9,426   |
| Available-for-sale investment reserve                  |                |         |
| At beginning of the year                               | <b>202</b>     | (257)   |
| Transfer   | <b>(5)</b>     | –       |
| Total comprehensive income for the year                | <b>(758)</b>   | 459     |
|  | <b>(561)</b>   | 202     |
| Cash flow hedging reserve                              |                |         |
| At beginning of the year                               | <b>72</b>      | 174     |
| Total comprehensive income for the year                | <b>(66)</b>    | (102)   |
|  | <b>6</b>       | 72      |
| Foreign exchange reserve                               |                |         |
| At beginning of the year                               | <b>2,069</b>   | 1,382   |
| Total comprehensive income for the year                | <b>974</b>     | 687     |
|  | <b>3,043</b>   | 2,069   |
| Other reserve  |                |         |
| At beginning of the year                               | <b>2,085</b>   | 2,020   |
| Cost of share-based payment arrangements               | <b>61</b>      | 64      |
| Transfer   | <b>9</b>       | –       |
| Total comprehensive income for the year                | <b>–</b>       | 1       |
|  | <b>2,155</b>   | 2,085   |
| <b>Total equity</b>                                    |                |         |
| At beginning of the year                               | <b>70,012</b>  | 62,148  |
| Dividends to shareholders                              | <b>(9,942)</b> | (9,942) |
| Cost of share-based payment arrangements               | <b>61</b>      | 64      |
| Total comprehensive income for the year                | <b>18,624</b>  | 17,742  |
|  | <b>78,755</b>  | 70,012  |

## CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2011

(Expressed in millions of Hong Kong dollars)

|  |       | 2011            | 2010     |
|--|-------|-----------------|----------|
|  | note  |                 |          |
| <b>Net cash outflow from operating activities</b>                  | 53(a) | <b>(19,577)</b> | (30,098) |
| <b>Cash flows from investing activities</b>                        |       |                 |          |
| Dividends received from associates                                 |       | 488             | 424      |
| Purchase of an interest in an associate                            |       | –               | (2,626)  |
| Purchase of available-for-sale investments                         |       | (44,199)        | (27,401) |
| Purchase of held-to-maturity debt securities                       |       | (1,009)         | (1,113)  |
| Proceeds from sale or redemption of available-for-sale investments |       | 66,367          | 43,356   |
| Proceeds from redemption of held-to-maturity debt securities       |       | 530             | 260      |
| Proceeds from sales of loan portfolio                              |       | 5,643           | –        |
| Purchase of fixed assets and intangible assets                     |       | (422)           | (915)    |
| Proceeds from sale of fixed assets and assets held for sale        |       | –               | 19       |
| Interest received from available-for-sale investments              |       | 2,038           | 1,632    |
| Dividends received from available-for-sale investments             |       | 14              | 12       |
| Net cash inflow from investing activities                          |       | 29,450          | 13,648   |
| <b>Cash flows from financing activities</b>                        |       |                 |          |
| Dividends paid   |       | (9,942)         | (9,942)  |
| Interest paid for subordinated liabilities                         |       | (197)           | (63)     |
| Issue of subordinated liabilities                                  |       | 3,496           | 6,025    |
| Repayment of subordinated liabilities                              |       | (3,502)         | (4,516)  |
| Net cash outflow from financing activities                         |       | (10,145)        | (8,496)  |
| <b>Decrease in cash and cash equivalents</b>                       |       | <b>(272)</b>    | (24,946) |
| <b>Cash and cash equivalents at 1 January</b>                      |       | <b>118,560</b>  | 136,759  |
| Effect of foreign exchange rate changes                            |       | 2,181           | 6,747    |
| <b>Cash and cash equivalents at 31 December</b>                    | 53(b) | <b>120,469</b>  | 118,560  |

## NOTES TO THE FINANCIAL STATEMENTS

year ended 31 December 2011

(Figures expressed in millions of Hong Kong dollars unless otherwise indicated)

### 1. BASIS OF PREPARATION

**(a)** The consolidated financial statements comprise the statements of Hang Seng Bank Limited ("the Bank") and all its subsidiaries made up to 31 December. The consolidated financial statements include the attributable share of the results and reserves of associates, based on the financial statements made up to dates not earlier than three months prior to 31 December. All significant intra-group transactions have been eliminated on consolidation. The Bank and its subsidiaries and associates are collectively referred as "the Group".

**(b)** These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs"), which is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ("HKASs"), and interpretations ("Ints") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), accounting principles generally accepted in Hong Kong and the requirements of the Hong Kong Companies Ordinance. In addition, these financial statements comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. A summary of the principal accounting policies adopted by the Group is set out in note 4.

The HKICPA has issued certain amendments to HKFRSs and interpretations that are first effective or available for early adoption for the current accounting period of the Group. Note 5 provides information on the changes in accounting policies resulting from initial application of these developments to the extent that they are relevant to the Group for the current and prior accounting periods reflected in these financial statements.

**(c)** The measurement basis used in the preparation of the financial statements is historical cost except that the following assets and liabilities are stated at fair value as explained in the accounting policies set out below:

- financial instruments classified as trading, designated at fair value and available-for-sale (see note 4(g));
- derivative financial instruments (see note 4(h));
- investment property (see note 4(r));
- leasehold land and buildings held for own use, where the value of the land cannot be reliably separated from the value of the building at inception of the lease and the entire lease is therefore classified as a finance lease (see note 4(s)); and
- leasehold land and buildings held for own use, where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years (see note 4(s)).

**(d)** The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. The Group believes that the assumptions that have been made are appropriate and that the financial statements therefore present the financial position and results fairly, in all material respects.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and major sources of estimation uncertainty are discussed in note 6. Disclosures under HKFRS 4 "Insurance Contract" and HKFRS 7 "Financial Instrument: Disclosure" relating to the nature and extent of risks have been included in note 61 "Financial risk management".

## 2. NATURE OF BUSINESS

The Group is engaged primarily in the provision of banking and related financial services.

## 3. BASIS OF CONSOLIDATION

The consolidated financial statements cover the consolidated positions of Hang Seng Bank Limited and all its subsidiaries, unless otherwise stated, and include the attributable share of results and reserves of its associates. For regulatory reporting, the basis of consolidation is different from the basis of consolidation for accounting purposes. They are set out in notes 34, 54 and 61 to the financial statements.

## 4. PRINCIPAL ACCOUNTING POLICIES

### (a) Interest income and expense

Interest income and expense for all financial instruments are recognised in "Interest income" and "Interest expense" respectively in the income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instruments or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instrument but excluding future credit losses. The calculation includes all amounts paid or received by the Group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

For impaired loans, the accrual of interest income based on the original terms of the loan is discounted to arrive at the net present value of impaired loans. Subsequent increase of such net present value of impaired loans due to the passage of time is recognised as interest income.

### (b) Non-interest income

#### (i) Fee income

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

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue when the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and reported in "Interest income" (see note 4(a)).

#### (ii) Rental income from operating lease

Rental income received under an operating lease is recognised in "Other operating income" in equal instalments over the accounting periods covered by the lease term. Lease incentives granted are recognised in the income statement as an integral part of the aggregate net lease payments receivable. Contingent rentals receivable are recognised as income in the accounting period in which they are earned.

#### (iii) Dividend income

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



**4. PRINCIPAL ACCOUNTING POLICIES** (continued)**(b) Non-interest income** (continued)**(iv) Trading income**

Trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading and dividend income from equities held for trading. Gains or losses arising from changes in fair value of derivatives are recognised in "Trading income" to the extent as described in the accounting policy set out in notes 4(h) and 4(i). Gains and losses on foreign exchange trading and other transactions are also reported as "Trading income" except for those gains and losses on translation of foreign currencies recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve in accordance with the accounting policy set out in note 4(z).

**(v) Net income from financial instruments designated at fair value**

Net income from financial instruments designated at fair value comprises all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value and dividends arising on those financial instruments and the changes in fair value of the derivatives managed in conjunction with the financial assets and liabilities designated at fair value.

**(c) Segment reporting**

The Group's operating segments are determined to be customer group segment because the chief operating decision maker uses customer group information in order to make decisions about allocating resources and assessing performance.

**(d) Cash and cash equivalents**

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition. Cash and cash equivalents include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, and certificates of deposit.

**(e) Loans and advances to banks and customers**

Loans and advances to banks and customers include loans and advances originated or acquired by the Group, which have not been classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when borrowers repay their obligations, the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest rate method, less impairment allowances.

**(f) Loan impairment**

Losses for impaired loans are promptly recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are assessed either individually for individually significant loans or collectively for loan portfolios with similar credit risk characteristics.

**(i) Individually assessed loans**

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

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial restructuring; and
- a significant downgrading in credit rating by an external rating agency.

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (f) Loan impairment (continued)

##### (i) Individually assessed loans (continued)

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

- the Group's aggregate exposure to the borrower;
- the viability of the borrower's business model and capability to trade successfully out of financial difficulties and generate cash flow to service their debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the Group and the likelihood of other creditors continuing to support the borrower;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of collateral (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- where available, the secondary market price for the debt.

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

##### (ii) Collectively assessed loans

Impairment allowances are calculated on a collective basis for the following:

- to cover losses which have been incurred but have not yet been identified as loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

##### *Incurred but not yet identified impairment*

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses that the Group has incurred as a result of events occurring before the balance sheet date, which the Group is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identifies losses on individual loans within the Group, those loans are removed from the Group and assessed on an individual basis for impairment. The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan; and
- management's judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

##### *Homogeneous groups of loans*

Portfolios of small homogeneous loans are collectively assessed using roll rate or historical loss rate methodologies.

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (f) Loan impairment (continued)

###### (iii) Loan write-offs

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

###### (iv) Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in the income statement.

###### (v) Repossessed assets

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are reported under "Assets held for sale" if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and the sale is highly probable. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the income statement.

Financial assets acquired in exchange for loans are classified and reported in accordance with the relevant accounting policies.

###### (vi) Renegotiated loans

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

##### (g) Financial instruments

Other than loans and advances to banks and customers, the Group classifies its financial instruments into the following categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred.

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

Financial instruments and short positions thereof which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as held-for-trading. Trading liabilities also include customer deposits and certificates of deposit with embedded options or other derivatives, the market risk of which was managed in the trading book. Trading assets and liabilities are recognised initially at fair value with transaction costs taken to the income statement, and are subsequently remeasured at fair value. All subsequent gains and losses from changes in the fair value of these assets and liabilities, together with the related interest income and expense and dividends, are recognised in the income statement within "Trading income" as they arise. Upon disposal or repurchase, the difference between the net sale proceeds or the net payment and the carrying value is included in the income statement.

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (g) Financial instruments (continued)

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

A financial instrument is classified in this category if it meets any one of the criteria set out below, and is so designated by management. The Group may designate financial instruments at fair value where the designation:

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases.
- applies to a group of financial assets, financial liabilities or both that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel. Under this criterion, certain liabilities under investment contracts and financial assets held to meet liabilities under insurance and investment contracts are the main classes of financial instrument so designated.
- The Group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.

Financial assets and financial liabilities so designated are recognised initially at fair value, with transaction costs taken directly to the income statement, and are subsequently remeasured at fair value. This designation, once made, is irrevocable in respect of the financial instruments to which it is made. Gains and losses from changes in the fair value of such assets and liabilities and dividends are recognised in the income statement as they arise, within "Net income from financial instruments designated at fair value". Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with financial assets or financial liabilities designated at fair value are also included in "Net income from financial instruments designated at fair value".

##### (iii) Available-for-sale financial assets

Financial instruments intended to be held on a continuing basis are classified as available-for-sale, unless they are designated at fair value (see note 4(g)(ii)) or classified as held-to-maturity (see note 4(g)(iv)).

Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income and accumulated separately in equity in the "Available-for-sale investment reserve" until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses which are previously recognised in other comprehensive income shall be reclassified from equity to the income statement as "Gains less losses from financial investments and fixed assets".

##### (iv) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group has the positive intention and ability to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment allowances.



#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (h) Derivative financial instruments

Derivative financial instruments ("derivatives") are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

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

The method of recognising the resulting fair value gains or losses depends on whether the derivative is held for trading, or is designated as a hedging instrument, and if so, the nature of the risk being hedged.

##### (i) Hedge accounting

The Group designates certain derivatives as either (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ("fair value hedge"); (ii) hedges of highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ("cash flow hedge"). Hedge accounting is applied to derivatives designated as hedging instruments in fair value or cash flow hedge provided certain criteria are met.

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

##### (i) Fair value hedge

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

If the hedging relationship no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

##### (ii) Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualified as cash flow hedge are recognised in other comprehensive income and accumulated separately in equity. Any gain or loss relating to an ineffective portion is recognised immediately in the income statement within "Trading income".

For cash flow hedge of a recognised asset or liability, the associated cumulative gain or loss is reclassified from equity to the income statement in the same periods during which the hedged cash flow affect profit and loss.

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

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (i) Hedge accounting (continued)

##### (iii) Hedge effectiveness testing

In order to qualify for hedge accounting, the Group carries out prospective effectiveness testing to demonstrate that it expects the hedge to be highly effective at the inception of the hedge and throughout its life. Actual effectiveness (retrospective effectiveness) is also demonstrated on an ongoing basis.

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

For fair value hedge relationships, the Group utilises the cumulative dollar offset method or regression as effectiveness testing methodology. For cash flow hedge relationships, the Group utilises the change in variable cash flow method or capacity test or the cumulative dollar offset method using the hypothetical derivative approach.

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

##### (iv) Derivatives that do not qualify for hedge accounting

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

##### (j) Sale and repurchase agreements

Where securities are sold subject to commitment to repurchase them at a pre-determined price, they remain on the balance sheet and a liability is recorded in respect of the consideration received in "Deposits from banks" where the counterparty is a bank, or in "Current, savings and other deposit accounts" where the counterparty is a non-bank. Conversely, securities purchased under analogous commitments to resell are not recognised on the balance sheet and the consideration paid is recorded in "Placings with and advances to banks and other financial institutions" where the counterparty is a bank, or in "Advance to customers" where the counterparty is a non-bank. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

##### (k) Offsetting financial instruments

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

##### (l) Application of trade date accounting

Except for loans and advances and deposits, all financial assets, liabilities and instruments are accounted for on trade date basis.

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

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

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (n) Valuation of financial instruments

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

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the Group's valuation methodologies, which are described in Note 62.

##### (o) Subsidiaries

A subsidiary is a corporate entity in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half of the voting power or controls the composition of the board of directors, or a non-corporate entity the Group otherwise controls, directly or indirectly, by way of having the power to govern its financial and operating policies so that the Group obtains benefits from these activities. A subsidiary is fully consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. In the Bank's balance sheet, an investment in subsidiary is stated at cost less impairment allowances.

##### (p) Associates

An associate is an entity over which the Group or the Bank has the ability to significantly influence, but not control over its management, including participation in the financial and operating policy decision. An interest in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition, post tax results of the associate and any impairment losses for the year, whereas the Group's share of the post-acquisition post-tax items of the associate's other comprehensive income is recognised in the consolidated statement of comprehensive income.

Unrealised gains on transactions between the Group and its associate are eliminated to the extent of the Group's interest in the associate. Unrealised losses are also eliminated to the extent of the Group's interest in the associate unless the transaction provides evidence of an impairment of the asset transferred.

In the Bank's balance sheet, interest in associate is stated at cost less impairment allowances.

##### (q) Goodwill and intangible assets

(i) Goodwill arises on business combinations, including the acquisition of subsidiaries or associates when the cost of acquisition exceeds the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired and is reported in the consolidated balance sheet. Goodwill on acquisitions of associates is included in "Interest in associates". Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Goodwill is tested for impairment annually by comparing the recoverable amount from a cash-generating unit with the carrying value of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of, its fair value less cost to sell, and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less any accumulated impairment losses.

Any excess of the Group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business over the cost to acquire is recognised immediately in the income statement.

At the date of disposal of a business, attributable goodwill is included in the Group's share of net assets in the calculation of the gain or loss on disposal.

**4. PRINCIPAL ACCOUNTING POLICIES** (continued)**(q) Goodwill and intangible assets** (continued)

(ii) Intangible assets include the value of in-force long-term insurance business, acquired software licences and capitalised development costs of computer software programmes. The value of in-force long-term insurance business is stated at a valuation determined annually in consultation with actuaries using the methodology as described in note 4(ac). Computer software acquired is stated at cost less amortisation and impairment allowances. Amortisation of computer software is charged to the income statement over its useful life. Costs incurred in the development phase of a project to produce application software for internal use are capitalised and amortised over the software's estimated useful life, usually five years. A periodic review is performed on intangible assets to confirm that there has been no impairment.

**(r) Investment property**

Investment properties are land and/or buildings which are owned or held under a leasehold interest to earn rental income and/or for capital appreciation. Investment properties are stated in the balance sheet at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement. Fair values are determined by independent professional valuers, primarily on the basis of capitalisation of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation or, both, are classified and accounted for as investment property on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 4(u)).

**(s) Premises, plant and equipment**

(i) The following land and buildings held for own use are stated in the balance sheet at their revalued amount, being their fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses:

- leasehold land and buildings where the fair value of the land cannot be reliably separated from the value of the building at inception of the lease and the premises are not clearly held under an operating lease; and
- leasehold land and buildings where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years.

Revaluations are performed by professionally qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value at the balance sheet date. Surpluses arising on revaluation are credited firstly to the income statement to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same land and buildings, and are thereafter taken to other comprehensive income and are accumulated separately in the "Premises revaluation reserve". Deficits arising on revaluation, are firstly set off against any previous revaluation surpluses included in the "Premises revaluation reserve" in respect of the same land and building, and are thereafter recognised in the income statement.

Depreciation is calculated to write-off the valuation of the land and building over their estimated useful lives as follows:

- freehold land is not depreciated;
- leasehold land is depreciated over the unexpired terms of the leases; and
- buildings and improvements thereto are depreciated at the greater of 2 per cent per annum on the straight-line basis or over the unexpired terms of the leases.

On revaluation of the property, depreciation accumulated during the year will be eliminated. Depreciation charged on revaluation surplus of the properties is transferred from "Premises revaluation reserve" to "Retained profits".

On disposal of the property, the profit and loss is calculated as the difference between the net sales proceeds and the net carrying amount and recognised in the income statement. Surpluses relating to the property disposed of included in the "Premises revaluation reserve" are transferred as movements in reserves to "Retained profits".

(ii) Furniture, plant and other equipment, is stated at cost less depreciation calculated on the straight-line basis to write off the assets over their estimated useful lives, which are generally between 3 and 10 years. On disposal, the profit and loss is calculated as the difference between the net sales proceeds and the net carrying amount.

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



#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (t) Interest in leasehold land held for own use under operating lease

The Government of Hong Kong owns all the land in Hong Kong and permits its use under leasehold arrangements. Similar arrangements exist in mainland China. At inception of the lease, where the cost of land is known or can be reliably determined and the term of the lease is less than 50 years, the Group records its interest in leasehold land and land use rights separately as operating leases.

Where the cost of land is known or can be reliably determined and the term of the lease is not less than 50 years, the Group records its interest in leasehold land and land use rights as land and buildings held for own use.

Where the cost of the land is unknown or cannot be reliably determined, and the leasehold land and land use rights are not clearly held under an operating lease, they are accounted for as land and buildings held for own use.

##### (u) Finance and operating leases

Leases which transfer substantially all the risks and rewards of ownership to the lessees are classified as finance leases. Leases which do not transfer substantially all the risks and rewards of ownership to the lessees are classified as operating leases, with the exceptions of land and building held under a leasehold interest as set out in notes 4(r) & 4(s).

##### (i) Finance leases

Where the Group is a lessor under finance leases, an amount representing the net investment in the lease is included in the balance sheet as loans and advances to customers. Hire purchase contracts having the characteristics of a finance lease are accounted for in the same manner as finance leases. Impairment allowances are accounted for in accordance with the accounting policies set out in note 4(f).

Where the Group acquires the use of assets under finance leases, the amount representing the fair value of the leased asset, or, if lower, the present value of the minimum payments of such assets is included in fixed assets and the corresponding liabilities, net of finance charges, are recorded as obligations under finance leases. Depreciation is provided at rates which write off the cost or valuation of the assets over the term of the relevant lease or, where it is likely the Group will obtain ownership of the asset, the life of the asset, as set out in note 4(s). Impairment allowances are accounted for in accordance with the accounting policy as set out in note 4(v). Finance charges implicit in the lease payments are charged to the income statement over the period of the leases so as to produce an approximately constant periodic rate of charge on the remaining balance of the obligations for each accounting period. Contingent rentals are written off as an expense of the accounting period in which they are incurred.

##### (ii) Operating leases

Where the Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable. Rental revenue arising from operating lease is recognised in accordance with the Group's revenue recognition policies as set out in note 4(b)(iii).

##### (v) Impairment of assets

The carrying amount of the Group's assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, the carrying amount is reduced to the estimated recoverable amount by means of a charge to the income statement.

The accounting policies on impairment losses on loans and receivables and goodwill are set out in notes 4(f) and 4(q) respectively.

##### (i) Held-to-maturity investments

For held-to-maturity investments, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets) on an individual basis.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. The reversal of impairment is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years.

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (v) Impairment of assets (continued)

##### (ii) Available-for-sale financial assets

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

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

Impairment losses on available-for-sale debt securities are recognised within "Loan impairment charges" in the income statement and impairment losses on available-for-sale equity securities are recognised within "Gains less losses from financial investments and fixed assets" in the income statement.

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if there is objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income and accumulated separately in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value; and
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised in other comprehensive income and accumulated separately in equity. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, only to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

##### (iii) Other assets

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following types of assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

- premises and equipment (other than properties carried at revalued amounts);
- pre-paid interests in leasehold land classified as "Interest in leasehold land held for own use under operating lease";
- investments in subsidiaries and associates; and
- intangible assets.

If any such indication exists, the asset's recoverable amount is estimated and impairment losses recognised.

##### *Calculation of recoverable amount*

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the assets. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (v) Impairment of assets (continued)

###### (iii) Other assets (continued)

###### *Recognition of impairment losses*

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the cash-generating unit (or group of units) and then, to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

###### *Reversals of impairment losses*

In respect of assets other than goodwill, an impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount. An impairment loss in respect of goodwill is not reversed.

A reversal of impairment losses is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the year in which the reversals are recognised.

##### (w) Income tax

Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised in other comprehensive income or directly in equity, in which case the relevant amounts of tax are recognised in other comprehensive income or directly in equity, respectively. Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset.

Current tax is the expected tax payable on the taxable profits for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are settled on an individual taxable entity basis.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purpose and their tax bases. Deferred tax assets also arise from unused tax losses and unused tax credits.

Deferred tax liabilities are generally recognised for all taxable temporary differences. Deferred tax assets are recognised to the extent that it is probable that taxable profits will be available, against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates that are expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are not discounted. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to offset exists in the entity.

The carrying amount of deferred tax assets/liabilities is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the related tax benefit to be utilised.

##### (x) Employee benefits

(i) Salaries, annual bonuses, paid annual leave, leave passage and the cost to the Group of non-monetary benefits are accrued in the year in which the associated services are rendered by the employees. Provision is made in respect of paid leave entitlement accumulated during the year, which can be carried forward into future periods for compensated absence or payment in lieu if the employee leaves employment.

**4. PRINCIPAL ACCOUNTING POLICIES** (continued)**(x) Employee benefits** (continued)

(ii) The Group provides retirement benefits for staff members and operates defined benefit and defined contribution schemes and participates in mandatory provident fund schemes in accordance with the relevant laws and regulations.

The retirement benefit costs of defined benefit schemes charged to the income statement are determined by calculating the current service cost, interest cost and expected return on scheme assets in accordance with a set of actuarial assumptions. Any actuarial gains and losses are fully recognised in shareholders' equity and presented in the statement of changes in equity in the period in which they arise.

The Group's net obligation in respect of defined benefit schemes is calculated separately for each scheme by estimating the amount of future benefit that employees have earned in return for their service in the current and prior years; that benefit is discounted to determine the present value, and the fair value of any scheme assets is deducted. The discount rate is the yield at the balance sheet date on high quality corporate bonds that have maturity dates approximating the terms of the Group's obligation. The calculation is performed by a qualified actuary using the Projected Unit Credit Method.

Where the calculation of the Group's net obligation results in a negative amount, the asset recognised is limited to the present value of any future refunds from the scheme or reductions in future contributions to the scheme less past service cost.

The retirement benefit costs of defined contribution schemes and mandatory provident fund schemes are the contributions made in accordance with the relative scheme rules and are charged to the income statement of the year.

**(y) Share-based payments**

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to the "Other reserves". The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using market prices or appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition is satisfied, provided all other conditions are satisfied.

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

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

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



#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (z) Translation of foreign currencies

Foreign currency transactions during the year are translated at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated at the foreign exchange rates ruling at the balance sheet date. Exchange gains and losses are recognised in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated using the foreign exchange rates ruling at the dates the fair value was determined.

Exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of separate subsidiary financial statements. In the consolidated financial statements, these exchange differences are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve.

##### (aa) Provisions

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

##### (ab) Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of the loans or debt instruments.

Financial guarantee liabilities are initially recognised at their fair value, and the initial fair value is amortised over the life of the financial guarantee. The guarantee liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment (when a payment under the guarantee has become probable). Financial guarantees are included within other liabilities.

##### (ac) Insurance contracts

Through its insurance subsidiaries, the Group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the Group accepts significant insurance risk from another party, by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

A contract issued by the Group that transfers financial risk, without significant insurance risk, is classified as an investment contract, and is accounted for as a financial instrument. The financial assets held by the Group for the purpose of meeting liabilities under insurance and investment contracts are classified and accounted for based on their classifications as set out in notes 4(d) to 4(i).

Insurance contracts are accounted for as follows:

##### *Net earned insurance premiums*

Premiums for life insurance are accounted for when receivable, except in unit-linked business where premiums are accounted for when liabilities are recognised.

Gross insurance premiums for general insurance business are accounted for in the period in which the amount is determined, which is generally the period in which the risk commences. The proportion of premiums written in the accounting year relating to the period of risk after the balance sheet date is carried forward as a provision for unearned premium and is calculated on a daily pro rata basis.

Reinsurance premiums, netted by the reinsurers' share of provision for unearned premiums, are accounted for in the same accounting year as the premiums for the direct insurance to which they relate.

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (ac) Insurance contracts (continued)

###### *Claims and reinsurance recoveries*

Gross insurance claims for life insurance reflect the total cost of claims arising during the year, including policyholder cash dividend payment upon policy anniversary and payments of maturities, surrenders and death claims. The technical reserves for non-linked liabilities (long-term business provision) are calculated based on actuarial principles. The technical reserves for linked liabilities are at least the element of any surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices. Reinsurance recoveries are accounted for in the same period as the related claims.

Gross insurance claims for general insurance business include paid claims and movements in outstanding claims reserves. Full provision for outstanding claims is made for the estimated cost of all claims notified but not settled at the balance sheet date, and claims incurred but not reported by that date. Provision is also made for the estimated cost of servicing claims notified but not settled at the balance sheet date, reduced by estimates of salvage and subrogation recoveries, and to meet expenses on claims incurred but not reported. Reinsurance recoveries are assessed in a manner similar to the assessment of provision for outstanding claims.

###### *Deferred acquisition costs*

The deferred acquisition costs related to insurance contract, such as initial commission, are amortised over the period in which the related revenues are earned.

###### *Present value of in-force long-term insurance business*

A value is placed on insurance contracts that are classified as long-term insurance business and are in force at the balance sheet date is recognised as an asset.

The value of the in-force long-term insurance business, referred to as PVIF, is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as future mortality, lapse rates, levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. The calculation of the PVIF asset was refined during the year by incorporating the explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the discount rate. The valuation has also included explicit risk margins for non-economic risks in the projection assumptions, and explicit allowances for financial options and guarantees using stochastic methods. Risk discount rates are set on an active basis with reference to market risk free yields. Movements in the value of in-force long-term insurance business are included in other operating income on a pre-tax basis. The value of in-force long-term insurance business is reported under "Intangible assets" in the balance sheet.

##### (ad) Investment contracts

Customer liabilities under linked investment contracts are measured at fair value and reported under "Financial liabilities designated at fair value". The linked financial assets are measured at fair value and the movements in fair value are recognised in the income statement in "Net income from financial instruments designated at fair value". Deposits receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Investment management fee receivables are recognised in the income statement over the period of the provision of the investment management services.

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

Debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest rate method, and are reported under "Debt securities in issue" or "Subordinated liabilities", except for those issued for trading or designated at fair value, which are carried at fair value and reported under the "Trading liabilities" and "Financial liabilities designated at fair value" in the balance sheet.

##### (af) Assets held for sale

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use are classified as "Assets held for sale". Immediately before classification as Assets held for sale, the assets are remeasured in accordance with the Group's accounting policies set out elsewhere in note 4. Thereafter, generally the assets are measured at the lower of their carrying amount and fair value less cost to sell. Impairment losses on initial classification as Assets held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

#### 4. PRINCIPAL ACCOUNTING POLICIES (continued)

##### (ag) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are members of the same group. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or other entities which are under the significant influence of related parties of the Group and post employment benefit scheme. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and its holding companies, directly or indirectly, including any directors (whether executive or otherwise) and Executive Committee members of the Bank and its holding companies.

##### (ah) Dividends

Dividends proposed or declared after the balance sheet date are disclosed as a separate component of shareholders' equity.

#### 5. CHANGES IN ACCOUNTING POLICIES

The Group adopted a number of amendments to HKFRSs and interpretations which had insignificant or no effect on the consolidated financial statements. These are:

- Amendments to HKAS 32 "Financial Instruments: Presentation – Classification of Rights Issues";
- Amendment to Hong Kong (IFRIC) Interpretation 14 "HKAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction" – "Prepayments of a Minimum Funding Requirement";
- Hong Kong (IFRIC) Interpretation 19 "Extinguishing Financial Liabilities with Equity Instruments"; and
- Other amendments made under "Improvements to HKFRSs" in May 2010.

During the year, the Group adopted the following amendments to HKFRSs:

The Improvements to HKFRS 7 which the Group adopted are applied retrospectively and emphasise the interaction between quantitative and qualitative disclosures, and the nature and extent of risks associated with financial instruments. The new disclosures have been included in note 61(a)(ii) under "Financial Risk Management".

The Group also adopted the revised Hong Kong Accounting Standard 24, "Related Party Disclosures" ("the revised standard") which is effective for annual periods beginning on or after 1 January 2011 and with retrospective application. The revised standard clarifies the definition of a related party and upon adoption, transactions with associates of immediate and ultimate holding companies are identified as related party transactions with the Group. The prior year comparatives under "Associates" in note 60(a) have been adjusted accordingly:

##### (i) For the Group

| <i>Figures in HK\$m</i>  | As reported | Adjustment | Restated |
|--|-------------|------------|----------|
| Interest income  | 11          | 37         | 48       |
| Other operating income   | 1           | 5          | 6        |
| <b>Amounts due from:</b>   |             |            |          |
| Placings with and advances to banks and other financial institutions | 1,141       | 4,406      | 5,547    |

##### (ii) For the Bank

| <i>Figures in HK\$m</i>  | As reported | Adjustment | Restated |
|--|-------------|------------|----------|
| <b>Amounts due from:</b>   |             |            |          |
| Placings with and advances to banks and other financial institutions | 552         | 3,016      | 3,568    |

## 6. ACCOUNTING ESTIMATES AND JUDGEMENTS

Key sources of estimation uncertainty and critical judgements in applying the Group's accounting policies which have significant effect on the financial statements are set out below.

### (a) Key sources of estimation uncertainty

#### (i) Impairment allowances on loans and advances

The Group periodically reviews its loan portfolios to assess whether impairment allowances exist. In determining whether impairment allowances should be recorded in the income statement, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the Group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

#### (ii) Valuation of financial instruments

The Group's accounting policy for valuation of financial instruments is included in note 4(n) and is discussed further within note 62 "Fair value of financial instruments".

When fair values are determined by using valuation techniques which refer to observable market data because independent prices are not available, management will consider the following when applying a valuation model:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;
- an appropriate discount rate for the instrument. Management uses all relevant market information in determining the appropriate spread over the risk-free/benchmark rate used by market participants for the particular instrument; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivatives.

When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure, liquidity, credit rating and other market factors of the instrument with which the position held is being compared. When valuing instruments on a model basis using the fair value of underlying components, management also considers the need for adjustments to take into account of factors such as bid-offer spread, credit profile, model limitation and any other factors market participants would consider in the valuation of that instrument. These adjustments are based on defined policies which are applied consistently across the Group.

When unobservable market data have a significant impact on the valuation of derivatives, the entire initial change in fair value indicated by the valuation model is recognised on one of the following bases: over the life of the transaction on an appropriate basis; in the income statement when the inputs become observable; or when the transaction matures or is closed out.

Financial instruments measured at fair value through profit or loss comprise of financial instruments held for trading and financial instruments designated at fair value. Changes in their fair value directly impact the Group's income statement in the period in which they occur.

A change in the fair value of a financial asset which is classified as "available-for-sale" is recorded directly in equity until the financial asset is sold, when the cumulative change in fair value is charged or credited to the income statement. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in equity is reclassified from equity to the income statement, reducing the Group's operating profit.



## 6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

### (a) Key sources of estimation uncertainty (continued)

#### (iii) Insurance contracts

##### *Classification*

HKFRS 4 – Insurance Contracts (“HKFRS 4”) requires the Group to determine whether an insurance contract that transfers both insurance risk and financial risk is classified as an insurance contract, or as a financial instrument under HKAS 39, or whether the insurance and non-insurance elements of the contract should be accounted for separately. This process involves judgement and estimation of the amounts of different types of risks that are transferred or assumed under a contract. The estimation of such risks often involves the use of assumptions about future events and is thus subject to a degree of uncertainty.

##### *Present value of in-force long-term insurance business (“PVIF”)*

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in note 41(a). The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

##### *Insurance liabilities*

The estimation of insurance claims liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in note 61(d).

### (b) Critical accounting judgements in applying the Group’s accounting policies

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

For available-for-sale financial assets, a significant or prolonged decline in fair value below cost is considered to be objective evidence of impairment. Judgement is required when determining whether a decline in fair value has been significant or prolonged. In making this judgement, the historical data on market volatility as well as the price of the specific investment are taken into account. The Group also takes into account other factors, such as industry and sector performance and financial information regarding the issuer/investee.

#### (ii) Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity investments if the Group has the intention and ability to hold them until maturity. In evaluating whether the requirements to classify a financial asset as held-to-maturity are met, management makes significant judgements. Failure in correctly assessing the Group’s intention and ability to hold specific investments until maturity may result in reclassification of the whole portfolio as available-for-sale.

#### (iii) Income taxes

Determining income tax provisions involves judgement on the future tax treatment of certain transactions. The Group carefully evaluates tax implications of transactions and tax provisions are set up accordingly. The tax treatment of such transactions is reconsidered periodically to take into account all changes in tax legislations.

## 7. POSSIBLE IMPACT OF AMENDMENTS AND NEW STANDARDS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2011

The HKICPA has issued a number of amendments and new standards which are not yet effective for the year ended 31 December 2011 and which have not been adopted in the financial statements. Key changes are summarised as follows:

- Amendment to HKFRS 7 “Financial Instruments: Disclosures” issued in October 2010 which requires additional disclosures for risk exposures arising from transferred financial assets, will be effective for annual periods beginning on or after 1 July 2011, with early adoption permitted. No disclosures are required for prior periods.
- Amendment to HKAS 12 “Income Taxes” issued in December 2010 whereby deferred taxes on an investment property, carried under the fair value model in IAS 40, will be measured presuming that an investment property is recovered entirely through sale. The presumption is rebutted if the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The amendment will be effective for annual periods beginning on or after 1 January 2012 with early adoption permitted. The Group is currently assessing the impact of this new HKFRS and expected the balance of deferred tax liabilities on investment properties would be reduced.

## 7. POSSIBLE IMPACT OF AMENDMENTS AND NEW STANDARDS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2011 (continued)

- Amendment to HKAS 1 “Presentation of financial statements” issued in July 2011 which requires grouping of items presented in other comprehensive income on the basis of whether they are potentially reclassifiable to profit or loss subsequently, will be effective for annual periods beginning on or after 1 July 2012, with early adoption permitted.
- HKAS 28 (2011) “Investments in associates and joint ventures”, HKFRS 10 “Consolidated Financial Statements” (“HKFRS 10”), HKFRS 11 “Joint Arrangements” (“HKFRS 11”) and HKFRS 12 “Disclosure of Interests in Other Entities” (“HKFRS 12”) will be effective for annual periods beginning on or after 1 January 2013, with early adoption permitted.

Under HKFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal control or exposure to risks and rewards, depending on the nature of the entity. HKFRS 11 places more focus on rights and obligations than on legal form, and introduces the concept of a joint operation. It requires a joint venturer to recognise an investment and to account for that investment using the equity method in accordance with HKAS 28, unless the entity is exempted from applying the equity method as specified in that standard. HKFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities.

The Group is currently assessing the impact of these new HKFRSs but it is impracticable to quantify their effect as at the date of publication of these consolidated financial statements.

- HKFRS 13 “Fair Value Measurement” (“HKFRS 13”) will be effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of HKFRS 13 do not require comparative information to be provided for periods prior to initial application.

HKFRS 13 establishes a single source of guidance for all fair value measurements required or permitted by HKFRSs. The standard clarifies the definition of fair value as an exit price, which is defined as a price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions, and enhances disclosures about fair value measurement.

The Group is currently assessing the impact of this new HKFRS but it is impracticable to quantify its effect as at the date of publication of these consolidated financial statements.

- Amendments to HKAS 19 “Employee Benefits” (“HKAS 19 revised”) issued in July 2011 will be effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKAS 19 revised must be applied retrospectively.

The most significant amendment to HKAS 19 for the Group is the replacement of interest cost and expected return on plan assets by a finance cost component comprising the net interest on the net defined benefit liability or asset. This finance cost component is determined by applying the same discount rate used to measure the defined benefit obligation to the net defined benefit liability or asset. The difference between the actual return on plan assets and the return included in the finance cost component in the income statement will be presented in other comprehensive income. The effect of this change is to increase the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

Based on an initial estimate of the impact of this particular amendment on the 2011 consolidated financial statements, the change would decrease pre-tax profit, with no effect on the pension liability. The effect on total operating expenses and pre-tax profit is not expected to be material. The effect at the date of adoption will depend on market interest rates, rates of return and the actual mix of scheme assets at that time.

## 7. POSSIBLE IMPACT OF AMENDMENTS AND NEW STANDARDS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2011 (continued)

- Amendments to HKFRS 7 “Disclosures – Offsetting Financial Assets and Financial Liabilities” issued in December 2011 requires disclosures about the effect or potential effects of offsetting financial assets and financial liabilities and related arrangements on an entity’s financial position. The amendments are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendments are required to be applied retrospectively.
- Amendments to HKAS 32 “Offsetting Financial Assets and Financial Liabilities” issued in December 2011 clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32 “Financial Instruments: Presentation”. The amendments are effective for annual periods beginning on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively. The Group is currently assessing the impact of these clarifications but it is impracticable to quantify its effect as at the date of publication of these consolidated financial statements.
- HKFRS 9 “Financial Instruments” (“HKFRS 9”) was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. In December 2010, the HKICPA issued additions to HKFRS 9 dealing with financial liabilities. The main changes to the requirements of HKAS 39 are summarised below.

All financial assets are classified into two measurement categories: amortised cost or fair value on the basis of both an entity’s business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets. These two categories replace the four categories under the current HKAS 39 “Financial Instruments: Recognition and Measurement”.

Financial assets are measured at fair value through profit or loss, if they do not meet the criteria specified for measurement at amortised cost or if doing so significantly reduces or eliminates an accounting mismatch. An entity has the option to designate all subsequent changes in fair value of an equity instrument not held for trading at fair value through other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.

Financial assets which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under HKFRS 9.

HKFRS 9 retains all the existing requirements for derecognition of financial instruments and most of the requirements for financial liabilities, except that for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts, fair value changes attributable to changes in own credit risk are to be presented in the statement of other comprehensive income, and are not subsequently reclassified to income statement but may be transferred within equity.

HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2015 with earlier application permitted. In December 2011, the amendment to HKFRS 9 and HKFRS 7 issued by HKICPA provided relief from the requirement to restate prior period comparative information and required additional disclosures on transition from HKAS 39 to HKFRS 9. The Group is presently studying the implications of applying HKFRS 9 but it is impracticable to quantify its effect as at the date of publication of these consolidated financial statements.

## 8. INTEREST INCOME/INTEREST EXPENSE

### (a) Interest income

|   | 2011          | 2010   |
|---|---------------|--------|
| Interest income arising from:   |               |        |
| – financial assets that are not at fair value through profit and loss | <b>19,535</b> | 16,228 |
| – trading assets  | <b>251</b>    | 197    |
| – financial assets designated at fair value                           | <b>59</b>     | 82     |
|   | <b>19,845</b> | 16,507 |
| of which:   |               |        |
| – interest income from listed investments                             | <b>1,585</b>  | 1,436  |
| – interest income from unlisted investments                           | <b>3,387</b>  | 3,072  |
| – interest income from impaired financial assets                      | <b>18</b>     | 48     |

### (b) Interest expense

|  | 2011         | 2010  |
|--|--------------|-------|
| Interest expense arising from:   |              |       |
| – financial liabilities that are not at fair value through profit and loss | <b>3,010</b> | 1,769 |
| – trading liabilities  | <b>1,099</b> | 435   |
| – financial liabilities designated at fair value                           | <b>–</b>     | 3     |
|  | <b>4,109</b> | 2,207 |
| of which:  |              |       |
| – interest expense from debt securities in issue maturing after five years | <b>–</b>     | –     |
| – interest expense from customer accounts maturing after five years        | <b>–</b>     | –     |
| – interest expense from subordinated liabilities                           | <b>197</b>   | 63    |



## 9. NET FEE INCOME

|   | 2011         | 2010         |
|---|--------------|--------------|
| – stockbroking and related services   | 1,285        | 1,468        |
| – retail investment funds   | 905          | 1,039        |
| – structured investment products  | 13           | 19           |
| – insurance agency  | 242          | 256          |
| – account services  | 371          | 349          |
| – private banking service fee   | 129          | 160          |
| – remittances   | 273          | 259          |
| – cards   | 1,676        | 1,462        |
| – credit facilities   | 253          | 195          |
| – trade services  | 461          | 452          |
| – other   | 315          | 236          |
| Fee income  | 5,923        | 5,895        |
| Fee expense   | (1,087)      | (998)        |
|   | <b>4,836</b> | <b>4,897</b> |
| of which:   |              |              |
| Net fee income, other than amounts included in determining the effective interest rate,<br>arising from financial assets or financial liabilities that are not held for trading<br>nor designated at fair value | 1,967        | 1,810        |
| – fee income  | 2,761        | 2,452        |
| – fee expense   | (794)        | (642)        |
| Net fee income on trust and other fiduciary activities where the Group holds or<br>invests on behalf of its customers   | 685          | 773          |
| – fee income  | 823          | 973          |
| – fee expense   | (138)        | (200)        |

## 10. TRADING INCOME

|   | 2011         | 2010         |
|---|--------------|--------------|
| Foreign exchange                                      | 1,843        | 1,768        |
| (Losses)/gains from hedging activities:               |              |              |
| – fair value hedge                                    |              |              |
| – on hedging instruments                              | (603)        | (261)        |
| – on the hedged items attributable to the hedged risk | 538          | 272          |
| – cash flow hedge                                     |              |              |
| – net hedging income                                  | –            | –            |
| Securities, derivatives and other trading activities  | 18           | 280          |
|   | <b>1,796</b> | <b>2,059</b> |

## 11. NET (LOSS)/INCOME FROM FINANCIAL INSTRUMENTS DESIGNATED AT FAIR VALUE

|  | 2011  | 2010 |
|--|-------|------|
| Net (loss)/income on assets designated at fair value which back insurance and investment contracts | (160) | 297  |
| Net change in fair value of other financial instruments designated at fair value                   | -     | (15) |
|  | (160) | 282  |
| of which dividend income from:   |       |      |
| – listed investments   | 16    | 3    |
| – unlisted investments   | 1     | 1    |
|  | 17    | 4    |

## 12. DIVIDEND INCOME

|                        | 2011 | 2010 |
|------------------------|------|------|
| Dividend income:       |      |      |
| – listed investments   | 4    | 2    |
| – unlisted investments | 13   | 12   |
|                        | 17   | 14   |

## 13. NET EARNED INSURANCE PREMIUMS

|  | Non-life insurance | Life insurance (non-linked) | Life insurance (linked) | Total  |
|--|--------------------|-----------------------------|-------------------------|--------|
| <b>2011</b>  |                    |                             |                         |        |
| Gross written premiums                             | 456                | 10,802                      | 9                       | 11,267 |
| Movement in unearned premiums                      | (12)               | -                           | -                       | (12)   |
| Gross earned premiums                              | 444                | 10,802                      | 9                       | 11,255 |
| Gross written premiums ceded to reinsurers         | (107)              | (88)                        | -                       | (195)  |
| Reinsurers' share of movement in unearned premiums | 1                  | -                           | -                       | 1      |
| Reinsurers' share of gross earned premiums         | (106)              | (88)                        | -                       | (194)  |
| Net earned insurance premiums                      | 338                | 10,714                      | 9                       | 11,061 |
| <b>2010</b>  |                    |                             |                         |        |
| Gross written premiums                             | 466                | 11,031                      | 11                      | 11,508 |
| Movement in unearned premiums                      | (29)               | -                           | -                       | (29)   |
| Gross earned premiums                              | 437                | 11,031                      | 11                      | 11,479 |
| Gross written premiums ceded to reinsurers         | (122)              | (76)                        | -                       | (198)  |
| Reinsurers' share of movement in unearned premiums | 26                 | -                           | -                       | 26     |
| Reinsurers' share of gross earned premiums         | (96)               | (76)                        | -                       | (172)  |
| Net earned insurance premiums                      | 341                | 10,955                      | 11                      | 11,307 |

## 14. OTHER OPERATING INCOME

|  | 2011       | 2010         |
|--|------------|--------------|
| Rental income from investment properties                           | 174        | 155          |
| Movement in present value of in-force long-term insurance business | 595        | 1,126        |
| Other  | 152        | 277          |
|  | <b>921</b> | <b>1,558</b> |

## 15. NET INSURANCE CLAIMS INCURRED AND MOVEMENT IN POLICYHOLDERS' LIABILITIES

|   | Non-life insurance | Life insurance (non-linked) | Life insurance (linked) | Total         |
|---|--------------------|-----------------------------|-------------------------|---------------|
| <b>2011</b>   |                    |                             |                         |               |
| Claims, benefits and surrenders paid  | 109                | 3,533                       | 30                      | 3,672         |
| Movement in provisions  | 23                 | 8,040                       | (41)                    | 8,022         |
| Gross claims incurred and movement in policyholders' liabilities                | 132                | 11,573                      | (11)                    | 11,694        |
| Reinsurers' share of claims, benefits and surrenders paid                       | (28)               | (29)                        | –                       | (57)          |
| Reinsurers' share of movement in provisions                                     | (9)                | (18)                        | –                       | (27)          |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | (37)               | (47)                        | –                       | (84)          |
| Net insurance claims incurred and movement in policyholders' liabilities        | <b>95</b>          | <b>11,526</b>               | <b>(11)</b>             | <b>11,610</b> |
| <b>2010</b>   |                    |                             |                         |               |
| Claims, benefits and surrenders paid  | 113                | 2,402                       | 24                      | 2,539         |
| Movement in provisions  | 21                 | 10,085                      | 4                       | 10,110        |
| Gross claims incurred and movement in policyholders' liabilities                | 134                | 12,487                      | 28                      | 12,649        |
| Reinsurers' share of claims, benefits and surrenders paid                       | (26)               | (22)                        | –                       | (48)          |
| Reinsurers' share of movement in provisions                                     | –                  | (14)                        | –                       | (14)          |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | (26)               | (36)                        | –                       | (62)          |
| Net insurance claims incurred and movement in policyholders' liabilities        | <b>108</b>         | <b>12,451</b>               | <b>28</b>               | <b>12,587</b> |

## 16. LOAN IMPAIRMENT CHARGES

|                                       | Group |       | Bank  |       |
|---------------------------------------|-------|-------|-------|-------|
|                                       | 2011  | 2010  | 2011  | 2010  |
| Loan impairment charges (note 35(b)): |       |       |       |       |
| – individually assessed               | (103) | (186) | (163) | (97)  |
| – collectively assessed               | (337) | (204) | (322) | (185) |
|                                       | (440) | (390) | (485) | (282) |
| of which:                             |       |       |       |       |
| – new and additional                  | (740) | (609) | (662) | (475) |
| – releases                            | 222   | 157   | 112   | 142   |
| – recoveries                          | 78    | 62    | 65    | 51    |
|                                       | (440) | (390) | (485) | (282) |
| Other credit risk provisions          | –     | –     | –     | –     |
|                                       | (440) | (390) | (485) | (282) |

There was no impairment charge (2010: Nil) provided for available-for-sale debt securities by the Group and the Bank. There was also no impairment loss made in relation to held-to-maturity debt securities in 2011 (2010: Nil).

## 17. OPERATING EXPENSES

|  | 2011  | 2010  |
|--|-------|-------|
| Employee compensation and benefits:                          |       |       |
| – salaries and other costs*                                  | 3,566 | 3,448 |
| – retirement benefit costs                                   |       |       |
| – defined benefit scheme (note 58(a))                        | 230   | 191   |
| – defined contribution scheme (note 58(b))                   | 92    | 78    |
|  | 3,888 | 3,717 |
| General and administrative expenses:                         |       |       |
| – rental expenses  | 497   | 464   |
| – other premises and equipment                               | 959   | 902   |
| – marketing and advertising expenses                         | 559   | 470   |
| – other operating expenses                                   | 1,176 | 1,081 |
|  | 3,191 | 2,917 |
| Depreciation of business premises and equipment (note 40(a)) | 700   | 619   |
| Amortisation of intangible assets (note 41(c))               | 119   | 102   |
|  | 7,898 | 7,355 |
| * of which:  |       |       |
| share-based payments (note 59(e))                            | 88    | 100   |
| Cost efficiency ratio  | 35.0% | 33.7% |

Included in operating expenses are minimum lease payments under operating leases of HK\$526 million (2010: HK\$493 million).



**18. THE EMOLUMENTS OF THE FIVE HIGHEST PAID INDIVIDUALS****(a) The aggregate emoluments**

|   | <b>2011</b> | 2010<br>(restated) |
|---|-------------|--------------------|
| Salaries, allowances and benefits in kind | <b>20</b>   | 20                 |
| Retirement scheme contributions           | <b>2</b>    | 2                  |
| Variable bonuses                          | <b>27</b>   | 26                 |
|   | <b>49</b>   | 48                 |

**(b) The numbers of the five highest paid individuals whose emoluments fell within the following bands were:**

|                         | <b>2011<br/>Number of<br/>Individuals</b> | 2010<br>Number of<br>Individuals<br>(restated) |
|-------------------------|---|--|
| HK\$                    |   |  |
| 5,000,001 – 5,500,000   | <b>1</b>                                  | 2  |
| 5,500,001 – 6,000,000   | <b>1</b>                                  | –  |
| 6,500,001 – 7,000,000   | <b>–</b>                                  | 1  |
| 7,000,001 – 7,500,000   | <b>1</b>                                  | 1  |
| 8,000,001 – 8,500,000   | <b>1</b>                                  | –  |
| 22,000,001 – 22,500,000 | <b>1</b>                                  | –  |
| 23,000,001 – 23,500,000 | <b>–</b>                                  | 1  |
|                         | <b>5</b>                                  | 5  |

The basis of calculating the five highest paid individuals have been revised and details have been set out in note 19. The comparative figures for 2010 were restated to conform with current year presentation. The emoluments of the five highest paid individuals set out above include the emoluments of two (2010: two) Executive Directors and one Non-executive Director (2010: one). Their respective directors' emoluments are included in note 19.

## 19. DIRECTORS' EMOLUMENTS

The emoluments of the Directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance were:

|  | Variable bonus <sup>(5)</sup> |  |   |                             |                               |                       |                                     |
|--|-------------------------------|--|---|-----------------------------|-------------------------------|-----------------------|-------------------------------------|
|  | Fees<br>'000                  | Salaries,<br>allowances<br>and benefits<br>in kind<br>'000 | Pension and<br>Pension<br>contribution <sup>(4)</sup><br>'000 | Cash <sup>(6)</sup><br>'000 | Shares <sup>(6)</sup><br>'000 | Total<br>2011<br>'000 | Total<br>2010<br>'000<br>(restated) |
| <b>Executive Directors</b>   |                               |  |   |                             |                               |                       |                                     |
| Mrs Margaret Leung <sup>(2)</sup>  | –                             | 5,999  | 825   | 7,786                       | 7,786                         | 22,396                | 23,450                              |
| Mr Andrew H C Fung <sup>(2)</sup><br>(Appointed on 10 October 2011)  | –                             | 722  | 39  | 589                         | 1,110 <sup>(7)</sup>          | 2,460                 | –                                   |
| Mr William W C Leung <sup>(2)</sup><br>(Resigned on 20 August 2011)  | –                             | 2,353  | 287   | –                           | –                             | 2,640                 | 5,025                               |
| <b>Non-Executive Directors</b>   |                               |  |   |                             |                               |                       |                                     |
| Dr Raymond K F Ch'ien <sup>(3)</sup>   | 500                           | –  | –   | –                           | –                             | 500                   | 367                                 |
| Dr John C C Chan <sup>(3)</sup>  | 430                           | –  | –   | –                           | –                             | 430                   | 340                                 |
| Dr Marvin K T Cheung <sup>(3)</sup>  | 500                           | –  | –   | –                           | –                             | 500                   | 360                                 |
| Ms L Y Chiang <sup>(3)</sup>   | 340                           | –  | –   | –                           | –                             | 340                   | 93                                  |
| Mr Alexander A Flockhart <sup>(1)</sup><br>(Resignation took effect from<br>the close of business on 31 December 2010) | –                             | –  | –   | –                           | –                             | –                     | 280                                 |
| Ms Anita Y M Fung <sup>(1)</sup><br>(Appointed on 1 November 2011)   | 56                            | –  | –   | –                           | –                             | 56                    | –                                   |
| Dr Fred Zulu Hu <sup>(3)</sup><br>(Appointed on 30 May 2011)   | 227                           | –  | –   | –                           | –                             | 227                   | –                                   |
| Mr Jenkin Hui <sup>(3)</sup>   | 400                           | –  | –   | –                           | –                             | 400                   | 320                                 |
| Ms Sarah C Legg <sup>(1)</sup><br>(Appointed on 14 February 2011)  | 312                           | –  | –   | –                           | –                             | 312                   | –                                   |
| Dr Eric K C Li <sup>(3)</sup>  | 600                           | –  | –   | –                           | –                             | 600                   | 400                                 |
| Dr Vincent H S Lo  | 340                           | –  | –   | –                           | –                             | 340                   | 280                                 |
| Mr Iain J Mackay <sup>(1)</sup><br>(Resignation took effect from<br>the close of business on 31 December 2010)         | –                             | –  | –   | –                           | –                             | –                     | 280                                 |
| Mr Mark S Mccombe <sup>(1)</sup><br>(Appointed on 14 February 2011 and<br>resigned on 9 September 2011)                | 227                           | –  | –   | –                           | –                             | 227                   | –                                   |
| Mrs Dorothy K Y P Sit <sup>(2)</sup>   | –                             | 3,946  | 414   | 2,660                       | 1,140                         | 8,160                 | 7,455                               |
| Mr Richard Y S Tang <sup>(3)</sup>   | 623                           | –  | –   | –                           | –                             | 623                   | 478                                 |
| Mr Peter T S Wong <sup>(1)</sup>   | 340                           | –  | –   | –                           | –                             | 340                   | 280                                 |
| Mr Michael W K Wu <sup>(3)</sup>   | 340                           | –  | –   | –                           | –                             | 340                   | 93                                  |
| <b>Past Directors</b>  | –                             | –  | 2,206   | –                           | –                             | 2,206                 | 2,169                               |
|  | <b>5,235</b>                  | <b>13,020</b>  | <b>3,771</b>  | <b>11,035</b>               | <b>10,036</b>                 | <b>43,097</b>         | <b>41,670</b>                       |
| 2010 (restated)  | 3,571                         | 13,469   | 3,786   | 10,879                      | 9,965                         |                       |                                     |

### Notes:

- (1) Fees receivable as a Director of Hang Seng Bank Limited were surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy.
- (2) Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2011.
- (3) Independent Non-Executive Director.
- (4) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK\$2.2 million in 2011. The Bank made contributions during 2011 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.
- (5) The amount of bonus comprises the cash and the estimated purchase cost of the award of HSBC Holdings Restricted Share and Performance Share which is measured according to the Group's accounting policies for share-based payment as set out in note 4(y). Prior to 2011, the accrued bonus amount in respect of the cash portion was based on the amount paid during the year while the shares portion was based on the amortised amount of purchase cost of the awarded shares. In order to align with the Basel Committee's paper on "Pillar 3 Disclosure requirements for remunerations" issued in July 2011, the amount of bonus disclosed in 2011 have been revised which represented the amount of cash and the purchase cost of shares on accrual basis in respect of the Directors' services rendered in the year. The comparative figures for the year 2010 were also restated to conform with current year presentation. The bonus comprises the deferred and non-deferred bonus, details of which are also set out in the section of "remuneration of senior management and key personnel" under "Corporate Governance and Other Information". The details are also set out in note 59.
- (6) The bonus - cash portion payable to the above directors was on non-deferred basis except HK\$4.67 million (2010: HK\$4.64 million) payable to Mrs Margaret Leung which was on deferred basis. The bonus - share portion payable to the above directors was on deferred basis except HK\$3.11 million (2010: HK\$3.10 million) payable to Mrs Margaret Leung which was on non-deferred basis.
- (7) The amount represented the share payable to Mr Andrew H C Fung in 2011 and have not been pro-rata from the date of being appointed as Director of the Bank.

**20. AUDITORS' REMUNERATION**

|   | Group |      | Bank |      |
|---|-------|------|------|------|
|   | 2011  | 2010 | 2011 | 2010 |
| Statutory audit services                | 13    | 13   | 8    | 8    |
| Non-statutory audit services and others | 7     | 6    | 6    | 5    |
|   | 20    | 19   | 14   | 13   |

**21. GAINS LESS LOSSES FROM FINANCIAL INVESTMENTS AND FIXED ASSETS**

|  | 2011 | 2010 |
|--|------|------|
| Net gains from disposal of available-for-sale equity securities: |      |      |
| – reclassified from reserve                                      | 25   | 9    |
| – net gains arising in the year                                  | 17   | 1    |
|  | 42   | 10   |
| Net gains from disposal of available-for-sale debt securities    | 11   | 95   |
| Impairment of available-for-sale equity securities               | –    | –    |
| Gain on disposal of assets held for sale                         | –    | 12   |
| Losses on disposal of fixed assets                               | (3)  | (5)  |
|  | 50   | 112  |

There was no impairment losses or gains less losses on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost for 2011 and 2010.

**22. NET SURPLUS ON PROPERTY REVALUATION**

|  | 2011 | 2010 |
|--|------|------|
| Surplus of revaluation on investment properties (note 39(a)) | 982  | 474  |
| Surplus of revaluation on assets held for sale               | 8    | 10   |
| Reversal of revaluation deficit on premises (note 40(a))     | 2    | 3    |
|  | 992  | 487  |

## 23. TAX EXPENSE

### (a) Taxation in the consolidated income statement represents:

|  | 2011         | 2010  |
|--|--------------|-------|
| <b>Current tax – provision for Hong Kong profits tax</b> |              |       |
| Tax for the year   | 1,942        | 1,967 |
| Adjustment in respect of prior year                      | (14)         | (19)  |
|  | <b>1,928</b> | 1,948 |
| <b>Current tax – taxation outside Hong Kong</b>          |              |       |
| Tax for the year   | 76           | 38    |
| <b>Deferred tax</b> (note 49(b))                         |              |       |
| Origination and reversal of temporary differences        | 529          | 442   |
| <b>Total tax expense</b>                                 | <b>2,533</b> | 2,428 |

The current tax provision is based on the estimated assessable profit for 2011, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2010: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

### (b) Reconciliation between taxation charge and accounting profit at applicable tax rates:

|  | 2011         | 2010   |
|--|--------------|--------|
| Profit before tax  | 19,213       | 17,345 |
| Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2010: 16.5%) | 3,170        | 2,862  |
| Tax effect of:   |              |        |
| – different tax rates in other countries/areas   | (290)        | (172)  |
| – non-taxable income and non-deductible expenses   | (34)         | (41)   |
| – share of results of associates   | (658)        | (439)  |
| – others   | 345          | 218    |
| Actual charge for taxation   | <b>2,533</b> | 2,428  |

## 24. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to shareholders, HK\$14,145 million (2010: HK\$10,914 million) has been dealt with in the financial statements of the Bank.

Reconciliation of the above amount to the Bank's profit for the year:

|  | 2011          | 2010   |
|--|---------------|--------|
| Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements | 14,145        | 10,914 |
| Dividends declared during the year by subsidiaries from retained profits                                 | 82            | 565    |
| The Bank's profit for the year   | <b>14,227</b> | 11,479 |



## 25. EARNINGS PER SHARE

The calculation of earnings per share for 2011 is based on earnings of HK\$16,680 million (HK\$14,917 million in 2010) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2010).

## 26. DIVIDENDS PER SHARE

### (a) Dividends attributable to the year:

|                | 2011              |              | 2010              |              |
|----------------|-------------------|--------------|-------------------|--------------|
|                | per share<br>HK\$ | HK\$ million | per share<br>HK\$ | HK\$ million |
| First interim  | 1.10              | 2,103        | 1.10              | 2,103        |
| Second interim | 1.10              | 2,103        | 1.10              | 2,103        |
| Third interim  | 1.10              | 2,103        | 1.10              | 2,103        |
| Fourth interim | 1.90              | 3,633        | 1.90              | 3,633        |
|                | 5.20              | 9,942        | 5.20              | 9,942        |

The fourth interim dividend proposed after the balance sheet date has not been recognised as a liability at the balance sheet date.

### (b) Dividends attributable to the previous year, approved and paid during the year:

|  | 2011  | 2010  |
|--|-------|-------|
| Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK\$1.90 per share (2010: HK\$1.90 per share) | 3,633 | 3,633 |

## 27. SEGMENTAL ANALYSIS

The Group's business comprises five customer groups. To be consistent with the way in which information is reported internally for the purposes of resource allocation and performance assessment, the Group identified the following five reportable segments.

Retail Banking and Wealth Management provides banking (including deposits, credit cards, mortgages and other retail lending) and wealth management services (including private banking, investment and insurance) to personal customers. Commercial Banking manages middle market and smaller corporate relationships and specialises in trade-related financial services. Corporate Banking handles relationships with large corporate and institutional customers. Treasury engages in balance sheet management. Treasury also manages the funding and liquidity positions of the Group and other market risk positions arising from banking activities. "Other" mainly represents management of shareholders' funds and investments in premises, investment properties and equity shares.

### (a) Segment result

For the purpose of segmental analysis, the allocation of revenue reflects the benefits of capital and other funding resources allocated to the customer groups by way of internal capital allocation and fund transfer-pricing mechanisms. Cost allocation is based on the direct costs incurred by the respective customer groups and apportionment of management overheads. Rental charges at market rates for usage of premises are reflected in other operating income for the "Other" customer group and total operating expenses for the respective customer groups.

## 27. SEGMENTAL ANALYSIS (continued)

## (a) Segment result (continued)

|   | Retail<br>Banking<br>and Wealth<br>Management | Commercial<br>Banking | Corporate<br>Banking | Treasury     | Other        | Total<br>reportable<br>segments | Inter-<br>segment<br>elimination | Total         |
|---|---|-----------------------|----------------------|--------------|--------------|---------------------------------|----------------------------------|---------------|
| <b>2011</b>   |   |                       |                      |              |              |                                 |                                  |               |
| Net interest income   | 8,150   | 3,400                 | 1,998                | 2,108        | 80           | 15,736                          | -                                | 15,736        |
| Net fee income/(expense)  | 3,298   | 1,210                 | 219                  | (34)         | 143          | 4,836                           | -                                | 4,836         |
| Trading income/(loss)   | 351   | 530                   | 13                   | 1,001        | (99)         | 1,796                           | -                                | 1,796         |
| Net loss from financial<br>instruments designated at fair value             | (158)   | (1)                   | -                    | (1)          | -            | (160)                           | -                                | (160)         |
| Dividend income   | -   | 7                     | -                    | -            | 10           | 17                              | -                                | 17            |
| Net earned insurance premiums   | 10,820  | 239                   | 2                    | -            | -            | 11,061                          | -                                | 11,061        |
| Other operating income/(loss)   | 719   | 18                    | (1)                  | -            | 679          | 1,415                           | (494)                            | 921           |
| <b>Total operating income</b>   | <b>23,180</b>                                 | <b>5,403</b>          | <b>2,231</b>         | <b>3,074</b> | <b>813</b>   | <b>34,701</b>                   | <b>(494)</b>                     | <b>34,207</b> |
| Net insurance claims incurred and<br>movement in policyholders' liabilities | (11,487)                                      | (122)                 | (1)                  | -            | -            | (11,610)                        | -                                | (11,610)      |
| <b>Net operating income before<br/>loan impairment charges</b>              | <b>11,693</b>                                 | <b>5,281</b>          | <b>2,230</b>         | <b>3,074</b> | <b>813</b>   | <b>23,091</b>                   | <b>(494)</b>                     | <b>22,597</b> |
| Loan impairment (charges)/releases  | (254)   | (233)                 | 46                   | 1            | -            | (440)                           | -                                | (440)         |
| <b>Net operating income</b>   | <b>11,439</b>                                 | <b>5,048</b>          | <b>2,276</b>         | <b>3,075</b> | <b>813</b>   | <b>22,651</b>                   | <b>(494)</b>                     | <b>22,157</b> |
| Operating expenses*   | (5,177)                                       | (1,836)               | (436)                | (346)        | (597)        | (8,392)                         | 494                              | (7,898)       |
| Impairment loss on intangible assets  | (75)  | (3)                   | -                    | -            | -            | (78)                            | -                                | (78)          |
| <b>Operating profit</b>   | <b>6,187</b>                                  | <b>3,209</b>          | <b>1,840</b>         | <b>2,729</b> | <b>216</b>   | <b>14,181</b>                   | <b>-</b>                         | <b>14,181</b> |
| Gains less losses from<br>financial investments and fixed assets            | 20  | 11                    | 3                    | 12           | 4            | 50                              | -                                | 50            |
| Net surplus on property revaluation   | -   | -                     | -                    | -            | 992          | 992                             | -                                | 992           |
| Share of profits from associates  | 416   | 1,811                 | -                    | 1,486        | 277          | 3,990                           | -                                | 3,990         |
| <b>Profit before tax</b>  | <b>6,623</b>                                  | <b>5,031</b>          | <b>1,843</b>         | <b>4,227</b> | <b>1,489</b> | <b>19,213</b>                   | <b>-</b>                         | <b>19,213</b> |
| Share of profit before tax  | 34.5%   | 26.2%                 | 9.6%                 | 22.0%        | 7.7%         | 100.0%                          | -                                | 100.0%        |
| Operating profit excluding loan impairment charges                          | 6,441   | 3,442                 | 1,794                | 2,728        | 216          | 14,621                          | -                                | 14,621        |
| * Depreciation/amortisation included<br>in operating expenses               | (155)   | (31)                  | (5)                  | (5)          | (623)        | (819)                           | -                                | (819)         |
| Total assets  | 274,294                                       | 185,350               | 143,734              | 329,295      | 42,772       | 975,445                         | -                                | 975,445       |
| Total liabilities   | 596,593                                       | 149,416               | 64,736               | 51,897       | 34,048       | 896,690                         | -                                | 896,690       |
| Interest in associates  | 2,115   | 8,185                 | -                    | 6,441        | 2,666        | 19,407                          | -                                | 19,407        |
| Non-current assets incurred during the year                                 | 160   | 49                    | 5                    | 4            | 204          | 422                             | -                                | 422           |

## 27. SEGMENTAL ANALYSIS (continued)

## (a) Segment result (continued)

|   | Retail<br>Banking<br>and Wealth<br>Management | Commercial<br>Banking | Corporate<br>Banking | Treasury | Other  | Total<br>reportable<br>segments | Inter-<br>segment<br>elimination | Total    |
|---|---|-----------------------|----------------------|----------|--------|---------------------------------|----------------------------------|----------|
| 2010  |   |                       |                      |          |        |                                 |                                  |          |
| Net interest income   | 8,485   | 2,709                 | 1,440                | 1,403    | 263    | 14,300                          | –                                | 14,300   |
| Net fee income/(expense)  | 3,423   | 1,209                 | 188                  | (29)     | 106    | 4,897                           | –                                | 4,897    |
| Trading income/(loss)   | 630   | 334                   | 11                   | 1,162    | (78)   | 2,059                           | –                                | 2,059    |
| Net income/(loss) from financial<br>instruments designated at fair value    | 297   | –                     | –                    | (1)      | (14)   | 282                             | –                                | 282      |
| Dividend income   | –   | 5                     | –                    | –        | 9      | 14                              | –                                | 14       |
| Net earned insurance premiums   | 11,059  | 246                   | 2                    | –        | –      | 11,307                          | –                                | 11,307   |
| Other operating income/(loss)   | 1,271   | 23                    | 1                    | (1)      | 712    | 2,006                           | (448)                            | 1,558    |
| <b>Total operating income</b>   | 25,165  | 4,526                 | 1,642                | 2,534    | 998    | 34,865                          | (448)                            | 34,417   |
| Net insurance claims incurred and<br>movement in policyholders' liabilities | (12,436)                                      | (152)                 | 1                    | –        | –      | (12,587)                        | –                                | (12,587) |
| <b>Net operating income before<br/>loan impairment charges</b>              | 12,729  | 4,374                 | 1,643                | 2,534    | 998    | 22,278                          | (448)                            | 21,830   |
| Loan impairment charges   | (209)   | (178)                 | (3)                  | –        | –      | (390)                           | –                                | (390)    |
| <b>Net operating income</b>   | 12,520  | 4,196                 | 1,640                | 2,534    | 998    | 21,888                          | (448)                            | 21,440   |
| Total operating expenses*   | (4,864)                                       | (1,703)               | (379)                | (327)    | (530)  | (7,803)                         | 448                              | (7,355)  |
| <b>Operating profit</b>   | 7,656   | 2,493                 | 1,261                | 2,207    | 468    | 14,085                          | –                                | 14,085   |
| Gains less losses from<br>financial investments and fixed assets            | –   | –                     | 5                    | 95       | 12     | 112                             | –                                | 112      |
| Net surplus on property revaluation   | –   | –                     | –                    | –        | 487    | 487                             | –                                | 487      |
| Share of profits from associates  | 216   | 1,255                 | –                    | 1,059    | 131    | 2,661                           | –                                | 2,661    |
| <b>Profit before tax</b>  | 7,872   | 3,748                 | 1,266                | 3,361    | 1,098  | 17,345                          | –                                | 17,345   |
| Share of profit before tax  | 45.4%   | 21.6%                 | 7.3%                 | 19.4%    | 6.3%   | 100.0%                          | –                                | 100.0%   |
| Operating profit excluding loan impairment charges                          | 7,865   | 2,671                 | 1,264                | 2,207    | 468    | 14,475                          | –                                | 14,475   |
| * Depreciation/amortisation included<br>in total operating expenses         | (175)   | (34)                  | (5)                  | (4)      | (503)  | (721)                           | –                                | (721)    |
| Total assets  | 264,827                                       | 180,013               | 130,148              | 304,898  | 37,025 | 916,911                         | –                                | 916,911  |
| Total liabilities   | 581,118                                       | 141,518               | 50,862               | 39,268   | 34,133 | 846,899                         | –                                | 846,899  |
| Interest in associates  | 1,384   | 6,197                 | –                    | 5,626    | 2,459  | 15,666                          | –                                | 15,666   |
| Non-current assets incurred during the year                                 | 128   | 39                    | 5                    | 4        | 739    | 915                             | –                                | 915      |

**27. SEGMENTAL ANALYSIS** (continued)**(b) Geographic Information**

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

|   | 2011           |            | 2010           |            |
|---|----------------|------------|----------------|------------|
|   |                | %          |                | %          |
| <b>Total operating income</b>                 |                |            |                |            |
| – Hong Kong                                   | 31,106         | 91         | 32,124         | 93         |
| – Americas                                    | 1,339          | 4          | 1,047          | 3          |
| – Mainland and others                         | 1,762          | 5          | 1,246          | 4          |
|   | <b>34,207</b>  | <b>100</b> | <b>34,417</b>  | <b>100</b> |
| <b>Profit before tax</b>                      |                |            |                |            |
| – Hong Kong                                   | 13,629         | 71         | 13,722         | 79         |
| – Americas                                    | 1,307          | 7          | 996            | 6          |
| – Mainland and others                         | 4,277          | 22         | 2,627          | 15         |
|   | <b>19,213</b>  | <b>100</b> | <b>17,345</b>  | <b>100</b> |
| <b>Total assets</b>                           |                |            |                |            |
| – Hong Kong                                   | 789,988        | 81         | 752,206        | 82         |
| – Americas                                    | 58,506         | 6          | 68,216         | 7          |
| – Mainland and others                         | 126,951        | 13         | 96,489         | 11         |
|   | <b>975,445</b> | <b>100</b> | <b>916,911</b> | <b>100</b> |
| <b>Total liabilities</b>                      |                |            |                |            |
| – Hong Kong                                   | 818,966        | 91         | 786,304        | 93         |
| – Americas                                    | 1,085          | –          | 1,187          | –          |
| – Mainland and others                         | 76,639         | 9          | 59,408         | 7          |
|   | <b>896,690</b> | <b>100</b> | <b>846,899</b> | <b>100</b> |
| <b>Interest in associates</b>                 |                |            |                |            |
| – Hong Kong                                   | 1,198          | 6          | 989            | 6          |
| – Americas                                    | –              | –          | –              | –          |
| – Mainland and others                         | 18,209         | 94         | 14,677         | 94         |
|   | <b>19,407</b>  | <b>100</b> | <b>15,666</b>  | <b>100</b> |
| <b>Non-current assets*</b>                    |                |            |                |            |
| – Hong Kong                                   | 27,258         | 96         | 22,262         | 96         |
| – Americas                                    | –              | –          | –              | –          |
| – Mainland and others                         | 1,001          | 4          | 944            | 4          |
|   | <b>28,259</b>  | <b>100</b> | <b>23,206</b>  | <b>100</b> |
| <b>Contingent liabilities and commitments</b> |                |            |                |            |
| – Hong Kong                                   | 246,655        | 83         | 223,659        | 83         |
| – Americas                                    | –              | –          | –              | –          |
| – Mainland and others                         | 50,076         | 17         | 44,589         | 17         |
|   | <b>296,731</b> | <b>100</b> | <b>268,248</b> | <b>100</b> |

\* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

## 28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY

The maturity analysis is based on the remaining contractual maturity at the balance sheet date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

### Group

|  | Repayable<br>on<br>demand | One month<br>or less<br>but not<br>on demand | Over one<br>month but<br>within three<br>months | Over three<br>months but<br>within<br>one year | Over<br>one year<br>but within<br>five years | Over five<br>years | Trading | No<br>contractual<br>maturity | Total   |
|--|---------------------------|--|---|--|--|--------------------|---------|-------------------------------|---------|
| <b>2011</b>  |                           |  |   |  |  |                    |         |                               |         |
| <b>Assets</b>  |                           |  |   |  |  |                    |         |                               |         |
| Cash and balances with banks and other financial institutions        | 39,533                    | -  | -   | -  | -  | -                  | -       | -                             | 39,533  |
| Placings with and advances to banks and other financial institutions | 9,089                     | 47,699                                       | 43,686  | 5,639  | -  | 1,629              | -       | -                             | 107,742 |
| Trading assets   | -                         | -  | -   | -  | -  | -                  | 64,171  | -                             | 64,171  |
| Financial assets designated at fair value                            | -                         | 140  | 82  | 116  | 3,615  | 49                 | -       | 4,094                         | 8,096   |
| Derivative financial instruments                                     | -                         | 7  | 13  | 72   | 87   | -                  | 4,531   | -                             | 4,710   |
| Advances to customers  | 11,131                    | 39,239                                       | 43,024  | 89,609   | 164,318                                      | 133,253            | -       | -                             | 480,574 |
| Financial investments:   |                           |  |   |  |  |                    |         |                               |         |
| - available-for-sale investments                                     | -                         | 10,940                                       | 19,648  | 68,426   | 47,510                                       | 1,621              | -       | 1,134                         | 149,279 |
| - held-to-maturity debt securities                                   | -                         | 668  | 1,083   | 2,529  | 21,736                                       | 33,895             | -       | -                             | 59,911  |
| Interest in associates   | -                         | -  | -   | -  | -  | -                  | -       | 19,407                        | 19,407  |
| Investment properties  | -                         | -  | -   | -  | -  | -                  | -       | 4,314                         | 4,314   |
| Premises, plant and equipment  | -                         | -  | -   | -  | -  | -                  | -       | 17,983                        | 17,983  |
| Intangible assets  | -                         | -  | -   | -  | -  | -                  | -       | 5,962                         | 5,962   |
| Other assets   | 5,185                     | 3,231  | 3,234   | 1,616  | 124  | 19                 | -       | 354                           | 13,763  |
|  | 64,938                    | 101,924                                      | 110,770   | 168,007  | 237,390                                      | 170,466            | 68,702  | 53,248                        | 975,445 |
| <b>Liabilities</b>   |                           |  |   |  |  |                    |         |                               |         |
| Current, savings and other deposit accounts                          | 503,537                   | 93,809                                       | 69,086  | 32,401   | 1,024  | -                  | -       | -                             | 699,857 |
| Deposits from banks  | 2,072                     | 8,941  | 2,374   | 617  | -  | -                  | -       | -                             | 14,004  |
| Trading liabilities  | -                         | -  | -   | -  | -  | -                  | 59,712  | -                             | 59,712  |
| Financial liabilities designated at fair value                       | 1                         | -  | -   | -  | -  | 433                | -       | -                             | 434     |
| Derivative financial instruments                                     | -                         | 22   | 4   | 65   | 1,046  | 203                | 3,508   | -                             | 4,848   |
| Certificates of deposit and other debt securities in issue:          |                           |  |   |  |  |                    |         |                               |         |
| - certificates of deposit in issue                                   | -                         | 1,596  | -   | 1,475  | 6,213  | -                  | -       | -                             | 9,284   |
| Other liabilities  | 6,629                     | 4,205  | 3,343   | 1,817  | 64   | 19                 | -       | 4,061                         | 20,138  |
| Liabilities to customers under insurance contracts                   | -                         | -  | -   | -  | -  | -                  | -       | 72,225                        | 72,225  |
| Current tax liabilities  | -                         | -  | -   | 305  | -  | -                  | -       | -                             | 305     |
| Deferred tax liabilities   | -                         | -  | -   | -  | -  | -                  | -       | 4,037                         | 4,037   |
| Subordinated liabilities   | -                         | -  | -   | 2,328  | -  | 9,518              | -       | -                             | 11,846  |
|  | 512,239                   | 108,573                                      | 74,807  | 39,008   | 8,347  | 10,173             | 63,220  | 80,323                        | 896,690 |
| of which:  |                           |  |   |  |  |                    |         |                               |         |
| Certificates of deposit included in:                                 |                           |  |   |  |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -  | -  | -                  | 432     | -                             | 432     |
| - financial assets designated at fair value                          | -                         | -  | -   | -  | 1  | -                  | -       | -                             | 1       |
| - available-for-sale investments                                     | -                         | 2,650  | 1,538   | 926  | 853  | -                  | -       | 39                            | 6,006   |
| - held-to-maturity debt securities                                   | -                         | -  | 6   | 429  | 673  | 2,272              | -       | -                             | 3,380   |
|  | -                         | 2,650  | 1,544   | 1,355  | 1,527  | 2,272              | 432     | 39                            | 9,819   |
| Debt securities included in:   |                           |  |   |  |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -  | -  | -                  | 63,226  | -                             | 63,226  |
| - financial assets designated at fair value                          | -                         | 140  | 82  | 116  | 3,613  | 49                 | -       | (2)                           | 3,998   |
| - available-for-sale investments                                     | -                         | 8,290  | 18,110  | 67,500   | 46,657                                       | 1,621              | -       | 836                           | 143,014 |
| - held-to-maturity debt securities                                   | -                         | 668  | 1,077   | 2,100  | 21,063                                       | 31,623             | -       | -                             | 56,531  |
|  | -                         | 9,098  | 19,269  | 69,716   | 71,333                                       | 33,293             | 63,226  | 834                           | 266,769 |
| Certificates of deposit in issue included in:                        |                           |  |   |  |  |                    |         |                               |         |
| - trading liabilities  | -                         | -  | -   | -  | -  | -                  | 2,641   | -                             | 2,641   |
| - financial liabilities designated at fair value                     | -                         | -  | -   | -  | -  | -                  | -       | -                             | -       |
| - issue at amortised cost  | -                         | 1,596  | -   | 1,475  | 6,213  | -                  | -       | -                             | 9,284   |
|  | -                         | 1,596  | -   | 1,475  | 6,213  | -                  | 2,641   | -                             | 11,925  |



## 28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY (continued)

Group

|  | Repayable<br>on<br>demand | One month<br>or less<br>but not<br>on demand | Over one<br>month but<br>within three<br>months | Over three<br>months but<br>within one year | Over<br>one year<br>but within<br>five years | Over five<br>years | Trading | No<br>contractual<br>maturity | Total   |
|--|---------------------------|--|---|---|--|--------------------|---------|-------------------------------|---------|
| 2010   |                           |  |   |   |  |                    |         |                               |         |
| <b>Assets</b>  |                           |  |   |   |  |                    |         |                               |         |
| Cash and balances with banks and other financial institutions        | 44,411                    | -  | -   | -   | -  | -                  | -       | -                             | 44,411  |
| Placings with and advances to banks and other financial institutions | 4,730                     | 51,706                                       | 48,475  | 5,185                                       | -  | 468                | -       | -                             | 110,564 |
| Trading assets   | -                         | -  | -   | -   | -  | -                  | 26,055  | -                             | 26,055  |
| Financial assets designated at fair value                            | -                         | 50   | 7   | 384   | 3,951  | 48                 | -       | 2,674                         | 7,114   |
| Derivative financial instruments                                     | -                         | 20   | 74  | 113   | 288  | 16                 | 5,082   | -                             | 5,593   |
| Advances to customers  | 10,198                    | 65,179                                       | 34,733  | 71,444                                      | 151,430                                      | 139,653            | -       | -                             | 472,637 |
| Financial investments:   |                           |  |   |   |  |                    |         |                               |         |
| - available-for-sale investments                                     | -                         | 8,957  | 12,112  | 56,453                                      | 63,465                                       | 1,216              | -       | 855                           | 143,058 |
| - held-to-maturity debt securities                                   | -                         | 226  | 521   | 2,936                                       | 21,101                                       | 31,517             | -       | -                             | 56,301  |
| Interest in associates   | -                         | -  | -   | -   | -  | -                  | -       | 15,666                        | 15,666  |
| Investment properties  | -                         | -  | -   | -   | -  | -                  | -       | 3,251                         | 3,251   |
| Premises, plant and equipment  | -                         | -  | -   | -   | -  | -                  | -       | 14,561                        | 14,561  |
| Intangible assets  | -                         | -  | -   | -   | -  | -                  | -       | 5,394                         | 5,394   |
| Other assets   | 4,980                     | 2,765  | 2,390   | 1,708                                       | 74   | 18                 | -       | 371                           | 12,306  |
|  | 64,319                    | 128,903                                      | 98,312  | 138,223                                     | 240,309                                      | 172,936            | 31,137  | 42,772                        | 916,911 |
| <b>Liabilities</b>   |                           |  |   |   |  |                    |         |                               |         |
| Current, savings and other deposit accounts                          | 536,363                   | 78,218                                       | 37,862  | 29,611                                      | 1,574  | -                  | -       | -                             | 683,628 |
| Deposits from banks  | 6,387                     | 7,688  | 1,394   | -   | 117  | -                  | -       | -                             | 15,586  |
| Trading liabilities  | -                         | -  | -   | -   | -  | -                  | 42,581  | -                             | 42,581  |
| Financial liabilities designated at fair value                       | 2                         | -  | -   | -   | -  | 455                | -       | -                             | 457     |
| Derivative financial instruments                                     | -                         | -  | -   | 99  | 819  | 56                 | 3,709   | -                             | 4,683   |
| Certificates of deposit and other debt securities in issue:          |                           |  |   |   |  |                    |         |                               |         |
| - certificates of deposit in issue                                   | -                         | 96   | 447   | 112   | 2,440  | -                  | -       | -                             | 3,095   |
| Other liabilities  | 6,954                     | 3,293  | 2,597   | 1,598                                       | 97   | 25                 | -       | 2,454                         | 17,018  |
| Liabilities to customers under insurance contracts                   | -                         | -  | -   | -   | -  | -                  | -       | 64,425                        | 64,425  |
| Current tax liabilities  | -                         | -  | -   | 344   | -  | -                  | -       | -                             | 344     |
| Deferred tax liabilities   | -                         | -  | -   | -   | -  | -                  | -       | 3,234                         | 3,234   |
| Subordinated liabilities   | -                         | -  | -   | 3,495                                       | 2,328  | 6,025              | -       | -                             | 11,848  |
|  | 549,706                   | 89,295                                       | 42,300  | 35,259                                      | 7,375  | 6,561              | 46,290  | 70,113                        | 846,899 |
| of which:  |                           |  |   |   |  |                    |         |                               |         |
| Certificates of deposit included in:                                 |                           |  |   |   |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -   | -  | -                  | 18      | -                             | 18      |
| - financial assets designated at fair value                          | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
| - available-for-sale investments                                     | -                         | 120  | 700   | 1,813                                       | 1,246  | -                  | -       | 43                            | 3,922   |
| - held-to-maturity debt securities                                   | -                         | 20   | 79  | 259   | 861  | 1,572              | -       | -                             | 2,791   |
|  | -                         | 140  | 779   | 2,072                                       | 2,107  | 1,572              | 18      | 43                            | 6,731   |
| Debt securities included in:   |                           |  |   |   |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -   | -  | -                  | 25,305  | -                             | 25,305  |
| - financial assets designated at fair value                          | -                         | 50   | 7   | 384   | 3,951  | 48                 | -       | -                             | 4,440   |
| - available-for-sale investments                                     | -                         | 8,837  | 11,412  | 54,640                                      | 62,219                                       | 1,216              | -       | 486                           | 138,810 |
| - held-to-maturity debt securities                                   | -                         | 206  | 442   | 2,677                                       | 20,240                                       | 29,945             | -       | -                             | 53,510  |
|  | -                         | 9,093  | 11,861  | 57,701                                      | 86,410                                       | 31,209             | 25,305  | 486                           | 222,065 |
| Certificates of deposit in issue included in:                        |                           |  |   |   |  |                    |         |                               |         |
| - trading liabilities  | -                         | -  | -   | -   | -  | -                  | 26      | -                             | 26      |
| - financial liabilities designated at fair value                     | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
| - issue at amortised cost  | -                         | 96   | 447   | 112   | 2,440  | -                  | -       | -                             | 3,095   |
|  | -                         | 96   | 447   | 112   | 2,440  | -                  | 26      | -                             | 3,121   |

## 28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY (continued)

## Bank

|  | Repayable<br>on<br>demand | One month<br>or less<br>but not<br>on demand | Over one<br>month but<br>within three<br>months | Over three<br>months but<br>within one year | Over<br>one year<br>but within<br>five years | Over five<br>years | Trading | No<br>contractual<br>maturity | Total   |
|--|---------------------------|--|---|---|--|--------------------|---------|-------------------------------|---------|
| <b>2011</b>  |                           |  |   |   |  |                    |         |                               |         |
| <b>Assets</b>  |                           |  |   |   |  |                    |         |                               |         |
| Cash and balances with banks and other financial institutions        | 36,475                    | -  | -   | -   | -  | -                  | -       | -                             | 36,475  |
| Placings with and advances to banks and other financial institutions | 5,429                     | 19,521                                       | 20,877  | 1,897                                       | -  | -                  | -       | -                             | 47,724  |
| Trading assets   | -                         | -  | -   | -   | -  | -                  | 60,526  | -                             | 60,526  |
| Financial assets designated at fair value                            | -                         | 140  | -   | -   | -  | -                  | -       | -                             | 140     |
| Derivative financial instruments                                     | -                         | 7  | 13  | 28  | 20   | -                  | 4,368   | -                             | 4,436   |
| Advances to customers  | 11,156                    | 33,675                                       | 33,991  | 78,447                                      | 144,295                                      | 124,065            | -       | -                             | 425,629 |
| Amounts due from subsidiaries  | 57,743                    | 2,469  | 10,655  | 8,133                                       | 6,222  | -                  | -       | -                             | 85,222  |
| Financial investments:   |                           |  |   |   |  |                    |         |                               |         |
| - available-for-sale investments                                     | -                         | 9,307  | 14,809  | 55,856                                      | 23,108                                       | 1,621              | -       | 441                           | 105,142 |
| Investments in subsidiaries  | -                         | -  | -   | -   | -  | -                  | -       | 14,434                        | 14,434  |
| Interest in associates   | -                         | -  | -   | -   | -  | -                  | -       | 5,172                         | 5,172   |
| Investment properties  | -                         | -  | -   | -   | -  | -                  | -       | 2,806                         | 2,806   |
| Premises, plant and equipment  | -                         | -  | -   | -   | -  | -                  | -       | 13,249                        | 13,249  |
| Intangible assets  | -                         | -  | -   | -   | -  | -                  | -       | 408                           | 408     |
| Other assets   | 4,433                     | 2,820  | 1,470   | 365   | 50   | -                  | -       | 44                            | 9,182   |
|  | 115,236                   | 67,939                                       | 81,815  | 144,726                                     | 173,695                                      | 125,686            | 64,894  | 36,554                        | 810,545 |
| <b>Liabilities</b>   |                           |  |   |   |  |                    |         |                               |         |
| Current, savings and other deposit accounts                          | 489,880                   | 90,583                                       | 60,669  | 19,425                                      | 455  | -                  | -       | -                             | 661,012 |
| Deposits from banks  | 2,065                     | 7,007  | 2,300   | 617   | -  | -                  | -       | -                             | 11,989  |
| Trading liabilities  | -                         | -  | -   | -   | -  | -                  | 36,077  | -                             | 36,077  |
| Derivative financial instruments                                     | -                         | 22   | -   | 27  | 530  | 203                | 3,320   | -                             | 4,102   |
| Certificates of deposit and other debt securities in issue:          |                           |  |   |   |  |                    |         |                               |         |
| - certificates of deposit in issue                                   | -                         | 1,596  | -   | 1,475                                       | 6,213  | -                  | -       | -                             | 9,284   |
| Amounts due to subsidiaries  | 6,143                     | 4,629  | 22  | 3   | -  | -                  | -       | -                             | 10,797  |
| Other liabilities  | 6,019                     | 4,214  | 1,936   | 847   | 8  | 19                 | -       | 3,917                         | 16,960  |
| Current tax liabilities  | -                         | -  | -   | 270   | -  | -                  | -       | -                             | 270     |
| Deferred tax liabilities   | -                         | -  | -   | -   | -  | -                  | -       | 1,801                         | 1,801   |
| Subordinated liabilities   | -                         | -  | -   | 2,328                                       | -  | 9,518              | -       | -                             | 11,846  |
|  | 504,107                   | 108,051                                      | 64,927  | 24,992                                      | 7,206  | 9,740              | 39,397  | 5,718                         | 764,138 |
| of which:  |                           |  |   |   |  |                    |         |                               |         |
| Certificates of deposit included in:                                 |                           |  |   |   |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -   | -  | -                  | 432     | -                             | 432     |
| - financial assets designated at fair value                          | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
| - available-for-sale investments                                     | -                         | 2,650  | 1,538   | 926   | 853  | -                  | -       | 39                            | 6,006   |
| - held-to-maturity debt securities                                   | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
|  | -                         | 2,650  | 1,538   | 926   | 853  | -                  | 432     | 39                            | 6,438   |
| Debt securities included in:   |                           |  |   |   |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -   | -  | -                  | 59,581  | -                             | 59,581  |
| - financial assets designated at fair value                          | -                         | 140  | -   | -   | -  | -                  | -       | -                             | 140     |
| - available-for-sale investments                                     | -                         | 6,657  | 13,271  | 54,930                                      | 22,255                                       | 1,621              | -       | 340                           | 99,074  |
| - held-to-maturity debt securities                                   | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
|  | -                         | 6,797  | 13,271  | 54,930                                      | 22,255                                       | 1,621              | 59,581  | 340                           | 158,795 |
| Certificates of deposit in issue included in:                        |                           |  |   |   |  |                    |         |                               |         |
| - trading liabilities  | -                         | -  | -   | -   | -  | -                  | 2,641   | -                             | 2,641   |
| - financial liabilities designated at fair value                     | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
| - issue at amortised cost  | -                         | 1,596  | -   | 1,475                                       | 6,213  | -                  | -       | -                             | 9,284   |
|  | -                         | 1,596  | -   | 1,475                                       | 6,213  | -                  | 2,641   | -                             | 11,925  |

## 28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY (continued)

Bank

|  | Repayable<br>on<br>demand | One month<br>or less<br>but not<br>on demand | Over one<br>month but<br>within three<br>months | Over three<br>months but<br>within one year | Over<br>one year<br>but within<br>five years | Over five<br>years | Trading | No<br>contractual<br>maturity | Total   |
|--|---------------------------|--|---|---|--|--------------------|---------|-------------------------------|---------|
| 2010   |                           |  |   |   |  |                    |         |                               |         |
| <b>Assets</b>  |                           |  |   |   |  |                    |         |                               |         |
| Cash and balances with banks and other financial institutions        | 41,062                    | -  | -   | -   | -  | -                  | -       | -                             | 41,062  |
| Placings with and advances to banks and other financial institutions | 2,120                     | 16,999                                       | 28,875  | 4,137                                       | -  | -                  | -       | -                             | 52,131  |
| Trading assets   | -                         | -  | -   | -   | -  | -                  | 25,232  | -                             | 25,232  |
| Financial assets designated at fair value                            | -                         | -  | -   | -   | 148  | -                  | -       | -                             | 148     |
| Derivative financial instruments                                     | -                         | 19   | 72  | 92  | 55   | 16                 | 4,772   | -                             | 5,026   |
| Advances to customers  | 10,187                    | 61,578                                       | 25,706  | 62,337                                      | 134,127                                      | 129,139            | -       | -                             | 423,074 |
| Amounts due from subsidiaries  | 66,716                    | 1,577  | 13,028  | 6,494                                       | 5,630  | -                  | -       | -                             | 93,445  |
| Financial investments:   |                           |  |   |   |  |                    |         |                               |         |
| - available-for-sale investments                                     | -                         | 7,321  | 6,918   | 47,381                                      | 39,857                                       | 1,047              | -       | 582                           | 103,106 |
| Investments in subsidiaries  | -                         | -  | -   | -   | -  | -                  | -       | 11,584                        | 11,584  |
| Interest in associates   | -                         | -  | -   | -   | -  | -                  | -       | 5,172                         | 5,172   |
| Investment properties  | -                         | -  | -   | -   | -  | -                  | -       | 2,100                         | 2,100   |
| Premises, plant and equipment  | -                         | -  | -   | -   | -  | -                  | -       | 10,588                        | 10,588  |
| Intangible assets  | -                         | -  | -   | -   | -  | -                  | -       | 442                           | 442     |
| Other assets   | 4,652                     | 2,176  | 1,298   | 538   | 17   | -                  | -       | 106                           | 8,787   |
|  | 124,737                   | 89,670                                       | 75,897  | 120,979                                     | 179,834                                      | 130,202            | 30,004  | 30,574                        | 781,897 |
| <b>Liabilities</b>   |                           |  |   |   |  |                    |         |                               |         |
| Current, savings and other deposit accounts                          | 526,103                   | 73,458                                       | 32,405  | 16,145                                      | 1,033  | -                  | -       | -                             | 649,144 |
| Deposits from banks  | 6,386                     | 7,688  | 1,394   | -   | 117  | -                  | -       | -                             | 15,585  |
| Trading liabilities  | -                         | -  | -   | -   | -  | -                  | 30,106  | -                             | 30,106  |
| Derivative financial instruments                                     | -                         | -  | -   | 95  | 587  | 44                 | 3,802   | -                             | 4,528   |
| Certificates of deposit and other debt securities in issue:          |                           |  |   |   |  |                    |         |                               |         |
| - certificates of deposit in issue                                   | -                         | 96   | 447   | 112   | 2,440  | -                  | -       | -                             | 3,095   |
| Amounts due to subsidiaries  | 4,222                     | 4,337  | 338   | 2   | -  | -                  | -       | -                             | 8,899   |
| Other liabilities  | 6,704                     | 2,912  | 1,739   | 805   | 26   | 18                 | -       | 3,230                         | 15,434  |
| Current tax liabilities  | -                         | -  | -   | 320   | -  | -                  | -       | -                             | 320     |
| Deferred tax liabilities   | -                         | -  | -   | -   | -  | -                  | -       | 1,617                         | 1,617   |
| Subordinated liabilities   | -                         | -  | -   | 3,495                                       | 2,328  | 6,025              | -       | -                             | 11,848  |
|  | 543,415                   | 88,491                                       | 36,323  | 20,974                                      | 6,531  | 6,087              | 33,908  | 4,847                         | 740,576 |
| of which:  |                           |  |   |   |  |                    |         |                               |         |
| Certificates of deposit included in:                                 |                           |  |   |   |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -   | -  | -                  | 18      | -                             | 18      |
| - financial assets designated at fair value                          | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
| - available-for-sale investments                                     | -                         | 120  | 75  | 1,444                                       | 1,246  | -                  | -       | 43                            | 2,928   |
| - held-to-maturity debt securities                                   | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
|  | -                         | 120  | 75  | 1,444                                       | 1,246  | -                  | 18      | 43                            | 2,946   |
| Debt securities included in:   |                           |  |   |   |  |                    |         |                               |         |
| - trading assets   | -                         | -  | -   | -   | -  | -                  | 24,482  | -                             | 24,482  |
| - financial assets designated at fair value                          | -                         | -  | -   | -   | 148  | -                  | -       | -                             | 148     |
| - available-for-sale investments                                     | -                         | 7,201  | 6,843   | 45,937                                      | 38,611                                       | 1,047              | -       | 418                           | 100,057 |
| - held-to-maturity debt securities                                   | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
|  | -                         | 7,201  | 6,843   | 45,937                                      | 38,759                                       | 1,047              | 24,482  | 418                           | 124,687 |
| Certificates of deposit in issue included in:                        |                           |  |   |   |  |                    |         |                               |         |
| - trading liabilities  | -                         | -  | -   | -   | -  | -                  | 26      | -                             | 26      |
| - financial liabilities designated at fair value                     | -                         | -  | -   | -   | -  | -                  | -       | -                             | -       |
| - issue at amortised cost  | -                         | 96   | 447   | 112   | 2,440  | -                  | -       | -                             | 3,095   |
|  | -                         | 96   | 447   | 112   | 2,440  | -                  | 26      | -                             | 3,121   |

The tables below set out the Group's classification of financial assets and liabilities:

|  | <b>Group</b>   |                                     |   |                              |                                  |                                     |                |
|--|----------------|-------------------------------------|---|------------------------------|----------------------------------|-------------------------------------|----------------|
|  | <b>Trading</b> | <b>Designated<br/>at fair value</b> | <b>Available-<br/>for-sale/<br/>hedging</b> | <b>Held-to-<br/>maturity</b> | <b>Loans and<br/>receivables</b> | <b>Other<br/>amortised<br/>cost</b> | <b>Total</b>   |
| <b>2011</b>  |                |                                     |   |                              |                                  |                                     |                |
| Cash and balances with banks and other financial institutions        | -              | -                                   | -   | -                            | -                                | 39,533                              | 39,533         |
| Placings with and advances to banks and other financial institutions | -              | -                                   | -   | -                            | 107,742                          | -                                   | 107,742        |
| Derivative financial instruments                                     | 4,531          | -                                   | 179   | -                            | -                                | -                                   | 4,710          |
| Advances to customers  | -              | -                                   | -   | -                            | 480,574                          | -                                   | 480,574        |
| Investment securities  | 63,665         | 8,096                               | 149,279                                     | 59,911                       | -                                | -                                   | 280,951        |
| Acceptances and endorsements   | -              | -                                   | -   | -                            | -                                | 4,697                               | 4,697          |
| Other financial assets   | 506            | -                                   | -   | -                            | -                                | 8,638                               | 9,144          |
| Total financial assets   | 68,702         | 8,096                               | 149,458                                     | 59,911                       | 588,316                          | 52,868                              | 927,351        |
| Non-financial assets   |                |                                     |   |                              |                                  |                                     | 48,094         |
| <b>Total assets</b>  |                |                                     |   |                              |                                  |                                     | <b>975,445</b> |
| Current, savings and other deposit accounts                          | 30,923         | -                                   | -   | -                            | -                                | 699,857                             | 730,780        |
| Deposits from banks  | -              | -                                   | -   | -                            | -                                | 14,004                              | 14,004         |
| Derivative financial instruments                                     | 3,505          | 3                                   | 1,340                                       | -                            | -                                | -                                   | 4,848          |
| Certificates of deposit and other debt securities in issue           | 3,183          | -                                   | -   | -                            | -                                | 9,284                               | 12,467         |
| Other financial liabilities  | 25,606         | -                                   | -   | -                            | -                                | 11,290                              | 36,896         |
| Subordinated liabilities   | -              | -                                   | -   | -                            | -                                | 11,846                              | 11,846         |
| Liabilities to customers under investment contracts                  | -              | 434                                 | -   | -                            | -                                | -                                   | 434            |
| Acceptances and endorsements   | -              | -                                   | -   | -                            | -                                | 4,697                               | 4,697          |
| Total financial liabilities  | 63,217         | 437                                 | 1,340                                       | -                            | -                                | 750,978                             | 815,972        |
| Non-financial liabilities  |                |                                     |   |                              |                                  |                                     | 80,718         |
| <b>Total liabilities</b>   |                |                                     |   |                              |                                  |                                     | <b>896,690</b> |

## 29. ACCOUNTING CLASSIFICATIONS (continued)

[illegible]



## 29. ACCOUNTING CLASSIFICATIONS (continued)

|   | Bank    |                             |                                    |                      |                          |                            |         |
|---|---------|-----------------------------|------------------------------------|----------------------|--------------------------|----------------------------|---------|
|   | Trading | Designated<br>at fair value | Available-<br>for-sale/<br>hedging | Held-to-<br>maturity | Loans and<br>receivables | Other<br>amortised<br>cost | Total   |
| <b>2011</b>   |         |                             |                                    |                      |                          |                            |         |
| Cash and balances with banks and<br>other financial institutions        | -       | -                           | -                                  | -                    | -                        | 36,475                     | 36,475  |
| Placings with and advances to banks<br>and other financial institutions | -       | -                           | -                                  | -                    | 47,724                   | -                          | 47,724  |
| Derivative financial instruments  | 4,368   | -                           | 68                                 | -                    | -                        | -                          | 4,436   |
| Advances to customers   | -       | -                           | -                                  | -                    | 425,629                  | -                          | 425,629 |
| Investment securities   | 60,020  | 140                         | 105,142                            | -                    | -                        | -                          | 165,302 |
| Amounts due from subsidiaries   | -       | -                           | -                                  | -                    | -                        | 85,222                     | 85,222  |
| Acceptances and endorsements  | -       | -                           | -                                  | -                    | -                        | 3,052                      | 3,052   |
| Other financial assets  | 506     | -                           | -                                  | -                    | -                        | 5,971                      | 6,477   |
| Total financial assets  | 64,894  | 140                         | 105,210                            | -                    | 473,353                  | 130,720                    | 774,317 |
| Non-financial assets  |         |                             |                                    |                      |                          |                            | 36,228  |
| <b>Total assets</b>   |         |                             |                                    |                      |                          |                            | 810,545 |
| Current, savings and<br>other deposit accounts                          | 7,288   | -                           | -                                  | -                    | -                        | 661,012                    | 668,300 |
| Deposits from banks   | -       | -                           | -                                  | -                    | -                        | 11,989                     | 11,989  |
| Derivative financial instruments  | 3,317   | 3                           | 782                                | -                    | -                        | -                          | 4,102   |
| Certificates of deposit and<br>other debt securities in issue           | 3,183   | -                           | -                                  | -                    | -                        | 9,284                      | 12,467  |
| Amounts due to subsidiaries   | -       | -                           | -                                  | -                    | -                        | 10,797                     | 10,797  |
| Other financial liabilities   | 25,606  | -                           | -                                  | -                    | -                        | 10,845                     | 36,451  |
| Subordinated liabilities  | -       | -                           | -                                  | -                    | -                        | 11,846                     | 11,846  |
| Acceptances and endorsements  | -       | -                           | -                                  | -                    | -                        | 3,052                      | 3,052   |
| Total financial liabilities   | 39,394  | 3                           | 782                                | -                    | -                        | 718,825                    | 759,004 |
| Non-financial liabilities   |         |                             |                                    |                      |                          |                            | 5,134   |
| <b>Total liabilities</b>  |         |                             |                                    |                      |                          |                            | 764,138 |

## 29. ACCOUNTING CLASSIFICATIONS (continued)

[illegible]

**30. CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS**

|  | Group         |        | Bank          |        |
|--|---------------|--------|---------------|--------|
|  | 2011          | 2010   | 2011          | 2010   |
| Cash in hand   | <b>9,491</b>  | 6,101  | <b>9,247</b>  | 5,857  |
| Balances with central banks                          | <b>7,102</b>  | 6,591  | <b>5,027</b>  | 4,250  |
| Balances with banks and other financial institutions | <b>22,940</b> | 31,719 | <b>22,201</b> | 30,955 |
|  | <b>39,533</b> | 44,411 | <b>36,475</b> | 41,062 |

**31. PLACINGS WITH AND ADVANCES TO BANKS AND OTHER FINANCIAL INSTITUTIONS**

|  | Group          |         | Bank          |        |
|--|----------------|---------|---------------|--------|
|  | 2011           | 2010    | 2011          | 2010   |
| Placings with and advances to banks and other financial institutions maturing within one month                       | <b>56,787</b>  | 56,437  | <b>24,950</b> | 19,119 |
| Placings with and advances to banks and other financial institutions maturing after one month but less than one year | <b>49,326</b>  | 53,659  | <b>22,774</b> | 33,012 |
| Placings with and advances to banks and other financial institutions maturing after one year                         | <b>1,629</b>   | 468     | <b>-</b>      | -      |
|  | <b>107,742</b> | 110,564 | <b>47,724</b> | 52,131 |

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2011 by the Group and the Bank (2010: Nil).

## 32. TRADING ASSETS

|   | Group         |               | Bank          |               |
|---|---------------|---------------|---------------|---------------|
|   | 2011          | 2010          | 2011          | 2010          |
| Treasury bills                          | 54,220        | 20,204        | 54,220        | 20,204        |
| Certificates of deposit                 | 432           | 18            | 432           | 18            |
| Other debt securities                   | 9,006         | 5,101         | 5,361         | 4,278         |
| Debt securities                         | 63,658        | 25,323        | 60,013        | 24,500        |
| Equity shares                           | 7             | 8             | 7             | 8             |
| <b>Total trading securities</b>         | <b>63,665</b> | <b>25,331</b> | <b>60,020</b> | <b>24,508</b> |
| Other*                                  | 506           | 724           | 506           | 724           |
| <b>Total trading assets</b>             | <b>64,171</b> | <b>26,055</b> | <b>60,526</b> | <b>25,232</b> |
| <b>Debt securities:</b>                 |               |               |               |               |
| – listed in Hong Kong                   | 4,550         | 3,876         | 4,550         | 3,876         |
| – listed outside Hong Kong              | 717           | 170           | 717           | 170           |
|   | 5,267         | 4,046         | 5,267         | 4,046         |
| – unlisted                              | 58,391        | 21,277        | 54,746        | 20,454        |
|   | 63,658        | 25,323        | 60,013        | 24,500        |
| <b>Equity shares:</b>                   |               |               |               |               |
| – listed in Hong Kong                   | 7             | 8             | 7             | 8             |
| – unlisted                              | –             | –             | –             | –             |
|   | 7             | 8             | 7             | 8             |
| <b>Total trading securities</b>         | <b>63,665</b> | <b>25,331</b> | <b>60,020</b> | <b>24,508</b> |
| <b>Debt securities:</b>                 |               |               |               |               |
| Issued by public bodies:                |               |               |               |               |
| – central governments and central banks | 60,800        | 24,905        | 59,365        | 24,129        |
| – other public sector entities          | 82            | 101           | 82            | 101           |
|   | 60,882        | 25,006        | 59,447        | 24,230        |
| Issued by other bodies:                 |               |               |               |               |
| – banks                                 | 963           | 149           | 438           | 102           |
| – corporate entities                    | 1,813         | 168           | 128           | 168           |
|   | 2,776         | 317           | 566           | 270           |
|   | 63,658        | 25,323        | 60,013        | 24,500        |
| <b>Equity shares:</b>                   |               |               |               |               |
| Issued by corporate entities            | 7             | 8             | 7             | 8             |
| <b>Total trading securities</b>         | <b>63,665</b> | <b>25,331</b> | <b>60,020</b> | <b>24,508</b> |

\* This represents amount receivable from counterparties on trading transactions not yet settled.

## 33. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

|   | Group |       | Bank |      |
|---|-------|-------|------|------|
|   | 2011  | 2010  | 2011 | 2010 |
| Certificates of deposit                 | 1     | –     | –    | –    |
| Other debt securities                   | 3,998 | 4,440 | 140  | 148  |
| Debt securities                         | 3,999 | 4,440 | 140  | 148  |
| Equity shares                           | 473   | 583   | –    | –    |
| Investment funds                        | 3,624 | 2,091 | –    | –    |
|   | 8,096 | 7,114 | 140  | 148  |
| <b>Debt securities:</b>                 |       |       |      |      |
| – listed in Hong Kong                   | 15    | 11    | –    | –    |
| – listed outside Hong Kong              | 182   | 184   | 140  | 148  |
|   | 197   | 195   | 140  | 148  |
| – unlisted                              | 3,802 | 4,245 | –    | –    |
|   | 3,999 | 4,440 | 140  | 148  |
| <b>Equity shares:</b>                   |       |       |      |      |
| – listed in Hong Kong                   | 473   | 583   | –    | –    |
| <b>Investment funds:</b>                |       |       |      |      |
| – listed in Hong Kong                   | 23    | 23    | –    | –    |
| – listed outside Hong Kong              | 150   | 65    | –    | –    |
|   | 173   | 88    | –    | –    |
| – unlisted                              | 3,451 | 2,003 | –    | –    |
|   | 3,624 | 2,091 | –    | –    |
|   | 8,096 | 7,114 | 140  | 148  |
| <b>Debt securities:</b>                 |       |       |      |      |
| Issued by public bodies:                |       |       |      |      |
| – central governments and central banks | 140   | 148   | 140  | 148  |
| – other public sector entities          | 53    | 105   | –    | –    |
|   | 193   | 253   | 140  | 148  |
| Issued by other bodies:                 |       |       |      |      |
| – banks                                 | 3,725 | 4,113 | –    | –    |
| – corporate entities                    | 81    | 74    | –    | –    |
|   | 3,806 | 4,187 | –    | –    |
|   | 3,999 | 4,440 | 140  | 148  |
| <b>Equity shares:</b>                   |       |       |      |      |
| Issued by banks                         | 109   | 69    | –    | –    |
| Issued by public sector entities        | 5     | 15    | –    | –    |
| Issued by corporate entities            | 359   | 499   | –    | –    |
|   | 473   | 583   | –    | –    |
| <b>Investment funds:</b>                |       |       |      |      |
| Issued by banks                         | 1,869 | 2,004 | –    | –    |
| Issued by corporate entities            | 1,755 | 87    | –    | –    |
|   | 3,624 | 2,091 | –    | –    |
|   | 8,096 | 7,114 | 140  | 148  |



### 34. DERIVATIVE FINANCIAL INSTRUMENTS

Derivatives are financial contracts whose values and characteristics are derived from underlying assets, exchange and interest rates, and indices. Derivative instruments are subject to both credit risk and market risk. The credit risk relating to a derivative contract is principally the replacement cost of the contract when it has a positive mark-to-market value and the estimated potential future change in value over the residual maturity of the contract. The nominal value of the contracts does not represent the amount of the Group's exposure to credit risk. All activities relating to derivatives are subject to the same credit approval and monitoring standards used to control credit risk for other transactions. Market risk from derivative positions is controlled individually and in combination with on-balance sheet market risk positions within the Group's market risk limits regime as described in note 61(c).

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading, or financial instruments designated at fair value, or designated as either fair value hedge or cash flow hedge. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives.

#### Trading derivatives

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

Derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives. 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.

#### Hedging instruments

The Group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the Group to optimise the cost of managing the balance sheet, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

#### (a) Fair value hedge

The Group's fair value hedge principally consists 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.

**34. DERIVATIVE FINANCIAL INSTRUMENTS** (continued)**(b) Cash flow hedge**

The Group is exposed to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio for financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedge of forecast transactions.

Gains and losses are initially recognised in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2011, the amount of cash flow hedging reserve transferred to the income statement comprised HK\$197 million (2010: HK\$414 million) included in net interest income and nil balance included in net trading income (2010: Nil).

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2011 and 2010. During the years of 2011 and 2010, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur. In 2011, there was no gain recognised due to termination of such forecast transactions (2010: Nil).

The schedules of forecast principal balances on which the expected interest cash flows associated with derivatives that are cash flow hedge were as follows:

|                                | Group                |                                       |                                     |
|--------------------------------|----------------------|---------------------------------------|-------------------------------------|
|                                | Three months or less | Over three months but within one year | Over one year but within five years |
| <b>At 31 December 2011</b>     |                      |                                       |                                     |
| Cash inflows from assets       | <b>48,385</b>        | <b>34,920</b>                         | <b>9,681</b>                        |
| Cash outflows from liabilities | -                    | -                                     | -                                   |
| Net cash inflows               | <b>48,385</b>        | <b>34,920</b>                         | <b>9,681</b>                        |
| <b>At 31 December 2010</b>     |                      |                                       |                                     |
| Cash inflows from assets       | 78,389               | 40,443                                | 21,869                              |
| Cash outflows from liabilities | -                    | -                                     | -                                   |
| Net cash inflows               | 78,389               | 40,443                                | 21,869                              |

**34. DERIVATIVE FINANCIAL INSTRUMENTS** (continued)

(c) The following table shows the nominal contract amounts and marked-to-market value of assets and liabilities by each class of derivatives.

|  | Group            |                   |                        |                  |                   |                        |
|--|------------------|-------------------|------------------------|------------------|-------------------|------------------------|
|  | 2011             |                   |                        | 2010             |                   |                        |
|  | Contract amounts | Derivative assets | Derivative liabilities | Contract amounts | Derivative assets | Derivative liabilities |
| <b>Derivatives held for trading</b>  |                  |                   |                        |                  |                   |                        |
| Exchange rate contracts:   |                  |                   |                        |                  |                   |                        |
| – spot and forward foreign exchange  | 533,604          | 1,760             | 1,090                  | 495,913          | 2,471             | 1,802                  |
| – currency swaps   | 4,827            | 82                | 76                     | 17,366           | 190               | 139                    |
| – currency options purchased   | 81,173           | 401               | –                      | 41,183           | 59                | –                      |
| – currency options written   | 86,786           | –                 | 415                    | 46,657           | –                 | 87                     |
| – other exchange rate contracts  | 131              | 3                 | 1                      | 101              | 1                 | 3                      |
|  | <b>706,521</b>   | <b>2,246</b>      | <b>1,582</b>           | <b>601,220</b>   | <b>2,721</b>      | <b>2,031</b>           |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 267,229          | 2,042             | 1,590                  | 234,425          | 1,748             | 1,557                  |
| – interest rate options purchased  | –                | –                 | –                      | 25               | –                 | –                      |
| – interest rate options written  | –                | –                 | –                      | 25               | –                 | –                      |
| – other interest rate contracts  | 8,547            | 1                 | –                      | 1,555            | –                 | –                      |
|  | <b>275,776</b>   | <b>2,043</b>      | <b>1,590</b>           | <b>236,030</b>   | <b>1,748</b>      | <b>1,557</b>           |
| Equity and other contracts:  |                  |                   |                        |                  |                   |                        |
| – equity swaps   | 4,557            | 5                 | 290                    | 5,980            | 32                | 99                     |
| – equity options purchased   | 11,436           | 117               | –                      | 5,503            | 168               | –                      |
| – equity options written   | 1,673            | –                 | 29                     | 1,731            | –                 | 8                      |
| – other equity contracts   | 7                | –                 | –                      | 8                | –                 | –                      |
| – spot and forward contracts and others  | 3,359            | 120               | 14                     | 3,669            | 413               | 2                      |
|  | <b>21,032</b>    | <b>242</b>        | <b>333</b>             | <b>16,891</b>    | <b>613</b>        | <b>109</b>             |
| <b>Total derivatives held for trading</b>  | <b>1,003,329</b> | <b>4,531</b>      | <b>3,505</b>           | <b>854,141</b>   | <b>5,082</b>      | <b>3,697</b>           |
| <b>Derivatives managed in conjunction with financial assets designated at fair value</b> |                  |                   |                        |                  |                   |                        |
| Exchange rate contracts:   |                  |                   |                        |                  |                   |                        |
| – spot and forward foreign exchange  | –                | –                 | –                      | 769              | –                 | 3                      |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 140              | –                 | 3                      | 140              | –                 | 9                      |
|  | <b>140</b>       | <b>–</b>          | <b>3</b>               | <b>909</b>       | <b>–</b>          | <b>12</b>              |
| <b>Cash flow hedge derivatives</b>   |                  |                   |                        |                  |                   |                        |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 48,385           | 66                | 21                     | 78,389           | 256               | 19                     |
| <b>Fair value hedge derivatives</b>  |                  |                   |                        |                  |                   |                        |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 27,046           | 113               | 1,319                  | 27,122           | 255               | 955                    |
| <b>Total derivatives</b>   | <b>1,078,900</b> | <b>4,710</b>      | <b>4,848</b>           | <b>960,561</b>   | <b>5,593</b>      | <b>4,683</b>           |

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

## Bank

|  | 2011             |                   |                        | 2010             |                   |                        |
|--|------------------|-------------------|------------------------|------------------|-------------------|------------------------|
|  | Contract amounts | Derivative assets | Derivative liabilities | Contract amounts | Derivative assets | Derivative liabilities |
| <b>Derivatives held for trading</b>  |                  |                   |                        |                  |                   |                        |
| Exchange rate contracts:   |                  |                   |                        |                  |                   |                        |
| – spot and forward foreign exchange  | 514,440          | 1,656             | 972                    | 496,363          | 2,379             | 1,880                  |
| – currency swaps   | 4,827            | 82                | 76                     | 17,366           | 190               | 139                    |
| – currency options purchased   | 81,342           | 401               | –                      | 41,220           | 60                | –                      |
| – currency options written   | 86,918           | –                 | 560                    | 46,694           | –                 | 127                    |
| – other exchange rate contracts  | 131              | 3                 | 1                      | 101              | 1                 | 3                      |
|  | <b>687,658</b>   | <b>2,142</b>      | <b>1,609</b>           | 601,744          | 2,630             | 2,149                  |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 217,264          | 1,791             | 1,371                  | 227,205          | 1,662             | 1,509                  |
| – interest rate options purchased  | –                | –                 | –                      | 25               | –                 | –                      |
| – interest rate options written  | –                | –                 | –                      | 25               | –                 | –                      |
| – other interest rate contracts  | 8,547            | 1                 | –                      | 1,554            | –                 | –                      |
|  | <b>225,811</b>   | <b>1,792</b>      | <b>1,371</b>           | 228,809          | 1,662             | 1,509                  |
| Equity and other contracts:  |                  |                   |                        |                  |                   |                        |
| – equity swaps   | 8,444            | 285               | 294                    | 7,997            | 59                | 125                    |
| – equity options purchased   | 1,673            | 29                | –                      | 1,732            | 8                 | –                      |
| – equity options written   | 1,673            | –                 | 29                     | 1,731            | –                 | 8                      |
| – other equity contracts   | 7                | –                 | –                      | 8                | –                 | –                      |
| – spot and forward contracts and others  | 3,359            | 120               | 14                     | 3,695            | 413               | 2                      |
|  | <b>15,156</b>    | <b>434</b>        | <b>337</b>             | 15,163           | 480               | 135                    |
| Total derivatives held for trading   | <b>928,625</b>   | <b>4,368</b>      | <b>3,317</b>           | 845,716          | 4,772             | 3,793                  |
| <b>Derivatives managed in conjunction with financial assets designated at fair value</b> |                  |                   |                        |                  |                   |                        |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 140              | –                 | 3                      | 140              | –                 | 9                      |
| <b>Cash flow hedge derivatives</b>   |                  |                   |                        |                  |                   |                        |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 48,385           | 66                | 21                     | 76,495           | 232               | 19                     |
| <b>Fair value hedge derivatives</b>  |                  |                   |                        |                  |                   |                        |
| Interest rate contracts:   |                  |                   |                        |                  |                   |                        |
| – interest rate swaps  | 10,609           | 2                 | 761                    | 14,976           | 22                | 707                    |
| <b>Total derivatives</b>   | <b>987,759</b>   | <b>4,436</b>      | <b>4,102</b>           | 937,327          | 5,026             | 4,528                  |

The above derivative assets and liabilities, being the positive or negative marked-to-market value of the respective derivative contracts, represent gross replacement costs.

**34. DERIVATIVE FINANCIAL INSTRUMENTS** (continued)**(d) Contract amounts, credit equivalent amounts and risk-weighted amounts**

The table below gives the contract amounts, credit equivalent amounts and risk-weighted amounts of derivatives. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

Derivatives arise from futures, forward, swap and option transactions undertaken by the Group in the foreign exchange, interest rate, equity, credit and commodity markets. The contract amounts of these instruments indicate the volume of transactions outstanding at the end of the balance sheet date, they do not represent amounts at risk.

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Banking (Capital) Rules ("the Capital Rules") and depend on the status of the counterparty and maturity characteristics of the instrument.

The netting adjustments represent amounts where the Group has in place legally enforceable rights of offset with individual counterparties to offset the gross amount of positive marked-to-market assets with any negative marked-to-market liabilities with the same customer. These offsets are recognised by the Hong Kong Monetary Authority in the calculation of risk assets for the capital adequacy ratio.

The Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2011 and 2010 were calculated based on the advanced internal ratings-based approach.

|                                     | Group            |                           |                       | Bank             |                           |                       |
|-------------------------------------|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
|                                     | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| <b>2011</b>                         |                  |                           |                       |                  |                           |                       |
| Exchange rate contracts:            |                  |                           |                       |                  |                           |                       |
| – spot and forward foreign exchange | 493,588          | 2,441                     | 1,169                 | 480,558          | 2,198                     | 1,056                 |
| – currency swaps                    | 4,827            | 155                       | 17                    | 4,827            | 155                       | 16                    |
| – currency options purchased        | 87,005           | 2,316                     | 1,749                 | 87,083           | 2,317                     | 1,749                 |
| – other exchange rate contracts     | 131              | 4                         | –                     | 131              | 4                         | –                     |
|                                     | <b>585,551</b>   | <b>4,916</b>              | <b>2,935</b>          | <b>572,599</b>   | <b>4,674</b>              | <b>2,821</b>          |
| Interest rate contracts:            |                  |                           |                       |                  |                           |                       |
| – interest rate swaps               | 342,801          | 2,624                     | 950                   | 276,398          | 2,099                     | 757                   |
| – interest rate options purchased   | –                | –                         | –                     | –                | –                         | –                     |
|                                     | <b>342,801</b>   | <b>2,624</b>              | <b>950</b>            | <b>276,398</b>   | <b>2,099</b>              | <b>757</b>            |
| Equity and other contracts:         |                  |                           |                       |                  |                           |                       |
| – equity swaps                      | 4,386            | 276                       | 39                    | 8,274            | 798                       | 70                    |
| – equity options purchased          | 1,087            | 95                        | 75                    | 1,087            | 95                        | 75                    |
| – others                            | –                | –                         | –                     | –                | –                         | –                     |
|                                     | <b>5,473</b>     | <b>371</b>                | <b>114</b>            | <b>9,361</b>     | <b>893</b>                | <b>145</b>            |

The total fair value of the derivatives at 31 December 2011 was HK\$2,411 million (31 December 2010: HK\$2,513 million) after taking into account the effect of valid bilateral netting agreement amounting to HK\$1,664 million (31 December 2010: HK\$2,174 million).



**34. DERIVATIVE FINANCIAL INSTRUMENTS** (continued)**(d) Contract amounts, credit equivalent amounts and risk-weighted amounts** (continued)

|                                     | Group            |                           |                       | Bank             |                           |                       |
|-------------------------------------|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
|                                     | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| 2010                                |                  |                           |                       |                  |                           |                       |
| Exchange rate contracts:            |                  |                           |                       |                  |                           |                       |
| – spot and forward foreign exchange | 431,732          | 2,738                     | 1,417                 | 428,192          | 2,599                     | 1,337                 |
| – currency swaps                    | 17,366           | 433                       | 70                    | 17,366           | 433                       | 70                    |
| – currency options purchased        | 41,755           | 820                       | 642                   | 41,762           | 820                       | 642                   |
| – other exchange rate contracts     | 101              | 5                         | –                     | 101              | 5                         | –                     |
|                                     | 490,954          | 3,996                     | 2,129                 | 487,421          | 3,857                     | 2,049                 |
| Interest rate contracts:            |                  |                           |                       |                  |                           |                       |
| – interest rate swaps               | 340,076          | 2,522                     | 602                   | 318,816          | 2,084                     | 472                   |
| – interest rate options purchased   | 25               | –                         | –                     | 25               | –                         | –                     |
|                                     | 340,101          | 2,522                     | 602                   | 318,841          | 2,084                     | 472                   |
| Equity and other contracts:         |                  |                           |                       |                  |                           |                       |
| – equity swaps                      | 5,980            | 391                       | 65                    | 7,997            | 525                       | 72                    |
| – equity options purchased          | 1,732            | 112                       | 72                    | 1,732            | 112                       | 72                    |
| – others                            | 17               | 2                         | –                     | 33               | 4                         | –                     |
|                                     | 7,729            | 505                       | 137                   | 9,762            | 641                       | 144                   |

**35. ADVANCES TO CUSTOMERS****(a) Advances to customers**

|                                  | Group   |         | Bank    |         |
|----------------------------------|---------|---------|---------|---------|
|                                  | 2011    | 2010    | 2011    | 2010    |
| Gross advances to customers      | 482,241 | 474,473 | 427,038 | 424,506 |
| Less: loan impairment allowances |         |         |         |         |
| – individually assessed          | (896)   | (1,118) | (789)   | (844)   |
| – collectively assessed          | (771)   | (718)   | (620)   | (588)   |
|                                  | 480,574 | 472,637 | 425,629 | 423,074 |

Total loan impairment allowances as a percentage of gross advances to customers are as follows:

|                                  | Group |      | Bank |      |
|----------------------------------|-------|------|------|------|
|                                  | 2011  | 2010 | 2011 | 2010 |
|                                  | %     | %    | %    | %    |
| Loan impairment allowances:      |       |      |      |      |
| – individually assessed          | 0.19  | 0.24 | 0.18 | 0.20 |
| – collectively assessed          | 0.16  | 0.15 | 0.15 | 0.14 |
| Total loan impairment allowances | 0.35  | 0.39 | 0.33 | 0.34 |

**35. ADVANCES TO CUSTOMERS** (continued)**(b) Loan impairment allowances against advances to customers**

|   | Group                 |                       |       |
|---|-----------------------|-----------------------|-------|
|   | Individually assessed | Collectively assessed | Total |
| <b>2011</b>   |                       |                       |       |
| At 1 January  | 1,118                 | 718                   | 1,836 |
| Amounts written off   | (355)                 | (330)                 | (685) |
| Recoveries of advances written off in previous years                                | 35                    | 43                    | 78    |
| New impairment allowances charged to income statement (note 16)                     | 359                   | 381                   | 740   |
| Impairment allowances released to income statement (note 16)                        | (256)                 | (44)                  | (300) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (10)                  | (3)                   | (13)  |
| Exchange  | 5                     | 6                     | 11    |
| At 31 December  | 896                   | 771                   | 1,667 |
| <b>2010</b>   |                       |                       |       |
| At 1 January  | 1,151                 | 814                   | 1,965 |
| Amounts written off   | (227)                 | (345)                 | (572) |
| Recoveries of advances written off in previous years                                | 18                    | 44                    | 62    |
| New impairment allowances charged to income statement (note 16)                     | 296                   | 313                   | 609   |
| Impairment allowances released to income statement (note 16)                        | (110)                 | (109)                 | (219) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (16)                  | (3)                   | (19)  |
| Exchange  | 6                     | 4                     | 10    |
| At 31 December  | 1,118                 | 718                   | 1,836 |

|   | Bank                  |                       |       |
|---|-----------------------|-----------------------|-------|
|   | Individually assessed | Collectively assessed | Total |
| <b>2011</b>   |                       |                       |       |
| At 1 January  | 844                   | 588                   | 1,432 |
| Amounts written off   | (235)                 | (330)                 | (565) |
| Recoveries of advances written off in previous years                                | 22                    | 43                    | 65    |
| New impairment allowances charged to income statement (note 16)                     | 297                   | 365                   | 662   |
| Impairment allowances released to income statement (note 16)                        | (134)                 | (43)                  | (177) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (5)                   | (3)                   | (8)   |
| At 31 December  | 789                   | 620                   | 1,409 |
| <b>2010</b>   |                       |                       |       |
| At 1 January  | 957                   | 706                   | 1,663 |
| Amounts written off   | (211)                 | (344)                 | (555) |
| Recoveries of advances written off in previous years                                | 7                     | 44                    | 51    |
| New impairment allowances charged to income statement (note 16)                     | 162                   | 313                   | 475   |
| Impairment allowances released to income statement (note 16)                        | (65)                  | (128)                 | (193) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (6)                   | (3)                   | (9)   |
| At 31 December  | 844                   | 588                   | 1,432 |

**35. ADVANCES TO CUSTOMERS** (continued)**(c) Impaired advances and allowances**

|   | Group        |         | Bank         |       |
|---|--------------|---------|--------------|-------|
|   | 2011         | 2010    | 2011         | 2010  |
| Gross impaired advances   | <b>1,584</b> | 1,990   | <b>1,404</b> | 1,462 |
| Individually assessed allowances  | <b>(896)</b> | (1,118) | <b>(789)</b> | (844) |
| Net impaired advances   | <b>688</b>   | 872     | <b>615</b>   | 618   |
| Individually assessed allowances as a percentage of gross impaired advances | <b>56.6%</b> | 56.2%   | <b>56.2%</b> | 57.7% |
| Gross impaired advances as a percentage of gross advances to customers      | <b>0.33%</b> | 0.42%   | <b>0.33%</b> | 0.34% |

Impaired advances are those advances where objective evidence exists that full repayment of principal or interest is considered unlikely.

|   | Group        |         | Bank         |       |
|---|--------------|---------|--------------|-------|
|   | 2011         | 2010    | 2011         | 2010  |
| Gross individually assessed impaired advances   | <b>1,493</b> | 1,886   | <b>1,313</b> | 1,358 |
| Individually assessed allowances  | <b>(896)</b> | (1,118) | <b>(789)</b> | (844) |
|   | <b>597</b>   | 768     | <b>524</b>   | 514   |
| Gross individually assessed impaired advances as a percentage of gross advances to customers                              | <b>0.31%</b> | 0.40%   | <b>0.31%</b> | 0.32% |
| Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers | <b>423</b>   | 682     | <b>346</b>   | 464   |

Collateral includes any tangible security carries a fair market value and is readily marketable. This includes (but is not limited to) cash and deposits, stocks and bonds, mortgages over properties and charges over other fixed assets such as plant and equipment. Where collateral values are greater than gross advances, only the amount of collateral up to the gross advance was included.

**35. ADVANCES TO CUSTOMERS** (continued)**(d) Overdue advances**

Advances to customers that are more than three months overdue and their expression as a percentage of gross advances to customers are as follows:

|  | <b>Group</b> |            | <b>Bank</b>  |            |
|--|--------------|------------|--------------|------------|
|  |              | <b>%</b>   |              | <b>%</b>   |
| <b>2011</b>  |              |            |              |            |
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of: |              |            |              |            |
| – more than three months but not more than six months  | <b>228</b>   | <b>–</b>   | <b>225</b>   | <b>–</b>   |
| – more than six months but not more than one year  | <b>72</b>    | <b>–</b>   | <b>52</b>    | <b>–</b>   |
| – more than one year   | <b>756</b>   | <b>0.2</b> | <b>675</b>   | <b>0.2</b> |
|  | <b>1,056</b> | <b>0.2</b> | <b>952</b>   | <b>0.2</b> |
| of which:  |              |            |              |            |
| – individually impaired allowances   | <b>(822)</b> |            | <b>(743)</b> |            |
| – covered portion of overdue loans and advances  | <b>172</b>   |            | <b>147</b>   |            |
| – uncovered portion of overdue loans and advances  | <b>884</b>   |            | <b>805</b>   |            |
| – current market value held against the covered portion of overdue loans and advances                            | <b>368</b>   |            | <b>312</b>   |            |
| <b>2010</b>  |              |            |              |            |
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of: |              |            |              |            |
| – more than three months but not more than six months  | 137          | –          | 126          | –          |
| – more than six months but not more than one year  | 89           | –          | 88           | –          |
| – more than one year   | 1,147        | 0.3        | 904          | 0.3        |
|  | 1,373        | 0.3        | 1,118        | 0.3        |
| of which:  |              |            |              |            |
| – individually impaired allowances   | (994)        |            | (805)        |            |
| – covered portion of overdue loans and advances  | 354          |            | 291          |            |
| – uncovered portion of overdue loans and advances  | 1,019        |            | 827          |            |
| – current market value held against the covered portion of overdue loans and advances                            | 586          |            | 514          |            |

Advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid at year-end. Advances repayable by regular instalments are treated as overdue when an instalment payment is overdue and remains unpaid at year-end. Advances repayable on demand are classified as overdue either when a demand for repayment has been served on the borrower but repayment has not been made in accordance with the demand notice, or when the advances have remained continuously outside the approved limit advised to the borrower for more than the overdue period in question.

**35. ADVANCES TO CUSTOMERS** (continued)**(e) Rescheduled advances**

Rescheduled advances and their expression as a percentage of gross advances to customers are as follows:

|             | Group      |          | Bank      |          |
|-------------|------------|----------|-----------|----------|
|             |            | %        |           | %        |
| <b>2011</b> | <b>180</b> | <b>–</b> | <b>90</b> | <b>–</b> |
| 2010        | 194        | –        | 95        | –        |

Rescheduled advances are those that have been rescheduled or renegotiated for reasons related to the borrower's financial difficulties. This will normally involve the granting of concessionary terms and resetting the overdue account to non-overdue status.

Rescheduled advances to customers are stated net of any advances which have subsequently become overdue for more than three months and which are included in "Overdue advances" (note 35(d)).

**(f) Segmental analysis of advances to customers by geographical area**

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area that is different from that of the counterparty.

|                            | Group                       |   |                               |                                  |                                  |
|----------------------------|-----------------------------|---|-------------------------------|----------------------------------|----------------------------------|
|                            | Gross advances to customers | Individually impaired advances to customers | Overdue advances to customers | Individually assessed allowances | Collectively assessed allowances |
| <b>At 31 December 2011</b> |                             |   |                               |                                  |                                  |
| Hong Kong                  | 404,889                     | 1,315                                       | 929                           | 779                              | 603                              |
| Rest of Asia-Pacific       | 70,099                      | 158   | 127                           | 115                              | 150                              |
| Others                     | 7,253                       | 20  | –                             | 2                                | 18                               |
|                            | <b>482,241</b>              | <b>1,493</b>                                | <b>1,056</b>                  | <b>896</b>                       | <b>771</b>                       |
| At 31 December 2010        |                             |   |                               |                                  |                                  |
| Hong Kong                  | 392,836                     | 1,452                                       | 1,112                         | 838                              | 545                              |
| Rest of Asia-Pacific       | 76,308                      | 345   | 257                           | 234                              | 162                              |
| Others                     | 5,329                       | 89  | 4                             | 46                               | 11                               |
|                            | <b>474,473</b>              | <b>1,886</b>                                | <b>1,373</b>                  | <b>1,118</b>                     | <b>718</b>                       |

|                            | Bank                        |   |                               |                                  |                                  |
|----------------------------|-----------------------------|---|-------------------------------|----------------------------------|----------------------------------|
|                            | Gross advances to customers | Individually impaired advances to customers | Overdue advances to customers | Individually assessed allowances | Collectively assessed allowances |
| <b>At 31 December 2011</b> |                             |   |                               |                                  |                                  |
| Hong Kong                  | 385,958                     | 1,261                                       | 920                           | 778                              | 573                              |
| Rest of Asia-Pacific       | 38,089                      | 32  | 32                            | 9                                | 43                               |
| Others                     | 2,991                       | 20  | –                             | 2                                | 4                                |
|                            | <b>427,038</b>              | <b>1,313</b>                                | <b>952</b>                    | <b>789</b>                       | <b>620</b>                       |
| At 31 December 2010        |                             |   |                               |                                  |                                  |
| Hong Kong                  | 374,776                     | 1,308                                       | 1,094                         | 831                              | 528                              |
| Rest of Asia-Pacific       | 46,404                      | 32  | 20                            | 12                               | 56                               |
| Others                     | 3,326                       | 18  | 4                             | 1                                | 4                                |
|                            | <b>424,506</b>              | <b>1,358</b>                                | <b>1,118</b>                  | <b>844</b>                       | <b>588</b>                       |



**35. ADVANCES TO CUSTOMERS** (continued)**(g) Gross advances to customers by industry sector**

The analysis of gross advances to customers by industry sector based on categories and definitions used by the Hong Kong Monetary Authority is as follows:

|  | Group                                     |  |
|--|---|--|
|  | 2011                                      | 2010   |
|  | % of gross advances covered by collateral | % of gross advances covered by collateral (restated) |
| <b>Gross advances to customers for use in Hong Kong</b>  |   |  |
| <b>Industrial, commercial and financial sectors</b>  |   |  |
| – property development   | 27,090 50.0                               | 32,430 43.0  |
| – property investment  | 102,066 88.3                              | 100,023 83.0   |
| – financial concerns   | 2,648 24.7                                | 2,907 33.7   |
| – stockbrokers   | 1,227 5.9                                 | 165 82.4   |
| – wholesale and retail trade   | 11,511 44.5                               | 11,339 43.5  |
| – manufacturing  | 16,274 30.4                               | 14,628 35.7  |
| – transport and transport equipment  | 6,309 64.0                                | 7,546 72.8   |
| – recreational activities  | 62 24.9                                   | 532 99.5   |
| – information technology   | 899 2.0                                   | 1,957 0.7  |
| – other  | 21,859 52.5                               | 20,177 61.8  |
|  | <b>189,945 68.4</b>                       | <b>191,704 66.1</b>                                  |
| <b>Individuals</b>   |   |  |
| – advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme | 14,405 99.7                               | 14,834 100.0   |
| – advances for the purchase of other residential properties  | 107,563 100.0                             | 112,394 100.0  |
| – credit card advances   | 18,547 –                                  | 15,735 –   |
| – other  | 13,887 29.4                               | 13,776 30.9  |
|  | <b>154,402 81.5</b>                       | <b>156,739 83.9</b>                                  |
| <b>Total gross advances for use in Hong Kong</b>   | <b>344,347 74.3</b>                       | <b>348,443 74.1</b>                                  |
| <b>Trade finance</b>   | <b>49,552 27.8</b>                        | <b>63,660 18.3</b>                                   |
| <b>Gross advances for use outside Hong Kong</b>  | <b>88,342 25.8</b>                        | <b>62,370 40.5</b>                                   |
| <b>Gross advances to customers</b>   | <b>482,241 60.6</b>                       | <b>474,473 62.2</b>                                  |

**35. ADVANCES TO CUSTOMERS** (continued)**(g) Gross advances to customers by industry sector** (continued)

|  | Bank                                      |  |
|--|---|--|
|  | 2011                                      | 2010   |
|  | % of gross advances covered by collateral | % of gross advances covered by collateral (restated) |
| <b>Gross advances to customers for use in Hong Kong</b>  |   |  |
| <b>Industrial, commercial and financial sectors</b>  |   |  |
| – property development   | 27,090 50.0                               | 32,430 43.0  |
| – property investment  | 101,445 88.4                              | 98,994 83.4  |
| – financial concerns   | 2,648 24.7                                | 2,907 33.7   |
| – stockbrokers   | 1,227 5.9                                 | 165 82.4   |
| – wholesale and retail trade   | 11,511 44.5                               | 11,339 43.5  |
| – manufacturing  | 16,274 30.4                               | 14,626 35.7  |
| – transport and transport equipment  | 5,887 61.4                                | 6,711 69.7   |
| – recreational activities  | 62 24.9                                   | 532 99.5   |
| – information technology   | 899 2.0                                   | 1,957 0.7  |
| – other  | 21,852 52.5                               | 20,158 61.8  |
|  | <b>188,895 68.4</b>                       | <b>189,819 66.1</b>                                  |
| <b>Individuals</b>   |   |  |
| – advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme | 6,950 99.3                                | 5,695 100.0  |
| – advances for the purchase of other residential properties  | 105,525 100.0                             | 109,776 100.0  |
| – credit card advances   | 18,547 –                                  | 15,735 –   |
| – other  | 13,885 29.4                               | 13,773 30.9  |
|  | <b>144,907 80.3</b>                       | <b>144,979 82.6</b>                                  |
| <b>Total gross advances for use in Hong Kong</b>   | <b>333,802 73.5</b>                       | <b>334,798 73.2</b>                                  |
| <b>Trade finance</b>   | <b>49,552 27.8</b>                        | <b>63,660 18.3</b>                                   |
| <b>Gross advances for use outside Hong Kong</b>  | <b>43,684 8.4</b>                         | <b>26,048 7.4</b>                                    |
| <b>Gross advances to customers</b>   | <b>427,038 61.6</b>                       | <b>424,506 61.0</b>                                  |

**35. ADVANCES TO CUSTOMERS** (continued)**(h) Net investments in finance leases**

Advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring by the lessee the leased asset at nominal value at the end of the lease period. The total minimum lease payments receivable and their present value at the year-end are as follows:

|                         | <b>Group</b> |       | <b>Bank</b>  |       |
|-------------------------|--------------|-------|--------------|-------|
|                         | <b>2011</b>  | 2010  | <b>2011</b>  | 2010  |
| Finance leases          | <b>1</b>     | 9     | <b>1</b>     | 9     |
| Hire purchase contracts | <b>4,102</b> | 5,751 | <b>3,679</b> | 4,918 |
|                         | <b>4,103</b> | 5,760 | <b>3,680</b> | 4,927 |

|   | <b>Group</b>  |   |  |
|---|---|---|--|
|   | <b>Present value of minimum lease payments receivable</b> | <b>Interest income relating to future periods</b> | <b>Total minimum lease payments receivable</b> |
| <b>2011</b>   |   |   |  |
| Amounts receivable:   |   |   |  |
| – within one year   | <b>454</b>  | <b>64</b>   | <b>518</b>                                     |
| – after one year but within five years                        | <b>1,027</b>  | <b>198</b>  | <b>1,225</b>                                   |
| – after five years  | <b>2,647</b>  | <b>314</b>  | <b>2,961</b>                                   |
|   | <b>4,128</b>  | <b>576</b>  | <b>4,704</b>                                   |
| Loans impairment allowances                                   | <b>(25)</b>   |   |  |
| Net investments in finance leases and hire purchase contracts | <b>4,103</b>  |   |  |
| <b>2010</b>   |   |   |  |
| Amounts receivable:   |   |   |  |
| – within one year   | 260   | 54  | 314  |
| – after one year but within five years                        | 1,026   | 166   | 1,192  |
| – after five years  | 4,500   | 1,029   | 5,529  |
|   | 5,786   | 1,249   | 7,035  |
| Loans impairment allowances                                   | (26)  |   |  |
| Net investments in finance leases and hire purchase contracts | 5,760   |   |  |

**35. ADVANCES TO CUSTOMERS** (continued)**(h) Net investments in finance leases** (continued)

|   | Bank   |  |   |
|---|--|--|---|
|   | Present value of minimum lease payments receivable | Interest income relating to future periods | Total minimum lease payments receivable |
| <b>2011</b>   |  |  |   |
| Amounts receivable:   |  |  |   |
| – within one year   | 417  | 56   | 473                                     |
| – after one year but within five years                        | 893  | 171  | 1,064                                   |
| – after five years  | 2,395  | 292  | 2,687                                   |
|   | <b>3,705</b>                                       | <b>519</b>                                 | <b>4,224</b>                            |
| Loans impairment allowances                                   | (25)   |  |   |
| Net investments in finance leases and hire purchase contracts | <b>3,680</b>                                       |  |   |
| <b>2010</b>   |  |  |   |
| Amounts receivable:   |  |  |   |
| – within one year   | 189  | 36   | 225                                     |
| – after one year but within five years                        | 766  | 111  | 877                                     |
| – after five years  | 3,994  | 977  | 4,971                                   |
|   | <b>4,949</b>                                       | <b>1,124</b>                               | <b>6,073</b>                            |
| Loans impairment allowances                                   | (22)   |  |   |
| Net investments in finance leases and hire purchase contracts | <b>4,927</b>                                       |  |   |

## 36. FINANCIAL INVESTMENTS

|   | Group   |         | Bank    |         |
|---|---------|---------|---------|---------|
|   | 2011    | 2010    | 2011    | 2010    |
| Financial investments:  |         |         |         |         |
| – which may be repledged or resold by counterparties  | 156     | 207     | 156     | 207     |
| – which may not be repledged or resold or are not subject to repledge or resale by counterparties | 209,034 | 199,152 | 104,986 | 102,899 |
|   | 209,190 | 199,359 | 105,142 | 103,106 |
| Held-to-maturity debt securities at amortised cost  | 59,911  | 56,301  | –       | –       |
| Available-for-sale at fair value:   |         |         |         |         |
| – debt securities   | 149,020 | 142,732 | 105,080 | 102,985 |
| – equity shares   | 259     | 326     | 62      | 121     |
|   | 209,190 | 199,359 | 105,142 | 103,106 |
| Treasury bills  | 43,296  | 18,010  | 43,296  | 17,225  |
| Certificates of deposit   | 9,386   | 6,713   | 6,006   | 2,928   |
| Other debt securities   | 156,249 | 174,310 | 55,778  | 82,832  |
| Debt securities   | 208,931 | 199,033 | 105,080 | 102,985 |
| Equity shares   | 259     | 326     | 62      | 121     |
|   | 209,190 | 199,359 | 105,142 | 103,106 |

There was no overdue debt securities at 31 December 2011 (31 December 2010: Nil).

## (a) Held-to-maturity debt securities

|   | Group  |        | Bank |      |
|---|--------|--------|------|------|
|   | 2011   | 2010   | 2011 | 2010 |
| Listed in Hong Kong                             | 977    | 997    | –    | –    |
| Listed outside Hong Kong                        | 10,234 | 9,822  | –    | –    |
|   | 11,211 | 10,819 | –    | –    |
| Unlisted  | 48,700 | 45,482 | –    | –    |
|   | 59,911 | 56,301 | –    | –    |
| Issued by public bodies:                        |        |        |      |      |
| – central governments and central banks         | 309    | 272    | –    | –    |
| – other public sector entities                  | 8,273  | 7,563  | –    | –    |
|   | 8,582  | 7,835  | –    | –    |
| Issued by other bodies:                         |        |        |      |      |
| – banks   | 36,304 | 36,225 | –    | –    |
| – corporate entities                            | 15,025 | 12,241 | –    | –    |
|   | 51,329 | 48,466 | –    | –    |
|   | 59,911 | 56,301 | –    | –    |
| Fair value of held-to-maturity debt securities: |        |        |      |      |
| – listed  | 11,879 | 11,189 | –    | –    |
| – unlisted                                      | 51,517 | 47,138 | –    | –    |
|   | 63,396 | 58,327 | –    | –    |

There was no held-to-maturity debt securities determined to be impaired at 31 December 2011 for the Group and the Bank (31 December 2010: Nil).



**36. FINANCIAL INVESTMENTS** (continued)**(b) Available-for-sale debt securities**

|   | <b>Group</b>   |         | <b>Bank</b>    |         |
|---|----------------|---------|----------------|---------|
|   | <b>2011</b>    | 2010    | <b>2011</b>    | 2010    |
| Listed in Hong Kong                     | <b>20,164</b>  | 8,786   | <b>20,158</b>  | 8,780   |
| Listed outside Hong Kong                | <b>29,793</b>  | 57,317  | <b>16,901</b>  | 43,528  |
|   | <b>49,957</b>  | 66,103  | <b>37,059</b>  | 52,308  |
| Unlisted                                | <b>99,063</b>  | 76,629  | <b>68,021</b>  | 50,677  |
|   | <b>149,020</b> | 142,732 | <b>105,080</b> | 102,985 |
| Issued by public bodies:                |                |         |                |         |
| – central governments and central banks | <b>78,350</b>  | 38,735  | <b>63,537</b>  | 28,757  |
| – other public sector entities          | <b>17,748</b>  | 15,478  | <b>9,307</b>   | 10,371  |
|   | <b>96,098</b>  | 54,213  | <b>72,844</b>  | 39,128  |
| Issued by other bodies:                 |                |         |                |         |
| – banks                                 | <b>48,947</b>  | 83,075  | <b>28,402</b>  | 60,100  |
| – corporate entities                    | <b>3,975</b>   | 5,444   | <b>3,834</b>   | 3,757   |
|   | <b>52,922</b>  | 88,519  | <b>32,236</b>  | 63,857  |
|   | <b>149,020</b> | 142,732 | <b>105,080</b> | 102,985 |

At 31 December 2011 and 2010, there were no available-for-sale debt securities individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities for the Group and the Bank.

**(c) Available-for-sale equity shares**

|                              | <b>Group</b> |      | <b>Bank</b> |      |
|------------------------------|--------------|------|-------------|------|
|                              | <b>2011</b>  | 2010 | <b>2011</b> | 2010 |
| Listed in Hong Kong          | <b>48</b>    | 47   | <b>–</b>    | –    |
| Listed outside Hong Kong     | <b>18</b>    | 64   | <b>18</b>   | 64   |
|                              | <b>66</b>    | 111  | <b>18</b>   | 64   |
| Unlisted                     | <b>193</b>   | 215  | <b>44</b>   | 57   |
|                              | <b>259</b>   | 326  | <b>62</b>   | 121  |
| Issued by corporate entities | <b>259</b>   | 326  | <b>62</b>   | 121  |

There were no available-for-sale equity securities individually determined to be impaired during the year of 2011 and 2010 for the Group and the Bank.

## 37. INVESTMENTS IN SUBSIDIARIES

|                          | Bank   |        |
|--------------------------|--------|--------|
|                          | 2011   | 2010   |
| Unlisted shares, at cost | 14,434 | 11,584 |

The principal subsidiaries of the Bank are:

| Name of company   | Place of incorporation     | Principal activities                                       | Issued equity capital |
|---|----------------------------|--|-----------------------|
| Hang Seng Bank (China) Limited                          | People's Republic of China | Banking  | RMB4,500,000,000      |
| Hang Seng Finance Limited                               | Hong Kong SAR              | Lending  | HK\$1,000,000,000     |
| Hang Seng Credit Limited                                | Hong Kong SAR              | Lending  | HK\$200,000,000       |
| Hang Seng Bank (Bahamas) Limited                        | Bahamas                    | Banking  | US\$1,000,000         |
| Hang Seng Finance (Bahamas) Limited                     | Bahamas                    | Finance  | US\$5,000             |
| Hang Seng Bank (Trustee) Limited                        | Hong Kong SAR              | Trustee service  | HK\$3,000,000         |
| Hang Seng (Nominee) Limited                             | Hong Kong SAR              | Nominee service  | HK\$100,000           |
| Hang Seng Life Limited                                  | Hong Kong SAR              | Retirement benefits and life assurance                     | HK\$970,000,000       |
| Hang Seng Insurance Company Limited                     | Hong Kong SAR              | Retirement benefits and life assurance                     | HK\$5,226,184,570     |
| Hang Seng General Insurance (Hong Kong) Company Limited | Hong Kong SAR              | General insurance  | HK\$620,000,000       |
| Hang Seng Asset Management Pte Ltd                      | Singapore                  | Fund management  | SG\$2,000,000         |
| Hang Seng Investment Management Limited                 | Hong Kong SAR              | Fund management  | HK\$10,000,000        |
| Haseba Investment Company Limited                       | Hong Kong SAR              | Investment holding   | HK\$6,000             |
| Hang Seng Securities Limited                            | Hong Kong SAR              | Stockbroking   | HK\$26,000,000        |
| Yan Nin Development Company Limited                     | Hong Kong SAR              | Investment holding   | HK\$100,000           |
| Hang Seng Indexes Company Limited                       | Hong Kong SAR              | Compilation and dissemination of the Hang Seng share index | HK\$10,000            |
| Hang Seng Real Estate Management Limited                | Hong Kong SAR              | Property management  | HK\$10,000            |
| High Time Investments Limited                           | Hong Kong SAR              | Investment holding   | HK\$2,250,010,000     |

All the above companies are wholly-owned subsidiaries and unlisted. All subsidiaries are held directly by the Bank except for Hang Seng Life Limited and Hang Seng Indexes Company Limited. The principal places of operation are the same as the places of incorporation.

Some principal subsidiaries are regulated banking and insurance entities and as such, are required to maintain certain minimum levels of capital and liquid assets to support their operations. The effect of these regulatory requirements is to limit the extent to which the subsidiaries may transfer funds to the Bank in the form of repayment of certain shareholder loans or cash dividends.

## 38. INTEREST IN ASSOCIATES

|                               | Group  |        | Bank  |       |
|-------------------------------|--------|--------|-------|-------|
|                               | 2011   | 2010   | 2011  | 2010  |
| Unlisted investments, at cost | –      | –      | 912   | 912   |
| Listed investments, at cost   | –      | –      | 4,260 | 4,260 |
| Share of net assets           | 18,875 | 15,119 | –     | –     |
| Intangible asset              | 57     | 84     | –     | –     |
| Goodwill                      | 475    | 463    | –     | –     |
|                               | 19,407 | 15,666 | 5,172 | 5,172 |

The associates are:

| Name of company           | Place of incorporation and operation | Principal activity  | Group's interest in equity capital | Issued equity capital |
|---------------------------|--------------------------------------|---------------------|------------------------------------|-----------------------|
| <b>Unlisted</b>           |                                      |                     |                                    |                       |
| Barrowgate Limited        | Hong Kong SAR                        | Property investment | 24.64%                             | HK\$10,000            |
| Yantai Bank Co., Ltd.     | People's Republic of China           | Banking             | 20.00%                             | RMB2,000,000,000      |
| <b>Listed</b>             |                                      |                     |                                    |                       |
| Industrial Bank Co., Ltd. | People's Republic of China           | Banking             | 12.80%                             | RMB5,992,000,000      |

Interest in associates included listed investment of HK\$17,199 million (2010: HK\$13,752 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK\$21,307 million (2010: HK\$21,753 million).

In accordance with Hong Kong Accounting Standard 28 "Investments in Associates", an associate is an entity over which the investor has significant influence, including the power to participate in the financial and operating policy decisions without controlling the management of the investee. Usually a holding of less than 20 per cent is presumed not to have significant influence, unless such influence can be clearly demonstrated. The interests are recognised at cost and dividends accounted for as declared.

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. ("IB") and Yantai Bank Co., Ltd. ("Yantai Bank") are owned directly by the Bank.

The Group's interest in IB has been accounted for as an associate using the equity method as the Group has representation in both the Board and Executive Committee of IB, and the ability to participate in the decision making process.

For the year ended 31 December 2011, the financial results of IB and Yantai Bank were included in the financial statements based on financial statements drawn up to 30 September 2011, but taking into account any changes in the subsequent period from 1 October 2011 to 31 December 2011 that would materially affect the results. The Group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 "Investments in Associates" whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

**38. INTEREST IN ASSOCIATES** (continued)

The following table shows the summarised financial information of the associates with the aggregated amounts in which the Group's interests have been accounted for:

|                                | Assets           | Liabilities      | Equity         | Revenue       | Expenses      | Revenue Less Expenses |
|--------------------------------|------------------|------------------|----------------|---------------|---------------|-----------------------|
| <b>2011</b>                    |                  |                  |                |               |               |                       |
| 100 per cent                   | <b>2,628,083</b> | <b>2,487,408</b> | <b>140,675</b> | <b>66,218</b> | <b>36,226</b> | <b>29,992</b>         |
| The Group's effective interest | <b>340,228</b>   | <b>321,353</b>   | <b>18,875</b>  | <b>8,713</b>  | <b>4,723</b>  | <b>3,990</b>          |
| <b>2010</b>                    |                  |                  |                |               |               |                       |
| 100 per cent                   | 2,173,920        | 2,061,507        | 112,413        | 49,336        | 29,003        | 20,333                |
| The Group's effective interest | 281,332          | 266,213          | 15,119         | 6,462         | 3,801         | 2,661                 |

There was no impairment loss on our interest in associates for the years ended 31 December 2011 and 2010.

**39. INVESTMENT PROPERTIES**

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2011, and were updated for any material changes in the valuation as at 31 December 2011. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

**(a) Movement of investment properties**

|   | Group        |       | Bank         |       |
|---|--------------|-------|--------------|-------|
|   | 2011         | 2010  | 2011         | 2010  |
| At 1 January  | <b>3,251</b> | 2,872 | <b>2,100</b> | 1,883 |
| Surplus on revaluation credited to income statement (note 22) | <b>982</b>   | 474   | <b>613</b>   | 291   |
| Transfer from/(to) assets held for sale                       | <b>77</b>    | (78)  | <b>77</b>    | (78)  |
| Transfer from/(to) premises (note 40(a))                      | <b>4</b>     | (17)  | <b>16</b>    | 4     |
| At 31 December  | <b>4,314</b> | 3,251 | <b>2,806</b> | 2,100 |

**(b) Terms of lease**

|  | Group        |       | Bank         |       |
|--|--------------|-------|--------------|-------|
|  | 2011         | 2010  | 2011         | 2010  |
| <b>Leaseholds</b>                          |              |       |              |       |
| Held in Hong Kong:                         |              |       |              |       |
| – long leases (over 50 years unexpired)    | <b>1,495</b> | 1,086 | <b>776</b>   | 533   |
| – medium leases (10 to 50 years unexpired) | <b>2,819</b> | 2,165 | <b>2,030</b> | 1,567 |
| Held outside Hong Kong:                    |              |       |              |       |
| – medium leases (10 to 50 years unexpired) | <b>–</b>     | –     | <b>–</b>     | –     |
|  | <b>4,314</b> | 3,251 | <b>2,806</b> | 2,100 |

**39. INVESTMENT PROPERTIES** (continued)

(c) The Group leases out investment properties under operating leases. The leases typically run for an initial period of 2 years, and may contain an option to renew the lease after that date at which time all terms are renegotiated. None of the leases includes contingent rentals.

|   | Group |      | Bank |      |
|---|-------|------|------|------|
|   | 2011  | 2010 | 2011 | 2010 |
| Direct operating expenses arising from investment properties                      | 24    | 21   | 16   | 14   |
| Direct operating expenses from investment properties that generated rental income | 22    | 19   | 15   | 11   |

The Group's total future minimum lease payments receivable under non-cancellable operating leases are as follows:

|                                     | Group |      | Bank |      |
|-------------------------------------|-------|------|------|------|
|                                     | 2011  | 2010 | 2011 | 2010 |
| Less than one year                  | 146   | 120  | 100  | 72   |
| Over one year but within five years | 71    | 91   | 52   | 59   |
|                                     | 217   | 211  | 152  | 131  |

**40. PREMISES, PLANT AND EQUIPMENT**

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2011, and were updated for any material changes in the valuation as at 31 December 2011. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use.

**(a) Movement of premises, plant and equipment**

|  | Group    |                     |         |
|--|----------|---------------------|---------|
|  | Premises | Plant and equipment | Total   |
| <b>2011</b>  |          |                     |         |
| Cost or valuation:   |          |                     |         |
| At 1 January   | 13,899   | 3,502               | 17,401  |
| Exchange adjustments   | 31       | 21                  | 52      |
| Additions  | –        | 254                 | 254     |
| Disposals  | –        | (77)                | (77)    |
| Elimination of accumulated depreciation on revalued premises | (398)    | –                   | (398)   |
| Surplus on revaluation:                                      |          |                     |         |
| – credited to premises revaluation reserve                   | 3,729    | –                   | 3,729   |
| – credited to income statement (note 22)                     | 2        | –                   | 2       |
| Transfer from assets held for sale                           | 102      | –                   | 102     |
| Transfer to investment property (note 39(a))                 | (4)      | –                   | (4)     |
| Other  | 16       | (14)                | 2       |
| At 31 December   | 17,377   | 3,686               | 21,063  |
| Accumulated depreciation:                                    |          |                     |         |
| At 1 January   | (1)      | (2,839)             | (2,840) |
| Exchange adjustments   | –        | (12)                | (12)    |
| Charge for the year (note 17)                                | (404)    | (296)               | (700)   |
| Written off on disposal                                      | –        | 74                  | 74      |
| Elimination of accumulated depreciation on revalued premises | 398      | –                   | 398     |
| At 31 December   | (7)      | (3,073)             | (3,080) |
| Net book value at 31 December                                | 17,370   | 613                 | 17,983  |



**40. PREMISES, PLANT AND EQUIPMENT** (continued)**(a) Movement of premises, plant and equipment** (continued)

|  | Premises | Group<br>Plant and<br>equipment | Total   |
|--|----------|---------------------------------|---------|
| 2010   |          |                                 |         |
| Cost or valuation:   |          |                                 |         |
| At 1 January   | 11,638   | 3,387                           | 15,025  |
| Exchange adjustments   | 20       | 15                              | 35      |
| Additions  | 585      | 175                             | 760     |
| Disposals  | –        | (75)                            | (75)    |
| Elimination of accumulated depreciation on revalued premises | (329)    | –                               | (329)   |
| Surplus on revaluation:                                      |          |                                 |         |
| – credited to premises revaluation reserve                   | 2,102    | –                               | 2,102   |
| – credited to income statement (note 22)                     | 3        | –                               | 3       |
| Transfer to assets held for sale                             | (137)    | –                               | (137)   |
| Transfer from investment property (note 39(a))               | 17       | –                               | 17      |
| At 31 December   | 13,899   | 3,502                           | 17,401  |
| Accumulated depreciation:                                    |          |                                 |         |
| At 1 January   | –        | (2,611)                         | (2,611) |
| Exchange adjustments   | –        | (9)                             | (9)     |
| Charge for the year (note 17)                                | (330)    | (289)                           | (619)   |
| Written off on disposal                                      | –        | 70                              | 70      |
| Elimination of accumulated depreciation on revalued premises | 329      | –                               | 329     |
| At 31 December   | (1)      | (2,839)                         | (2,840) |
| Net book value at 31 December                                | 13,898   | 663                             | 14,561  |

**40. PREMISES, PLANT AND EQUIPMENT** (continued)**(a) Movement of premises, plant and equipment** (continued)

|  | Bank     |                     |         |
|--|----------|---------------------|---------|
|  | Premises | Plant and equipment | Total   |
| <b>2011</b>  |          |                     |         |
| Cost or valuation:   |          |                     |         |
| At 1 January   | 10,107   | 3,054               | 13,161  |
| Additions  | –        | 178                 | 178     |
| Disposals  | –        | (71)                | (71)    |
| Elimination of accumulated depreciation on revalued premises | (305)    | –                   | (305)   |
| Surplus on revaluation:                                      |          |                     |         |
| – credited to premises revaluation reserve                   | 2,923    | –                   | 2,923   |
| – credited to income statement                               | 1        | –                   | 1       |
| Transfer from assets held for sale                           | 102      | –                   | 102     |
| Transfer to investment property (note 39(a))                 | (16)     | –                   | (16)    |
| At 31 December   | 12,812   | 3,161               | 15,973  |
| Accumulated depreciation:                                    |          |                     |         |
| At 1 January   | –        | (2,573)             | (2,573) |
| Charge for the year  | (305)    | (220)               | (525)   |
| Written off on disposal                                      | –        | 69                  | 69      |
| Elimination of accumulated depreciation on revalued premises | 305      | –                   | 305     |
| At 31 December   | –        | (2,724)             | (2,724) |
| Net book value at 31 December                                | 12,812   | 437                 | 13,249  |

|  | Bank     |                     |         |
|--|----------|---------------------|---------|
|  | Premises | Plant and equipment | Total   |
| <b>2010</b>  |          |                     |         |
| Cost or valuation:   |          |                     |         |
| At 1 January   | 8,837    | 3,006               | 11,843  |
| Additions  | –        | 114                 | 114     |
| Disposals  | –        | (66)                | (66)    |
| Elimination of accumulated depreciation on revalued premises | (259)    | –                   | (259)   |
| Surplus on revaluation:                                      |          |                     |         |
| – credited to premises revaluation reserve                   | 1,667    | –                   | 1,667   |
| – credited to income statement                               | 3        | –                   | 3       |
| Transfer to assets held for sale                             | (137)    | –                   | (137)   |
| Transfer to investment property (note 39(a))                 | (4)      | –                   | (4)     |
| At 31 December   | 10,107   | 3,054               | 13,161  |
| Accumulated depreciation:                                    |          |                     |         |
| At 1 January   | –        | (2,409)             | (2,409) |
| Charge for the year  | (259)    | (226)               | (485)   |
| Written off on disposal                                      | –        | 62                  | 62      |
| Elimination of accumulated depreciation on revalued premises | 259      | –                   | 259     |
| At 31 December   | –        | (2,573)             | (2,573) |
| Net book value at 31 December                                | 10,107   | 481                 | 10,588  |

**40. PREMISES, PLANT AND EQUIPMENT** (continued)**(b) Terms of lease**

The net book value of premises comprises:

|  | Group         |        | Bank          |        |
|--|---------------|--------|---------------|--------|
|  | 2011          | 2010   | 2011          | 2010   |
| <b>Leaseholds</b>                          |               |        |               |        |
| Held in Hong Kong:                         |               |        |               |        |
| – long leases (over 50 years unexpired)    | <b>1,615</b>  | 1,031  | <b>1,226</b>  | 759    |
| – medium leases (10 to 50 years unexpired) | <b>14,963</b> | 12,098 | <b>11,584</b> | 9,311  |
| – short leases (under 10 years unexpired)  | <b>–</b>      | 36     | <b>–</b>      | 36     |
| Held outside Hong Kong:                    |               |        |               |        |
| – long leases (over 50 years unexpired)    | <b>8</b>      | 8      | <b>–</b>      | –      |
| – medium leases (10 to 50 years unexpired) | <b>784</b>    | 725    | <b>2</b>      | 1      |
|  | <b>17,370</b> | 13,898 | <b>12,812</b> | 10,107 |

**(c)** The carrying amount of all premises which have been stated in the balance sheet would have been as follows had they been stated at cost less accumulated depreciation:

|   | Group        |       | Bank         |       |
|---|--------------|-------|--------------|-------|
|   | 2011         | 2010  | 2011         | 2010  |
| Cost less accumulated depreciation at 31 December | <b>3,023</b> | 2,923 | <b>1,300</b> | 1,209 |

**41. INTANGIBLE ASSETS**

|  | Group        |       | Bank       |      |
|--|--------------|-------|------------|------|
|  | 2011         | 2010  | 2011       | 2010 |
| Present value of in-force long-term insurance business | <b>5,188</b> | 4,593 | <b>–</b>   | –    |
| Internally developed software                          | <b>399</b>   | 429   | <b>398</b> | 428  |
| Acquired software                                      | <b>46</b>    | 43    | <b>10</b>  | 14   |
| Goodwill   | <b>329</b>   | 329   | <b>–</b>   | –    |
|  | <b>5,962</b> | 5,394 | <b>408</b> | 442  |

**(a) Movement of present value of in-force long-term insurance business**

|   | Group        |       |
|---|--------------|-------|
|   | 2011         | 2010  |
| At 1 January                            | <b>4,593</b> | 3,466 |
| Addition from current year new business | <b>1,062</b> | 803   |
| Movement from in-force business         | <b>(467)</b> | 324   |
| At 31 December                          | <b>5,188</b> | 4,593 |

**41. INTANGIBLE ASSETS** (continued)**(a) Movement of present value of in-force long-term insurance business** (continued)

The key assumptions used in the computation of present value of in-force long-term insurance business ("PVIF") are as follows:

|                     | 2011 | 2010  |
|---------------------|------|-------|
| Risk discount rate  | 8.3% | 11.0% |
| Expenses inflation  | 3.0% | 3.0%  |
| Average lapse rate: |      |       |
| – 1st year          | 3.4% | 3.4%  |
| – 2nd year onwards  | 0.8% | 1.3%  |

The sensitivity of PVIF valuation to changes in individual assumptions at the balance sheet dates is shown in note 61(d).

**(b) Goodwill**

|                                 | Group |      | Bank |      |
|---------------------------------|-------|------|------|------|
|                                 | 2011  | 2010 | 2011 | 2010 |
| At 1 January and at 31 December | 329   | 329  | –    | –    |

Goodwill arising from acquisition of the remaining 50 per cent of Hang Seng Life Limited from HSBC Insurance (Asia-Pacific) Holdings Limited amounted to HK\$329 million is allocated to cash-generating units of Personal Financial Services (Life Insurance) - Hang Seng Insurance Company Limited ("HSIC") for the purpose of impairment testing.

During 2011, there was no impairment of goodwill (2010: Nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating unit based on appraisal value with the carrying amount of its net assets, including attributable goodwill.

The appraisal value comprises HSIC's net assets (other than value of business acquired and goodwill) as at 31 December 2011, the present value of in-force long-term insurance business and the expected value of future business. The present value of the in-force long-term insurance business is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 41(a) and 61(d).

**(c) Movement of internally developed application software and acquired software**

|                               | Group |       | Bank  |       |
|-------------------------------|-------|-------|-------|-------|
|                               | 2011  | 2010  | 2011  | 2010  |
| Cost:                         |       |       |       |       |
| At 1 January                  | 817   | 666   | 776   | 641   |
| Additions                     | 168   | 155   | 155   | 140   |
| Disposals                     | (10)  | (5)   | (10)  | (5)   |
| Exchange and others           | 3     | 1     | –     | –     |
| At 31 December                | 978   | 817   | 921   | 776   |
| Accumulated amortisation:     |       |       |       |       |
| At 1 January                  | (345) | (247) | (334) | (242) |
| Charge for the year (note 17) | (119) | (102) | (111) | (96)  |
| Written off on disposals      | 10    | 5     | 10    | 4     |
| Impairment                    | (78)  | –     | (78)  | –     |
| Exchange and others           | (1)   | (1)   | –     | –     |
| At 31 December                | (533) | (345) | (513) | (334) |
| Net book value at 31 December | 445   | 472   | 408   | 442   |

During 2011, there was impairment on internally developed application software and acquired software of HK\$78 million (2010: Nil).

## 42. OTHER ASSETS

|  | Group         |               | Bank         |              |
|--|---------------|---------------|--------------|--------------|
|  | 2011          | 2010          | 2011         | 2010         |
| Items in the course of collection from other banks | 4,513         | 4,673         | 4,513        | 4,673        |
| Prepayments and accrued income                     | 2,844         | 2,259         | 950          | 835          |
| Assets held for sale*                              |               |               |              |              |
| – repossessed assets                               | 3             | 12            | –            | 7            |
| – other assets held for sale                       | 35            | 206           | 35           | 206          |
| Acceptances and endorsements                       | 4,697         | 3,751         | 3,052        | 2,363        |
| Retirement benefit assets                          | 34            | 95            | 34           | 95           |
| Other accounts                                     | 1,637         | 1,310         | 598          | 608          |
|  | <b>13,763</b> | <b>12,306</b> | <b>9,182</b> | <b>8,787</b> |

\* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2011 and 2010.

There are no significant impaired, overdue or rescheduled other assets at the year-end.

## 43. CURRENT, SAVINGS AND OTHER DEPOSIT ACCOUNTS

|   | Group          |                | Bank           |                |
|---|----------------|----------------|----------------|----------------|
|   | 2011           | 2010           | 2011           | 2010           |
| Current, savings and other deposit accounts:                    |                |                |                |                |
| – as stated in balance sheet                                    | 699,857        | 683,628        | 661,012        | 649,144        |
| – structured deposits reported as trading liabilities (note 44) | 30,923         | 20,852         | 7,288          | 8,377          |
|   | <b>730,780</b> | <b>704,480</b> | <b>668,300</b> | <b>657,521</b> |
| By type:  |                |                |                |                |
| – demand and current accounts                                   | 57,977         | 59,116         | 57,975         | 59,104         |
| – savings accounts  | 431,863        | 466,158        | 421,003        | 456,818        |
| – time and other deposits                                       | 240,940        | 179,206        | 189,322        | 141,599        |
|   | <b>730,780</b> | <b>704,480</b> | <b>668,300</b> | <b>657,521</b> |

## 44. TRADING LIABILITIES

|   | Group         |               | Bank          |               |
|---|---------------|---------------|---------------|---------------|
|   | 2011          | 2010          | 2011          | 2010          |
| Structured certificates of deposit in issue (note 46) | 2,641         | 26            | 2,641         | 26            |
| Other debt securities in issue (note 46)              | 542           | 2,712         | 542           | 2,712         |
| Structured deposits (note 43)                         | 30,923        | 20,852        | 7,288         | 8,377         |
| Short positions in securities and others              | 25,606        | 18,991        | 25,606        | 18,991        |
|   | <b>59,712</b> | <b>42,581</b> | <b>36,077</b> | <b>30,106</b> |



## 45. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

|   | Group |      | Bank |      |
|---|-------|------|------|------|
|   | 2011  | 2010 | 2011 | 2010 |
| Liabilities to customers under investment contracts | 434   | 457  | –    | –    |

## 46. CERTIFICATES OF DEPOSIT AND OTHER DEBT SECURITIES IN ISSUE

|   | Group  |       | Bank   |       |
|---|--------|-------|--------|-------|
|   | 2011   | 2010  | 2011   | 2010  |
| Certificates of deposit and other debt securities in issue:                             |        |       |        |       |
| – as stated in balance sheet  | 9,284  | 3,095 | 9,284  | 3,095 |
| – structured certificates of deposit in issue reported as trading liabilities (note 44) | 2,641  | 26    | 2,641  | 26    |
| – other structured debt securities in issue reported as trading liabilities (note 44)   | 542    | 2,712 | 542    | 2,712 |
|   | 12,467 | 5,833 | 12,467 | 5,833 |
| By type:  |        |       |        |       |
| – certificates of deposit in issue  | 11,925 | 3,121 | 11,925 | 3,121 |
| – other debt securities in issue  | 542    | 2,712 | 542    | 2,712 |
|   | 12,467 | 5,833 | 12,467 | 5,833 |

## 47. OTHER LIABILITIES

|  | Group  |        | Bank   |        |
|--|--------|--------|--------|--------|
|  | 2011   | 2010   | 2011   | 2010   |
| Items in the course of transmission to other banks | 7,027  | 7,208  | 6,977  | 7,208  |
| Accruals   | 2,956  | 2,385  | 1,980  | 1,783  |
| Acceptances and endorsements                       | 4,697  | 3,751  | 3,052  | 2,363  |
| Retirement benefit liabilities                     | 3,260  | 1,718  | 3,260  | 1,718  |
| Other  | 2,198  | 1,956  | 1,691  | 2,362  |
|  | 20,138 | 17,018 | 16,960 | 15,434 |

## 48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS

## Group

|                                   | 2011   |             |        | 2010   |             |        |
|-----------------------------------|--------|-------------|--------|--------|-------------|--------|
|                                   | Gross  | Reinsurance | Net    | Gross  | Reinsurance | Net    |
| <b>Non-life insurance</b>         |        |             |        |        |             |        |
| Unearned premiums                 | 245    | (77)        | 168    | 227    | (75)        | 152    |
| Notified claims                   | 183    | (27)        | 156    | 160    | (18)        | 142    |
| Claims incurred but not reported  | 37     | (8)         | 29     | 41     | (9)         | 32     |
| Other                             | 54     | (1)         | 53     | 49     | (1)         | 48     |
|                                   | 519    | (113)       | 406    | 477    | (103)       | 374    |
| <b>Policyholders' liabilities</b> |        |             |        |        |             |        |
| Life (non-linked)                 | 71,523 | (42)        | 71,481 | 63,722 | (35)        | 63,687 |
| Life (linked)                     | 183    | –           | 183    | 226    | –           | 226    |
|                                   | 71,706 | (42)        | 71,664 | 63,948 | (35)        | 63,913 |
|                                   | 72,225 | (155)       | 72,070 | 64,425 | (138)       | 64,287 |

Amounts recoverable from reinsurance of liabilities under insurance contracts issued are included in the consolidated balance sheet in "Other assets".

The movement of liabilities under insurance contracts was as follows:

## (a) Non-life insurance

## Group

|  | Gross | Reinsurance | Net   |
|--|-------|-------------|-------|
| <b>2011</b>  |       |             |       |
| <b>Unearned premiums</b>                             |       |             |       |
| At 1 January   | 227   | (75)        | 152   |
| Gross written premiums                               | 456   | (107)       | 349   |
| Gross earned premiums                                | (444) | 106         | (338) |
| Exchange and other movements                         | 6     | (1)         | 5     |
| At 31 December                                       | 245   | (77)        | 168   |
| <b>Notified and incurred but not reported claims</b> |       |             |       |
| At 1 January   |       |             |       |
| – notified claims                                    | 160   | (18)        | 142   |
| – claims incurred but not reported                   | 41    | (9)         | 32    |
|  | 201   | (27)        | 174   |
| Claims paid  | (109) | 28          | (81)  |
| Claims incurred                                      | 132   | (37)        | 95    |
|  | 23    | (9)         | 14    |
| Exchange and other movements                         | (4)   | 1           | (3)   |
| At 31 December                                       |       |             |       |
| – notified claims                                    | 183   | (27)        | 156   |
| – claims incurred but not reported                   | 37    | (8)         | 29    |
|  | 220   | (35)        | 185   |
| <b>Other</b>   | 54    | (1)         | 53    |
|  | 519   | (113)       | 406   |

**48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS** (continued)**(a) Non-life insurance** (continued)

|  | Group |             |       |
|--|-------|-------------|-------|
|  | Gross | Reinsurance | Net   |
| 2010   |       |             |       |
| <b>Unearned premiums</b>                             |       |             |       |
| At 1 January   | 192   | (52)        | 140   |
| Gross written premiums                               | 466   | (122)       | 344   |
| Gross earned premiums                                | (437) | 96          | (341) |
| Exchange and other movements                         | 6     | 3           | 9     |
| At 31 December                                       | 227   | (75)        | 152   |
| <b>Notified and incurred but not reported claims</b> |       |             |       |
| At 1 January   |       |             |       |
| – notified claims                                    | 146   | (19)        | 127   |
| – claims incurred but not reported                   | 43    | (8)         | 35    |
|  | 189   | (27)        | 162   |
| Claims paid  | (113) | 26          | (87)  |
| Claims incurred                                      | 134   | (26)        | 108   |
|  | 21    | –           | 21    |
| Exchange and other movements                         | (9)   | –           | (9)   |
| At 31 December                                       |       |             |       |
| – notified claims                                    | 160   | (18)        | 142   |
| – claims incurred but not reported                   | 41    | (9)         | 32    |
|  | 201   | (27)        | 174   |
| <b>Other</b>   | 49    | (1)         | 48    |
|  | 477   | (103)       | 374   |

## 48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

## (b) Policyholders' liabilities

|  | Group         |             |               |
|--|---------------|-------------|---------------|
|  | Gross         | Reinsurance | Net           |
| <b>2011</b>  |               |             |               |
| <b>Life (non-linked)</b>                                   |               |             |               |
| At 1 January   | 63,722        | (35)        | 63,687        |
| Benefits paid  | (3,533)       | 29          | (3,504)       |
| Claims incurred and movement in policyholders' liabilities | 11,573        | (47)        | 11,526        |
| Exchange and other movements                               | (239)         | 11          | (228)         |
| At 31 December   | 71,523        | (42)        | 71,481        |
| <b>Life (linked)</b>                                       |               |             |               |
| At 1 January   | 226           | –           | 226           |
| Benefits paid  | (30)          | –           | (30)          |
| Claims incurred and movement in policyholders' liabilities | (11)          | –           | (11)          |
| Exchange and other movements                               | (2)           | –           | (2)           |
| At 31 December   | 183           | –           | 183           |
|  | <b>71,706</b> | <b>(42)</b> | <b>71,664</b> |

|  | Group         |             |               |
|--|---------------|-------------|---------------|
|  | Gross         | Reinsurance | Net           |
| <b>2010</b>  |               |             |               |
| <b>Life (non-linked)</b>                                   |               |             |               |
| At 1 January   | 53,588        | (19)        | 53,569        |
| Benefits paid  | (2,402)       | 22          | (2,380)       |
| Claims incurred and movement in policyholders' liabilities | 12,487        | (36)        | 12,451        |
| Exchange and other movements                               | 49            | (2)         | 47            |
| At 31 December   | 63,722        | (35)        | 63,687        |
| <b>Life (linked)</b>                                       |               |             |               |
| At 1 January   | 224           | –           | 224           |
| Benefits paid  | (24)          | –           | (24)          |
| Claims incurred and movement in policyholders' liabilities | 28            | –           | 28            |
| Exchange and other movements                               | (2)           | –           | (2)           |
| At 31 December   | 226           | –           | 226           |
|  | <b>63,948</b> | <b>(35)</b> | <b>63,913</b> |

**49. CURRENT TAX AND DEFERRED TAX****(a) Current tax and deferred tax are represented in the balance sheet:**

|  | <b>Group</b> |       | <b>Bank</b>  |       |
|--|--------------|-------|--------------|-------|
|  | <b>2011</b>  | 2010  | <b>2011</b>  | 2010  |
| Current taxation recoverable<br>(included in "Other assets") | <b>13</b>    | 12    | <b>–</b>     | –     |
| Current tax liabilities:                                     |              |       |              |       |
| Provision for Hong Kong profits tax                          | <b>293</b>   | 337   | <b>260</b>   | 316   |
| Provision for taxation outside Hong Kong                     | <b>12</b>    | 7     | <b>10</b>    | 4     |
|  | <b>305</b>   | 344   | <b>270</b>   | 320   |
| Deferred tax liabilities                                     | <b>4,037</b> | 3,234 | <b>1,801</b> | 1,617 |
|  | <b>4,342</b> | 3,578 | <b>2,071</b> | 1,937 |

**(b) Deferred tax assets and liabilities recognised**

The major components of deferred tax (assets)/liabilities recognised in the balance sheet and the movements during the year are as follows:

|   | <b>Group</b>   |                                  |                                   |   |                        |              |              |
|---|--|----------------------------------|-----------------------------------|---|------------------------|--------------|--------------|
|   | <b>Depreciation allowances in excess of related depreciation</b> | <b>Revaluation of properties</b> | <b>Loan impairment allowances</b> | <b>Fair value adjustments for available-for-sale financial assets</b> | <b>Cash flow hedge</b> | <b>Other</b> | <b>Total</b> |
| <b>2011</b>   |  |                                  |                                   |   |                        |              |              |
| At 1 January  | <b>106</b>   | <b>2,348</b>                     | <b>(85)</b>                       | <b>28</b>   | <b>14</b>              | <b>823</b>   | <b>3,234</b> |
| (Credited)/charged to income statement (note 23(a)) | <b>(13)</b>  | <b>111</b>                       | <b>(3)</b>                        | <b>–</b>  | <b>–</b>               | <b>434</b>   | <b>529</b>   |
| Charged/(credited) to reserves                      | <b>–</b>   | <b>610</b>                       | <b>–</b>                          | <b>(59)</b>   | <b>(13)</b>            | <b>(264)</b> | <b>274</b>   |
| At 31 December                                      | <b>93</b>  | <b>3,069</b>                     | <b>(88)</b>                       | <b>(31)</b>   | <b>1</b>               | <b>993</b>   | <b>4,037</b> |
| <b>2010</b>   |  |                                  |                                   |   |                        |              |              |
| At 1 January  | 119  | 1,964                            | (99)                              | 5   | 35                     | 420          | 2,444        |
| (Credited)/charged to income statement (note 23(a)) | (13)   | 40                               | 14                                | –   | –                      | 401          | 442          |
| Charged/(credited) to reserves                      | –  | 344                              | –                                 | 23  | (21)                   | 2            | 348          |
| At 31 December                                      | 106  | 2,348                            | (85)                              | 28  | 14                     | 823          | 3,234        |



**49. CURRENT TAX AND DEFERRED TAX** (continued)**(b) Deferred tax assets and liabilities recognised** (continued)

|  | Bank  |                           |                            |  |                 |       |       |
|--|---|---------------------------|----------------------------|--|-----------------|-------|-------|
|  | Depreciation allowances in excess of related depreciation | Revaluation of properties | Loan impairment allowances | Fair value adjustments for available-for-sale financial assets | Cash flow hedge | Other | Total |
| <b>2011</b>                            |   |                           |                            |  |                 |       |       |
| At 1 January                           | 101   | 1,868                     | (84)                       | 25   | 14              | (307) | 1,617 |
| (Credited)/charged to income statement | (9)   | 59                        | (3)                        | –  | –               | (8)   | 39    |
| Charged/(credited) to reserves         | –   | 482                       | –                          | (59)   | (13)            | (265) | 145   |
| At 31 December                         | 92  | 2,409                     | (87)                       | (34)   | 1               | (580) | 1,801 |
| <b>2010</b>                            |   |                           |                            |  |                 |       |       |
| At 1 January                           | 118   | 1,578                     | (98)                       | 4  | 35              | (294) | 1,343 |
| (Credited)/charged to income statement | (17)  | 16                        | 14                         | –  | –               | (15)  | (2)   |
| Charged/(credited) to reserves         | –   | 274                       | –                          | 21   | (21)            | 2     | 276   |
| At 31 December                         | 101   | 1,868                     | (84)                       | 25   | 14              | (307) | 1,617 |

**(c) Deferred tax assets not recognised**

At the end of the balance sheet dates, the Group has not recognised deferred tax assets in respect of tax losses and revaluation loss on debt securities of subsidiaries amounting to HK\$64 million (2010: HK\$70 million) which are considered unlikely to be utilised. Of this amount, HK\$30 million (2010: HK\$40 million) has no expiry date and HK\$34 million (2010: HK\$30 million) is scheduled to expire within five years.

**(d) Deferred tax liabilities not recognised**

There were no deferred tax liabilities not recognised in 2011 (2010: Nil).

## 50. SUBORDINATED LIABILITIES

|   |  | Group  |        | Bank   |        |
|---|--|--------|--------|--------|--------|
|   |  | 2011   | 2010   | 2011   | 2010   |
| Nominal value                                 | Description  |        |        |        |        |
| <b>Amount owed to third parties</b>           |  |        |        |        |        |
| US\$450 million                               | Callable floating rate subordinated notes due July 2016 <sup>(1)</sup> | -      | 3,495  | -      | 3,495  |
| US\$300 million                               | Callable floating rate subordinated notes due July 2017 <sup>(2)</sup> | 2,328  | 2,328  | 2,328  | 2,328  |
| <b>Amount owed to HSBC Group undertakings</b> |  |        |        |        |        |
| US\$775 million                               | Floating rate subordinated loan debt due December 2020                 | 6,022  | 6,025  | 6,022  | 6,025  |
| US\$450 million                               | Floating rate subordinated loan debt due July 2021 <sup>(1)</sup>      | 3,496  | -      | 3,496  | -      |
|   |  | 11,846 | 11,848 | 11,846 | 11,848 |
| Representing:                                 |  |        |        |        |        |
| - measured at amortised cost                  |  | 11,846 | 11,848 | 11,846 | 11,848 |

The above subordinated notes (excluding the subordinated loan debt due December 2020 and July 2021) carries a one-time call option exercisable by the Group on a day falling five years plus one day after the relevant date of issue/drawdown.

(1) The Bank exercised its option to redeem these subordinated notes at par of US\$450 million and replenished them with a new issue of US\$450 million subordinated loan debt in July 2011.

(2) Interest rate at three-month US dollar LIBOR plus 0.25 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.75 per cent, payable quarterly.

The outstanding subordinated notes, which qualify as supplementary capital, help the Bank maintain a balanced capital structure and support business growth.

## 51. SHARE CAPITAL

Authorised:

The authorised share capital of the Bank is HK\$11,000 million (2010: HK\$11,000 million) divided into 2,200 million shares (2010: 2,200 million shares) of HK\$5 each.

|   | 2011  | 2010  |
|---|-------|-------|
| Issued and fully paid:  |       |       |
| 1,911,842,736 shares (2010: 1,911,842,736 shares) of HK\$5 each | 9,559 | 9,559 |

During the year, the Bank made no repurchase of its own shares (2010: Nil).

## 52. RESERVES

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity.

The Bank and its banking subsidiaries operate under regulatory jurisdictions which require the maintenance of minimum capital adequacy ratios and which could therefore potentially restrict the amount of realised profits which can be distributed to shareholders.

### Regulatory reserve

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2011, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group and the Bank to shareholders by HK\$4,226 million (2010: HK\$1,654 million) and HK\$3,896 million (2010: HK\$1,535 million) respectively.

### Retained profits

Retained profits are the cumulative net earnings of the Group that have not been paid out as dividends, but retained to be reinvested in the business.

### Premises revaluation reserve

The premises revaluation reserve represents the difference between the current fair value of the premises and its original depreciated cost.

The premises revaluation reserve included HK\$22 million in relation to a premise classified as assets held for sale, included in "Other assets" in the consolidated balance sheet at 31 December 2011 (31 December 2010: HK\$117 million).

### Cash flow hedging reserve

The cash flow hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions.

### Available-for-sale investment reserve

The available-for-sale investment reserve includes the cumulative net change in the fair value of available-for-sale investments other than impairments which have been recognised in the income statement.

### Capital redemption reserve

Capital redemption reserve represents the difference between the capital payment and the nominal value of the redeemed share capital.

### Other reserves

Other reserves mainly comprise foreign exchange reserve and share-based payment reserve. The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations. The share-based payment reserve is used to record the corresponding amount of share options granted by ultimate holding company to the Group's employees and other cost of share-based payment arrangement. Other reserves also included the gain on dilution of investment in an associate of HK\$1,465 million transferred from retained profits.

**52. RESERVES** (continued)

Details of the changes in the Bank's individual components of equity between the beginning and the end of the year are set out below:

|  | <b>Bank</b>    |         |
|--|----------------|---------|
|  | <b>2011</b>    | 2010    |
| Retained profits (including proposed dividends)        | <b>26,451</b>  | 23,270  |
| Premises revaluation reserve                           | <b>9,871</b>   | 7,654   |
| Cash flow hedging reserve                              | <b>6</b>       | 72      |
| Available-for-sale investment reserve:                 |                |         |
| – on debt securities                                   | <b>(174)</b>   | 109     |
| – on equity securities                                 | <b>10</b>      | 34      |
| Capital redemption reserve                             | <b>99</b>      | 99      |
| Other reserves   | <b>585</b>     | 524     |
| Total reserves (including proposed dividends)          | <b>36,848</b>  | 31,762  |
| <b>Retained profits (including proposed dividends)</b> |                |         |
| At beginning of the year                               | <b>23,270</b>  | 21,527  |
| Dividends to shareholders:                             |                |         |
| – dividends approved in respect of the previous year   | <b>(3,633)</b> | (3,633) |
| – dividends declared in respect of the current year    | <b>(6,309)</b> | (6,309) |
| Transfer   | <b>224</b>     | 185     |
| Total comprehensive income for the year                | <b>12,899</b>  | 11,500  |
|  | <b>26,451</b>  | 23,270  |
| <b>Premises revaluation reserve</b>                    |                |         |
| At beginning of the year                               | <b>7,654</b>   | 6,447   |
| Transfer   | <b>(224)</b>   | (185)   |
| Total comprehensive income for the year                | <b>2,441</b>   | 1,392   |
|  | <b>9,871</b>   | 7,654   |
| <b>Cash flow hedging reserve</b>                       |                |         |
| At beginning of the year                               | <b>72</b>      | 180     |
| Total comprehensive income for the year                | <b>(66)</b>    | (108)   |
|  | <b>6</b>       | 72      |
| <b>Available-for-sale investment reserve</b>           |                |         |
| At beginning of the year                               | <b>143</b>     | (1)     |
| Total comprehensive income for the year                | <b>(307)</b>   | 144     |
|  | <b>(164)</b>   | 143     |
| <b>Capital redemption reserve</b>                      |                |         |
| At beginning of the year                               | <b>99</b>      | 99      |
| Total comprehensive income for the year                | <b>–</b>       | –       |
|  | <b>99</b>      | 99      |
| <b>Other reserve</b>                                   |                |         |
| At beginning of the year                               | <b>524</b>     | 459     |
| Costs of share-based payment arrangements              | <b>61</b>      | 64      |
| Total comprehensive income for the year                | <b>–</b>       | 1       |
|  | <b>585</b>     | 524     |
| Total reserves (including proposed dividends)          | <b>36,848</b>  | 31,762  |

At 31 December 2011, the aggregate amount of reserves available for distribution to equity shareholders of the Bank as calculated under the provision of section 79B of the Hong Kong Companies Ordinance amounted to HK\$20,642 million (2010: HK\$20,556 million). After considering regulatory capital requirement and business development needs, an amount of HK\$3,633 million has been declared as the proposed fourth interim dividends in respect of the financial year ended 31 December 2011 (2010: HK\$3,633 million). The difference between the aggregate distributable reserves of HK\$20,642 million and the Bank's retained profit of HK\$26,451 million as reported above mainly represents the exclusion of unrealised revaluation gain on investment properties and the regulatory reserve of the Bank.

**53. RECONCILIATION OF CASH FLOW STATEMENT****(a) Reconciliation of operating profit to net cash flow from operating activities**

|  | 2011            | 2010            |
|--|-----------------|-----------------|
| Operating profit   | 14,181          | 14,085          |
| Net interest income  | (15,736)        | (14,300)        |
| Dividend income  | (17)            | (14)            |
| Loan impairment charges  | 440             | 390             |
| Impairment loss of intangible assets   | 78              | –               |
| Depreciation   | 700             | 619             |
| Amortisation of intangible assets  | 119             | 102             |
| Amortisation of available-for-sale investments   | (24)            | 80              |
| Amortisation of held-to-maturity debt securities   | 5               | 5               |
| Advances written off net of recoveries   | (607)           | (510)           |
| Interest received  | 18,403          | 15,219          |
| Interest paid  | (4,439)         | (2,301)         |
| <b>Operating profit before changes in working capital</b>  | <b>13,103</b>   | <b>13,375</b>   |
| Change in treasury bills and certificates of deposit with original maturity more than three months | (24,344)        | 32,409          |
| Change in placings with and advances to banks maturing after one month                             | 4,801           | (26,155)        |
| Change in trading assets   | (34,947)        | 24,451          |
| Change in financial assets designated at fair value  | 150             | 501             |
| Change in derivative financial instruments   | 1,048           | (111)           |
| Change in advances to customers  | (13,419)        | (127,906)       |
| Change in other assets   | (7,715)         | (15,680)        |
| Change in financial liabilities designated at fair value   | –               | (2)             |
| Change in current, savings and other deposit accounts  | 16,229          | 47,259          |
| Change in deposits from banks  | (1,582)         | 10,716          |
| Change in trading liabilities  | 17,131          | 4,190           |
| Change in certificates of deposit and other debt securities in issue                               | 6,189           | 1,269           |
| Change in other liabilities  | 10,659          | 15,448          |
| Elimination of exchange differences and other non-cash items                                       | (4,836)         | (8,158)         |
| <b>Cash used in operating activities</b>   | <b>(17,533)</b> | <b>(28,394)</b> |
| Taxation paid  | (2,044)         | (1,704)         |
| <b>Net cash outflow from operating activities</b>  | <b>(19,577)</b> | <b>(30,098)</b> |

**(b) Analysis of the balances of cash and cash equivalents**

|  | 2011           | 2010           |
|--|----------------|----------------|
| Cash and balances with banks and other financial institutions                                  | 39,533         | 44,411         |
| Placings with and advances to banks and other financial institutions maturing within one month | 54,049         | 53,457         |
| Treasury bills   | 23,738         | 20,692         |
| Certificates of deposit  | 3,149          | –              |
|  | <b>120,469</b> | <b>118,560</b> |

The balances of cash and cash equivalents included cash balances with central banks and financial institutions that are subject to exchange control and regulatory restrictions, amounting to HK\$20,004 million at 31 December 2011 (31 December 2010: HK\$13,331 million).

## 54. CONTINGENT LIABILITIES AND COMMITMENTS

### (a) Off-balance sheet contingent liabilities and commitments

The tables below give the contract amounts, credit equivalent amounts and risk-weighted amounts of off-balance sheet transactions. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

For the purposes of these financial statements, acceptances and endorsements are recognised on the balance sheet in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK\$4,697 million (2010: HK\$3,751 million) and HK\$3,052 million (2010: HK\$2,363 million) respectively.

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

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Capital Rules and depend on the status of the counterparty and maturity characteristics of the instrument.

The risk-weighted assets at balance sheet dates were calculated based on the "Advanced internal ratings-based approach".

|  | Group            |                           |                       | Bank             |                           |                       |
|--|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
|  | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| <b>2011</b>  |                  |                           |                       |                  |                           |                       |
| Direct credit substitutes  | 5,438            | 5,308                     | 3,426                 | 3,704            | 3,574                     | 1,692                 |
| Transaction-related contingencies  | 1,220            | 138                       | 72                    | 1,178            | 135                       | 72                    |
| Trade-related contingencies  | 9,807            | 979                       | 532                   | 7,933            | 791                       | 394                   |
| Forward asset purchases  | 35               | 35                        | 35                    | 35               | 35                        | 35                    |
| Undrawn formal standby facilities, credit lines and other commitments to lend: |                  |                           |                       |                  |                           |                       |
| – not unconditionally cancellable*   | 31,311           | 15,081                    | 5,384                 | 31,262           | 14,243                    | 5,334                 |
| – unconditionally cancellable  | 232,469          | 76,890                    | 23,420                | 196,627          | 70,777                    | 18,524                |
|  | <b>280,280</b>   | <b>98,431</b>             | <b>32,869</b>         | <b>240,739</b>   | <b>89,555</b>             | <b>26,051</b>         |



**54. CONTINGENT LIABILITIES AND COMMITMENTS** (continued)**(a) Off-balance sheet contingent liabilities and commitments** (continued)

|  | Group            |                           |                       | Bank             |                           |                       |
|--|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
|  | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| 2010   |                  |                           |                       |                  |                           |                       |
| Direct credit substitutes  | 4,365            | 4,220                     | 3,231                 | 3,263            | 3,118                     | 2,129                 |
| Transaction-related contingencies  | 455              | 337                       | 168                   | 351              | 300                       | 134                   |
| Trade-related contingencies  | 10,593           | 3,516                     | 2,008                 | 8,935            | 2,737                     | 1,530                 |
| Forward asset purchases  | 51               | 51                        | 51                    | 51               | 51                        | 51                    |
| Undrawn formal standby facilities, credit lines and other commitments to lend: |                  |                           |                       |                  |                           |                       |
| – not unconditionally cancellable*   | 38,273           | 17,788                    | 7,479                 | 34,363           | 15,191                    | 5,767                 |
| – unconditionally cancellable  | 198,724          | 66,852                    | 20,649                | 170,333          | 60,379                    | 15,042                |
|  | 252,461          | 92,764                    | 33,586                | 217,296          | 81,776                    | 24,653                |

\* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of “not more than one year” and “more than one year” as at 31 December 2011 were HK\$11,487 million and HK\$19,824 million respectively (31 December 2010: HK\$13,264 million and HK\$25,009 million).

**(b) Contingencies**

There is no material litigation expected to result in a significant adverse effect on the financial position of the Group and the Bank, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

**55. ASSETS PLEDGED AS SECURITY FOR LIABILITIES**

At 31 December 2011, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements for the Group and the Bank amounted to HK\$25,569 million (Group and Bank at 31 December 2010: HK\$18,971 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK\$25,881 million (Group and Bank at 31 December 2010: HK\$19,270 million) and mainly comprised items included in “Trading assets” and “Financial investments”.

These transactions are conducted under terms that are usual and customary to standard lending activities.

**56. CAPITAL COMMITMENTS**

|   | Group |      | Bank |      |
|---|-------|------|------|------|
|   | 2011  | 2010 | 2011 | 2010 |
| Expenditure authorised and contracted for     | 117   | 162  | 100  | 121  |
| Expenditure authorised but not contracted for | –     | –    | –    | –    |

**57. LEASE COMMITMENTS**

The Group leases certain properties and equipment under operating leases. The leases typically run for an initial period of one to five years and may include an option to renew the lease when all terms are renegotiated. None of these leases includes contingent rentals.

The total future minimum lease payments payable under non-cancellable operating leases are as follows:

|                            | Group |       | Bank |      |
|----------------------------|-------|-------|------|------|
|                            | 2011  | 2010  | 2011 | 2010 |
| Within one year            | 512   | 454   | 377  | 338  |
| Between one and five years | 647   | 717   | 517  | 611  |
| Over five years            | 11    | 14    | –    | –    |
|                            | 1,170 | 1,185 | 894  | 949  |

## 58. EMPLOYEE RETIREMENT BENEFITS

### (a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 40 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The latest annual actuarial valuations at 31 December 2011 were performed by T Ching, fellow of the Society of Actuaries of the United States of America, of HSBC Insurance (Asia) Limited, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the balance sheet at year-end and retirement benefits costs recognised in the income statement for the year in respect of these defined benefit schemes are set out below.

(i) The amounts recognised in the balance sheet are as follows:

|  | Group and Bank |              |              |
|--|----------------|--------------|--------------|
|  | HSBDBS         | HSBPS        | HSBNTBS      |
| <b>2011</b>  |                |              |              |
| Present value of funded obligations (note 58(a)(iii))                    | <b>(7,066)</b> | <b>(201)</b> | <b>(1)</b>   |
| Fair value of scheme assets (note 58(a)(iv))                             | <b>3,806</b>   | <b>204</b>   | <b>32</b>    |
| Net (liabilities)/assets recognised in the balance sheet (note 58(a)(v)) | <b>(3,260)</b> | <b>3</b>     | <b>31</b>    |
| Reported as "Assets"   | <b>-</b>       | <b>3</b>     | <b>31</b>    |
| Reported as "Liabilities"  | <b>(3,260)</b> | <b>-</b>     | <b>-</b>     |
|  | <b>(3,260)</b> | <b>3</b>     | <b>31</b>    |
| Obligations covered by scheme assets (%)                                 | <b>54</b>      | <b>101</b>   | <b>3,200</b> |
| <b>2010</b>  |                |              |              |
| Present value of funded obligations (note 58(a)(iii))                    | (5,710)        | (157)        | (2)          |
| Fair value of scheme assets (note 58(a)(iv))                             | 3,992          | 222          | 32           |
| Net (liabilities)/assets recognised in the balance sheet (note 58(a)(v)) | (1,718)        | 65           | 30           |
| Reported as "Assets"   | -              | 65           | 30           |
| Reported as "Liabilities"  | (1,718)        | -            | -            |
|  | (1,718)        | 65           | 30           |
| Obligations covered by scheme assets (%)                                 | 70             | 141          | 1,600        |

The Occupational Retirement Schemes Ordinance (Cap.426 of the laws of Hong Kong) ("the Ordinance") requires that registered retirement benefit schemes shall at all time be fully funded to meet its aggregate vested liability (i.e. on a wind-up basis) in accordance with the recommendations contained in an actuarial certificate supplied under the Ordinance. Any shortfall must be made up within the specified time under the Ordinance. Any deficits to meet the aggregate past service liability (i.e. on an on-going basis) can however be eliminated over a period of time in accordance with the funding recommendations of an actuary.

On an on-going basis, the actuarial value of the principal scheme assets of HSBDBS represented 87 per cent (2010: 97 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK\$594 million (deficit in 2010: HK\$109 million). On a wind-up basis, the actuarial value of the scheme assets represented 92 per cent (2010: 102 per cent) of the members' vested benefits, based on salaries at that date, and the resulting deficit amounted to HK\$316 million (surplus in 2010: HK\$71 million).

**58. EMPLOYEE RETIREMENT BENEFITS** (continued)**(a) Defined benefit schemes** (continued)

(ii) The composition of the scheme assets are as follows:

|  | Group and Bank |            |           |
|--|----------------|------------|-----------|
|  | HSBDBS         | HSBPS      | HSBNTBS   |
| <b>2011</b>  |                |            |           |
| Equity   | <b>1,324</b>   | <b>14</b>  | <b>-</b>  |
| Bonds  | <b>2,307</b>   | <b>170</b> | <b>-</b>  |
| Ordinary shares issued by ultimate holding company | <b>35</b>      | <b>-</b>   | <b>-</b>  |
| Other  | <b>140</b>     | <b>20</b>  | <b>32</b> |
|  | <b>3,806</b>   | <b>204</b> | <b>32</b> |
| <b>2010</b>  |                |            |           |
| Equity   | 1,297          | 29         | -         |
| Bonds  | 2,570          | 170        | -         |
| Ordinary shares issued by ultimate holding company | 45             | -          | -         |
| Other  | 80             | 23         | 32        |
|  | 3,992          | 222        | 32        |

(iii) Change in the present value of scheme obligations

|                          | Group and Bank |             |            |
|--------------------------|----------------|-------------|------------|
|                          | HSBDBS         | HSBPS       | HSBNTBS    |
| <b>2011</b>              |                |             |            |
| At 1 January             | <b>5,710</b>   | <b>157</b>  | <b>2</b>   |
| Current service cost     | <b>265</b>     | <b>-</b>    | <b>-</b>   |
| Interest cost            | <b>160</b>     | <b>5</b>    | <b>-</b>   |
| Actuarial losses/(gains) | <b>1,217</b>   | <b>54</b>   | <b>(1)</b> |
| Benefits paid            | <b>(286)</b>   | <b>(15)</b> | <b>-</b>   |
| At 31 December           | <b>7,066</b>   | <b>201</b>  | <b>1</b>   |
| <b>2010</b>              |                |             |            |
| At 1 January             | 5,557          | 170         | 2          |
| Current service cost     | 267            | -           | -          |
| Interest cost            | 141            | 4           | -          |
| Actuarial losses/(gains) | 51             | (3)         | 1          |
| Benefits paid            | (306)          | (14)        | (1)        |
| At 31 December           | 5,710          | 157         | 2          |

**58. EMPLOYEE RETIREMENT BENEFITS** (continued)**(a) Defined benefit schemes** (continued)**(iv) Change in the fair value of scheme assets**

|                                  | Group and Bank |             |            |
|----------------------------------|----------------|-------------|------------|
|                                  | HSBDBS         | HSBPS       | HSBNTBS    |
| <b>2011</b>                      |                |             |            |
| At 1 January                     | <b>3,992</b>   | <b>222</b>  | <b>32</b>  |
| Contributions by the Bank        | <b>227</b>     | <b>-</b>    | <b>-</b>   |
| Expected return on scheme assets | <b>190</b>     | <b>9</b>    | <b>1</b>   |
| Experience losses                | <b>(317)</b>   | <b>(12)</b> | <b>(1)</b> |
| Benefits paid                    | <b>(286)</b>   | <b>(15)</b> | <b>-</b>   |
| At 31 December                   | <b>3,806</b>   | <b>204</b>  | <b>32</b>  |
| <b>2010</b>                      |                |             |            |
| At 1 January                     | 3,845          | 225         | 33         |
| Contributions by the Bank        | 183            | -           | -          |
| Expected return on scheme assets | 212            | 8           | 1          |
| Experience gains/(losses)        | 58             | 3           | (1)        |
| Benefits paid                    | (306)          | (14)        | (1)        |
| At 31 December                   | 3,992          | 222         | 32         |

The Group and the Bank expect to make HK\$416 million of contributions to defined benefit schemes during the following year (2010: HK\$231 million).

**(v) Movements in the net (liabilities)/assets recognised in the balance sheet are as follows:**

|  | Group and Bank |             |            |
|--|----------------|-------------|------------|
|  | HSBDBS         | HSBPS       | HSBNTBS    |
| <b>2011</b>  |                |             |            |
| At 1 January   | <b>(1,718)</b> | <b>65</b>   | <b>30</b>  |
| Contributions by the Bank  | <b>227</b>     | <b>-</b>    | <b>-</b>   |
| Net (expense)/income recognised in the income statement (note 58(a)(vi)) | <b>(235)</b>   | <b>4</b>    | <b>1</b>   |
| Net actuarial losses   | <b>(1,534)</b> | <b>(66)</b> | <b>-</b>   |
| At 31 December   | <b>(3,260)</b> | <b>3</b>    | <b>31</b>  |
| Experience (losses)/gains on scheme liabilities                          | <b>(91)</b>    | <b>(6)</b>  | <b>1</b>   |
| Experience losses on scheme assets                                       | <b>(317)</b>   | <b>(12)</b> | <b>(1)</b> |
| Losses from change in actuarial assumptions                              | <b>(1,126)</b> | <b>(48)</b> | <b>-</b>   |
| Net actuarial losses   | <b>(1,534)</b> | <b>(66)</b> | <b>-</b>   |
| <b>2010</b>  |                |             |            |
| At 1 January   | (1,712)        | 55          | 31         |
| Contributions by the Bank  | 183            | -           | -          |
| Net (expense)/income recognised in the income statement (note 58(a)(vi)) | (196)          | 4           | 1          |
| Net actuarial gains/(losses)   | 7              | 6           | (2)        |
| At 31 December   | (1,718)        | 65          | 30         |
| Experience losses on scheme liabilities                                  | (14)           | (1)         | (1)        |
| Experience gains/(losses) on scheme assets                               | 58             | 3           | (1)        |
| (Losses)/gains from change in actuarial assumptions                      | (37)           | 4           | -          |
| Net actuarial gains/(losses)   | 7              | 6           | (2)        |

**58. EMPLOYEE RETIREMENT BENEFITS** (continued)**(a) Defined benefit schemes** (continued)

(vi) Amounts recognised in the income statement are as follows:

|   | Group and Bank |       |         |
|---|----------------|-------|---------|
|   | HSBDBS         | HSBPS | HSBNTBS |
| <b>2011</b>                                 |                |       |         |
| Current service cost                        | (265)          | –     | –       |
| Interest cost                               | (160)          | (5)   | –       |
| Expected return on scheme assets            | 190            | 9     | 1       |
| Net (expense)/income for the year (note 17) | (235)          | 4     | 1       |
| Actual return on scheme assets              | (127)          | (3)   | –       |
| <b>2010</b>                                 |                |       |         |
| Current service cost                        | (267)          | –     | –       |
| Interest cost                               | (141)          | (4)   | –       |
| Expected return on scheme assets            | 212            | 8     | 1       |
| Net (expense)/income for the year (note 17) | (196)          | 4     | 1       |
| Actual return on scheme assets              | 270            | 11    | –       |

The net actuarial losses recognised in the Group's retained profit during 2011 in respect of defined benefit schemes were HK\$1,336 million (net actuarial gains of HK\$9 million during 2010). The total cumulative amount of actuarial losses recognised in the retained profit was HK\$3,238 million (2010: the cumulative amount of actuarial losses was HK\$1,902 million). The total effect of the limit on schemes surpluses in 2011 and 2010 in respect of defined benefit schemes was nil.

(vii) The principal actuarial assumptions used as at 31 December (expressed as weighted averages) are as follows:

|  | Group and Bank |            |              |
|--|----------------|------------|--------------|
|  | HSBDBS<br>%    | HSBPS<br>% | HSBNTBS<br>% |
| <b>2011</b>                              |                |            |              |
| Discount rate                            | 1.5            | 1.5        | 1.5          |
| Expected rate of return on scheme assets | 4.5            | 4.0        | 1.8          |
| Expected rate of salary increases        | 5.0            | 5.0        | 5.0          |
| Expected rate of pension increases       | –              | 1.5        | –            |
| <b>2010</b>                              |                |            |              |
| Discount rate                            | 2.9            | 2.9        | 2.9          |
| Expected rate of return on scheme assets | 4.5            | 4.0        | 2.5          |
| Expected rate of salary increases        | 5.0            | 5.0        | 5.0          |
| Expected rate of pension increases       | –              | 1.0        | –            |

The expected rate of return on scheme assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates.

**58. EMPLOYEE RETIREMENT BENEFITS** (continued)**(a) Defined benefit schemes** (continued)

(viii) Amounts for the current and previous years

|   | Group and Bank |         |         |         |         |
|---|----------------|---------|---------|---------|---------|
|   | 2011           | 2010    | 2009    | 2008    | 2007    |
| Defined benefit obligations                         | <b>7,268</b>   | 5,869   | 5,729   | 7,183   | 5,913   |
| Plan assets   | <b>4,042</b>   | 4,246   | 4,103   | 3,681   | 5,388   |
| Net deficits  | <b>(3,226)</b> | (1,623) | (1,626) | (3,502) | (525)   |
| Experience (losses)/gains on scheme liabilities     | <b>(96)</b>    | (16)    | 293     | 260     | (212)   |
| Experience (losses)/gains on scheme assets          | <b>(330)</b>   | 60      | 348     | (1,989) | 416     |
| (Losses)/gains from change in actuarial assumptions | <b>(1,174)</b> | (33)    | 1,236   | (1,287) | (1,711) |

**(b) Defined contribution schemes**

The principal defined contribution scheme for Group employees joining on or after 1 April 1999 is the HSBC Group Hong Kong Local Staff Defined Contribution Scheme. The Group also operates three other defined contribution schemes, the Hang Seng Bank Provident Fund Scheme which was closed to new entrants since 31 December 1986, the Hang Seng Insurance Company Limited Employees' Provident Fund and the Hang Seng Bank (Bahamas) Limited Defined Contribution Scheme for employees of the respective subsidiaries. The Bank and relevant Group entities also participated in mandatory provident fund schemes ("MPF schemes") registered under the Hong Kong Mandatory Provident Fund Ordinance, which are also defined contribution schemes.

Contributions made in accordance with the relevant scheme rules to these defined contribution schemes (including MPF schemes) are charged to the income statement as below:

|   | 2011      | 2010 |
|---|-----------|------|
| Amounts charged to the income statement (note 17) | <b>92</b> | 78   |

Under the schemes, the Group's contributions are reduced by contributions forfeited by those employees who leave the schemes prior to the contributions vesting fully. There was no forfeited contributions utilised during the year or available at the year-end to reduce future contributions (2010: Nil).



## 59. SHARE-BASED PAYMENTS

The Group participated in various share compensation plans operated by the HSBC Group for acquiring of HSBC Holdings plc shares. They are the Savings-Related Share Option Plan, Executive/Group Share Option Plan and Restricted Share/Performance Share/Achievement Share Awards. These are to be settled by the delivery of shares of HSBC Holdings plc.

### Share Awards Plans

| Award                    | Policy  | Purpose  |
|--------------------------|---|--|
| Restricted Share Awards  | <ul style="list-style-type: none"> <li>– Vesting of awards based on continued employment within the Group of between one and five years from the date of award</li> <li>– Shares awarded without corporate performance conditions</li> <li>– Certain shares awarded subject to a retention requirement until cessation of employment</li> </ul>   | <ul style="list-style-type: none"> <li>– Rewards employee performance, potential and retention requirements</li> <li>– To aid recruitment</li> <li>– Part-deferral of annual bonuses</li> </ul>  |
| Performance Share Awards | <ul style="list-style-type: none"> <li>– Vesting of awards based on three independent performance measures (relative corporate performance condition, economic profit and growth in earnings per share)</li> <li>– Performance conditions are measured over a three year period and reviewed annually</li> <li>– Awards are forfeited to the extent the performance conditions have not been met</li> </ul> | <ul style="list-style-type: none"> <li>– Recognise individual performance and potential</li> </ul>   |
| Achievement Share Awards | <ul style="list-style-type: none"> <li>– Additional awards made throughout the three-year vesting period</li> <li>– Original award together with the additional share awards are released after three years of continued employment within the Group</li> <li>– Shares awarded without corporate performance conditions</li> </ul>  | <ul style="list-style-type: none"> <li>– Rewards eligible employees for their performance</li> <li>– High performing and/or senior and middle managers are normally eligible to receive achievement shares during their annual pay review</li> </ul> |

### Share Option Plans

| Plans   | Policy   | Purpose   |
|---|--|---|
| Savings-Related Share Option Plan   | <ul style="list-style-type: none"> <li>– Exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively</li> <li>– The exercise price is set at a 20% (2010: 20%) discount to the market value immediately preceding the date of invitation</li> </ul> | <ul style="list-style-type: none"> <li>– Eligible employees save up to £250 per month (or its equivalent in Hong Kong dollars), with the option to use the savings to acquire shares</li> </ul> |
| Executive Share Option Scheme ("ESOS") and Group Share Option Plan ("GSOP") | <ul style="list-style-type: none"> <li>– Vesting of awards based on achievement of certain corporate performance condition targets</li> <li>– Exercisable between third and tenth anniversaries of the date of grant</li> <li>– Plan ceased in 2004</li> </ul>   | <ul style="list-style-type: none"> <li>– Long-term incentive plan between 2000 and 2004 during which certain employees were awarded share options</li> </ul>                                    |

**59. SHARE-BASED PAYMENTS** (continued)**(a) Savings-Related Share Option Plan**

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the date of balance sheet, are as follows:

**(i) Option scheme with exercise price set in pounds sterling**

|                            | 2011                                 |               | 2010                                 |               |
|----------------------------|--------------------------------------|---------------|--------------------------------------|---------------|
|                            | Weighted average exercise price<br>£ | Number ('000) | Weighted average exercise price<br>£ | Number ('000) |
| Outstanding at 1 January   | -                                    | -             | 5.82                                 | 29            |
| Exercised in the year      | -                                    | -             | 5.82                                 | (23)          |
| Lapsed in the year         | -                                    | -             | 5.82                                 | (6)           |
| Outstanding at 31 December | -                                    | -             | -                                    | -             |
| Exercisable at 31 December | -                                    | -             | -                                    | -             |

There was no share options exercised during the year. The weighted average share price at the date of exercise for share options exercised during the year of 2010 was £6.53.

There was no option outstanding at the end of the year 2011 and 2010.

**(ii) Option scheme with exercise price set in Hong Kong dollars**

|                            | 2011                                    |               | 2010                                    |               |
|----------------------------|---|---------------|---|---------------|
|                            | Weighted average exercise price<br>HK\$ | Number ('000) | Weighted average exercise price<br>HK\$ | Number ('000) |
| Outstanding at 1 January   | 41.18                                   | 11,292        | 38.30                                   | 12,193        |
| Granted in the year        | 63.99                                   | 1,493         | 62.97                                   | 1,561         |
| Exercised in the year      | 62.20                                   | (772)         | 37.98                                   | (1,749)       |
| Lapsed in the year         | 41.18                                   | (1,127)       | 38.30                                   | (713)         |
| Outstanding at 31 December | 41.31                                   | 10,886        | 41.18                                   | 11,292        |
| Exercisable at 31 December | -                                       | -             | -                                       | -             |

The weighted average share price at the date of exercise for share options exercised during the year was HK\$69.24 (2010: HK\$79.38).

The options outstanding at the year end of 2011 had an exercise price in the range of HK\$37.88 to HK\$94.51 (2010: HK\$37.88 to HK\$94.51), and a weighted average remaining contractual life of 1.95 years (2010: 2.82 years).

The weighted average fair value of options granted during 2011 was HK\$15.54 (2010: HK\$18.80).

**59. SHARE-BASED PAYMENTS** (continued)**(b) Executive/Group Share Option Plan**

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at balance sheet date, are as follows:

|                            | 2011                                 |               | 2010                                 |               |
|----------------------------|--------------------------------------|---------------|--------------------------------------|---------------|
|                            | Weighted average exercise price<br>£ | Number ('000) | Weighted average exercise price<br>£ | Number ('000) |
| Outstanding at 1 January   | 7.10                                 | 2,251         | 7.04                                 | 2,652         |
| Exercised in the year      | 6.02                                 | (19)          | 6.40                                 | (145)         |
| Lapsed in the year         | 7.10                                 | (561)         | 7.04                                 | (256)         |
| Outstanding at 31 December | 6.95                                 | 1,671         | 7.10                                 | 2,251         |

The weighted average share price at the date of exercise for share options exercised during the year was £6.60 (2010: £6.76).

The options outstanding at the year end of 2011 had an exercise price in the range of £6.02 to £7.32 (2010: £6.02 to £7.59), and a weighted average remaining contractual life of 1.61 years (2010: 2.15 years).

**(c) Calculation of fair value**

The recognition of compensation cost of share option is based on the fair value of the options on grant date. The calculation of the fair value of HSBC share option is centrally managed by HSBC Holdings plc. Fair values of share options, measured at the date of grant of the options are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. Expected dividends are incorporated into the valuation model for share options and awards where applicable. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

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

|                                  | 1-year Savings-Related Share Option Plan | 3-year Savings-Related Share Option Plan | 5-year Savings-Related Share Option Plan |
|----------------------------------|--|--|--|
| <b>2011</b>                      |  |  |  |
| Risk-free interest rate (%)      | 0.8                                      | 1.7                                      | 2.5                                      |
| Expected life (years)            | 1  | 3  | 5  |
| Expected volatility (%)          | 25                                       | 25                                       | 25                                       |
| Share price at grant date (HK\$) | 82.90                                    | 82.90                                    | 82.90                                    |
| <b>2010</b>                      |  |  |  |
| Risk-free interest rate (%)      | 0.7                                      | 1.9                                      | 2.9                                      |
| Expected life (years)            | 1  | 3  | 5  |
| Expected volatility (%)          | 30                                       | 30                                       | 30                                       |
| Share price at grant date (HK\$) | 82.05                                    | 82.05                                    | 82.05                                    |

The risk-free rate was determined from the UK gilts yield curve for Savings-Related Share Option Plan. Expected life is not a single input parameter but a function of various behavioural assumptions. Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options. Expected dividend yield was based on historic levels of dividend growth.

**59. SHARE-BASED PAYMENTS** (continued)**(d) Restricted Share Awards/Performance Share Awards/Achievement Share Awards**

|                            | <b>2011<br/>Number<br/>(‘000)</b> | 2010<br>Number<br>(‘000) |
|----------------------------|-----------------------------------|--------------------------|
| Outstanding at 1 January   | <b>803</b>                        | 957                      |
| Additions during the year  | <b>19</b>                         | 28                       |
| Released in the year       | <b>(522)</b>                      | (182)                    |
| Outstanding at 31 December | <b>300</b>                        | 803                      |

The closing price of the HSBC Holdings plc share at 31 December 2011 was £4.91 (2010: £6.51).

The weighted average remaining vesting period as at 31 December 2011 was 0.94 years (2010: 1.21 years).

**(e) Income statement charge**

|                                      | <b>2011</b> | 2010 |
|--------------------------------------|-------------|------|
| Share awards plans                   | <b>26</b>   | 30   |
| Share option plans                   | <b>62</b>   | 70   |
|                                      | <b>88</b>   | 100  |
| Equity-settled share-based payments* | <b>86</b>   | 100  |
| Cash-settled share-based payments    | <b>2</b>    | –    |
|                                      | <b>88</b>   | 100  |

\* This charge, which was computed from the fair values of the share-based payment transaction when contracted, arose under employee share awards made in accordance with the Group's reward structures.

**60. MATERIAL RELATED-PARTY TRANSACTIONS****(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates**

In 2011, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The Group used the IT service of, and shared an automated teller machine network with, its immediate holding company. The Group also shared certain IT projects with and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. A fellow subsidiary company was appointed as fund manager to manage the Group's investment portfolios. The Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies.

There was an arrangement whereby a fellow subsidiary provided certain management services, being services related to risk management, back office processing and administration, development and pricing of selected products, information technology and business recovery, financial control and actuarial services, to Hang Seng Insurance Company Limited. The fees on these transactions are determined on an arm's length basis.

**60. MATERIAL RELATED-PARTY TRANSACTIONS** (continued)**(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates** (continued)

The aggregate amount of income and expenses arising from these transactions during the year, the balances of amounts due to and from the relevant related parties, and the total contract sum of off-balance sheet transactions at the year-end are as follows:

|  | Group  |               |                     |              |              |                    |
|--|--|---------------|---------------------|--------------|--------------|--------------------|
|  | Immediate holding company and its subsidiaries |               | Fellow subsidiaries |              | Associates   |                    |
|  | 2011   | 2010          | 2011                | 2010         | 2011         | 2010<br>(restated) |
| Interest income  | 72   | 84            | 2                   | –            | 116          | 48                 |
| Interest expense   | (191)  | (39)          | (2)                 | (3)          | 1            | –                  |
| Other operating income   | 123  | 104           | (3)                 | –            | 8            | 6                  |
| Operating expenses*  | (743)  | (740)         | (522)               | (442)        | (18)         | (14)               |
| <b>Amounts due from:</b>   |  |               |                     |              |              |                    |
| Cash and balances with banks and other financial institutions        | 1,220  | 463           | 4,140               | 2,081        | –            | 5                  |
| Placings with and advances to banks and other financial institutions | 3,412  | 8,915         | –                   | –            | 6,898        | 5,547              |
| Financial assets designated at fair value                            | 114  | 123           | 3,425               | 3,418        | –            | –                  |
| Derivative financial instruments                                     | 253  | 586           | 31                  | 19           | –            | –                  |
| Advances to customers  | –  | –             | –                   | –            | 233          | 233                |
| Financial investments  | 243  | 334           | –                   | –            | –            | –                  |
| Other assets   | 53   | 64            | –                   | –            | 4            | 3                  |
|  | <b>5,295</b>                                   | <b>10,485</b> | <b>7,596</b>        | <b>5,518</b> | <b>7,135</b> | <b>5,788</b>       |
| <b>Amounts due to:</b>   |  |               |                     |              |              |                    |
| Current, savings and other deposit accounts                          | 126  | 332           | –                   | –            | 110          | 68                 |
| Deposits from banks  | 829  | 2,484         | –                   | 8            | 610          | 117                |
| Derivative financial instruments                                     | 581  | 494           | 66                  | 59           | –            | –                  |
| Other liabilities  | 373  | 326           | 62                  | 67           | –            | –                  |
| Subordinated liabilities   | 9,518  | 6,025         | –                   | –            | –            | –                  |
|  | <b>11,427</b>                                  | <b>9,661</b>  | <b>128</b>          | <b>134</b>   | <b>720</b>   | <b>185</b>         |
| <b>Derivative contracts:</b>   |  |               |                     |              |              |                    |
| Contract amount  | 69,104   | 75,230        | 20,647              | 15,780       | –            | –                  |
| <b>Guarantees:</b>   |  |               |                     |              |              |                    |
| Guarantees issued  | –  | 2             | –                   | –            | 116          | 116                |
| <b>Committed facilities:</b>   |  |               |                     |              |              |                    |
| Committed facilities from  | –  | 826           | –                   | –            | –            | –                  |
| Committed facilities to  | –  | –             | –                   | –            | –            | –                  |

\* 2011 Operating expenses included payment of HK\$140 million (2010: HK\$97 million) of software costs which were capitalised as intangible assets in the balance sheet of the Group.

**60. MATERIAL RELATED-PARTY TRANSACTIONS** (continued)**(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates** (continued)

|  | Bank   |        |                     |        |              |        |            |                    |
|--|--|--------|---------------------|--------|--------------|--------|------------|--------------------|
|  | Immediate holding company and its subsidiaries |        | Fellow subsidiaries |        | Subsidiaries |        | Associates |                    |
|  | 2011   | 2010   | 2011                | 2010   | 2011         | 2010   | 2011       | 2010<br>(restated) |
| <b>Amounts due from:</b>   |  |        |                     |        |              |        |            |                    |
| Cash and balances with banks and other financial institutions        | 1,140  | 390    | 4,062               | 2,018  | -            | -      | -          | -                  |
| Placings with and advances to banks and other financial institutions | -  | 4,683  | -                   | -      | -            | -      | 5,309      | 3,568              |
| Financial assets designated at fair value                            | -  | -      | -                   | -      | -            | -      | -          | -                  |
| Derivative financial instruments                                     | 184  | 418    | 31                  | 19     | 373          | 88     | -          | -                  |
| Advances to customers  | -  | -      | -                   | -      | -            | -      | -          | -                  |
| Amounts due from subsidiaries  | -  | -      | -                   | -      | 85,222       | 93,445 | -          | -                  |
| Financial investments  | -  | -      | -                   | -      | -            | -      | -          | -                  |
| Other assets   | 35   | 18     | -                   | -      | -            | -      | 4          | 3                  |
|  | 1,359  | 5,509  | 4,093               | 2,037  | 85,595       | 93,533 | 5,313      | 3,571              |
| <b>Amounts due to:</b>   |  |        |                     |        |              |        |            |                    |
| Current, savings and other deposit accounts                          | 52   | 233    | -                   | -      | -            | -      | 110        | 68                 |
| Deposits from banks  | 822  | 2,484  | -                   | 8      | -            | -      | 117        | 117                |
| Derivative financial instruments                                     | 315  | 334    | 66                  | 59     | 211          | 298    | -          | -                  |
| Subordinated liabilities   | 9,518  | 6,025  | -                   | -      | -            | -      | -          | -                  |
| Amounts due to subsidiaries  | -  | -      | -                   | -      | 10,797       | 8,899  | -          | -                  |
| Other liabilities  | 223  | 276    | 61                  | 65     | -            | -      | -          | -                  |
|  | 10,930   | 9,352  | 127                 | 132    | 11,008       | 9,197  | 227        | 185                |
| <b>Derivative contracts:</b>   |  |        |                     |        |              |        |            |                    |
| Contract amount  | 40,354   | 57,371 | 20,647              | 15,780 | 25,874       | 33,333 | -          | -                  |
| <b>Guarantees:</b>   |  |        |                     |        |              |        |            |                    |
| Guarantees issued  | -  | 2      | -                   | -      | 565          | 559    | 116        | 116                |
| Guarantees received  | -  | -      | -                   | -      | 165          | 159    | -          | -                  |
| <b>Committed facilities:</b>   |  |        |                     |        |              |        |            |                    |
| Committed facilities from  | -  | -      | -                   | -      | -            | -      | -          | -                  |
| Committed facilities to  | -  | -      | -                   | -      | 1,500        | 2,332  | -          | -                  |



**60. MATERIAL RELATED-PARTY TRANSACTIONS** (continued)**(b) Key management personnel remuneration**

Remuneration for key management personnel, including amounts paid to the Bank's directors as disclosed in note 19 and highest paid employees as disclosed in note 18, is as follows:

|   | Group     |                    | Bank      |                    |
|---|-----------|--------------------|-----------|--------------------|
|   | 2011      | 2010<br>(restated) | 2011      | 2010<br>(restated) |
| Salaries, allowances and benefits in kind | <b>37</b> | 30                 | <b>37</b> | 30                 |
| Retirement scheme contributions           | <b>5</b>  | 5                  | <b>5</b>  | 5                  |
| Variable bonuses                          | <b>31</b> | 30                 | <b>31</b> | 30                 |
|   | <b>73</b> | 65                 | <b>73</b> | 65                 |

**(c) Material transactions with key management personnel**

During the year, the Group provided credit facilities to and accepted deposits from key management personnel of the Bank and its holding companies, their close family members and companies controlled or significantly influenced by them. The credit facilities extended and deposit taken were provided in the ordinary course of business and on substantially the same terms as for comparable transactions with persons of a similar standing or, where applicable, with other employees.

Material transactions conducted with key management personnel of the Bank and its holding companies and parties related to them are as follows:

|  | Group         |                    | Bank          |                    |
|--|---------------|--------------------|---------------|--------------------|
|  | 2011          | 2010<br>(restated) | 2011          | 2010<br>(restated) |
| Interest received  | <b>192</b>    | 173                | <b>192</b>    | 173                |
| Interest paid  | <b>8</b>      | 4                  | <b>8</b>      | 4                  |
| Fees and exchange income received                              | <b>15</b>     | 18                 | <b>15</b>     | 18                 |
| Loans and advances   | <b>10,857</b> | 12,156             | <b>10,210</b> | 11,363             |
| Deposits   | <b>2,784</b>  | 2,906              | <b>2,703</b>  | 2,906              |
| Undrawn commitments  | <b>1,844</b>  | 1,969              | <b>1,412</b>  | 1,670              |
| Maximum aggregate amount of loans and advances during the year | <b>13,714</b> | 14,542             | <b>12,736</b> | 13,401             |

The Group adheres to section 83 of the Hong Kong Banking Ordinance regarding lending to related parties; this includes unsecured lending to key management personnel, their relatives and companies that may be directly or indirectly influenced or controlled by such individuals.

No impairment losses have been recorded against balances outstanding during the year with key management personnel, and there is no specific impairment allowances on balances with key management personnel at the year-end.

**60. MATERIAL RELATED-PARTY TRANSACTIONS** (continued)**(d) Loans to officers**

Loans to officers of the Bank disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

|  | <b>Group</b> |                    | <b>Bank</b> |                    |
|--|--------------|--------------------|-------------|--------------------|
|  | <b>2011</b>  | 2010<br>(restated) | <b>2011</b> | 2010<br>(restated) |
| Aggregate amount of relevant transactions outstanding at 31 December | <b>20</b>    | 8                  | <b>20</b>   | 8                  |
| Maximum aggregate amount of relevant transactions during the year    | <b>28</b>    | 17                 | <b>28</b>   | 17                 |

**(e) Associates**

Information relating to associates and transactions with associates can be found in notes 38 and 60(a).

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2011 was HK\$233 million (2010: HK\$233 million).

The Bank has been assisting Industrial Bank Co., Ltd. in managing and growing the credit card business.

The Bank has entered into Technical Support Agreement with Yantai Bank Co., Ltd. ("Yantai Bank") to provide technical support and assistance in relation to various banking operations and businesses of Yantai Bank.

**(f) Ultimate holding company**

The Group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the Group. As disclosed in note 59, the Group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under "Other reserves". The balance of this reserve as at 31 December 2011 amounted to HK\$571 million comprising HK\$576 million relating to share option schemes and negative reserve amounted to HK\$5 million relating to share award schemes (2010: HK\$510 million comprising HK\$514 million relating to share option schemes and negative reserve amounted to HK\$4 million relating to share award schemes).

**(g) Employee retirement benefits**

At 31 December 2011, defined benefit scheme assets amounted to HK\$1,152 million (2010: HK\$1,269 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK\$5 million (2010: HK\$5 million).

## 61. FINANCIAL RISK MANAGEMENT

This section presents information about the Group's management and control of risks, in particular, those associated with its use of financial instruments ("financial risks"). Major types of financial risks to which the Group was exposed include credit risk, liquidity risk, market risk, insurance risk and operational risk.

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various management committees, including the Executive Committee, Audit Committee, Asset and Liability Management Committee ("ALCO") and Risk Management Committee ("RMC").

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising of senior executives from Risk, Legal, Compliance, Finance, and Operations/IT, is responsible for reviewing and approving the launch of such new products and services. Each new service and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new products and services in development prior to implementation.

### (a) Credit risk

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, and treasury businesses. The Group has dedicated standards, policies and procedures in place to control and monitor risk from all such activities.

The Credit Risk Management ("CRM") function headed by the Chief Credit Officer who reported to Chief Risk Officer is mandated to provide centralised management of credit risk through:

- formulating credit policies on approval process, post disbursement monitoring, recovery process and large exposure;
- issuing guidelines on lending to specified market sectors, industries and products; the acceptability of specific classes of collateral or risk mitigations and valuation parameters for collateral;
- undertaking an independent review and objective assessment of credit risk for all commercial non-bank credit facilities in excess of designated amount prior to the facilities being committed to customers;
- controlling exposures to selected industries, counterparties, countries and portfolio types etc by setting limits;
- maintaining and developing credit risk rating/facility grading process to categorise exposures and facilitate focused management;
- reporting to senior executives and various committees on aspects of the Group loan portfolio;
- managing and directing credit-related systems initiatives; and
- providing advice and guidance to business units on various credit-related issues.

### Impaired loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loans impairment allowance are made promptly where necessary and need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

#### Risk rating framework

A sophisticated risk rating framework on counterparty credit risk based on default probability and loss estimates is implemented across the Group. The rating methodology of this framework is based upon a wide range of financial analytics. This approach will allow a more granular analysis of risk and trends. The information generated from the risk rating framework is mainly, but not exclusively, applied to credit approval, credit monitoring, pricing, loan classification and capital adequacy assessment. The Bank also has control mechanisms in place to validate the performance and accuracy of the risk rating framework.

To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies.

#### Collateral and other credit enhancements

The Group has implemented guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determined the valuation parameters. Such parameters are established prudently and are reviewed regularly in light of changing market environment and empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfill their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the Group's policy to establish that loans are within the customer's capacity to repay rather than to rely excessively on security. Facilities may be granted on unsecured basis depending on the customer's standing and the type of product. The principal collateral types are as follows:

- in the personal sector, charges over the properties, securities, investment funds and deposits;
- in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery; and
- in the commercial real estate sector, charges over the properties being financed.

Reposessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the balance sheet within "Other assets" at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The Group does not generally occupy reposessed properties for its business use.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured.

#### Settlement risk

Settlement risk arises where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily Settlement Limits are established to cover the settlement risk arising from the Group's trading transactions on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated when effected via assured payment systems, or on a delivery-versus-payment basis.

The ISDA Master Agreement is the Group's preferred agreement for documenting derivative activities. It provides the contractual framework that a full range of over-the-counter ("OTC") products is conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement, if either party defaults or following other pre-agreed termination events.

#### Concentration of credit risk

Concentration of credit risk exists when changes in geographic, economic or industry factors similarly affect groups of counterparties whose aggregate credit exposure is material in relation to the Group's total exposures. The Group's portfolio of financial instrument is diversified along geographic, industry and product sectors. Analysis of geographical concentration of the Group's assets is disclosed in note 27 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 32, 33, 35 and 36.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)

The below analysis shows the exposures to credit risk in accordance with HKFRS 7 “Financial Instruments: Disclosures”.

**(i) Maximum exposure to credit risk before collateral held or other credit enhancements**

|  | <b>Group</b>     |           | <b>Bank</b>      |           |
|--|------------------|-----------|------------------|-----------|
|  | <b>2011</b>      | 2010      | <b>2011</b>      | 2010      |
| Cash and balances with banks and other financial institutions        | <b>39,533</b>    | 44,411    | <b>36,475</b>    | 41,062    |
| Placings with and advances to banks and other financial institutions | <b>107,742</b>   | 110,564   | <b>47,724</b>    | 52,131    |
| Trading assets   | <b>64,164</b>    | 26,047    | <b>60,519</b>    | 25,224    |
| Financial assets designated at fair value                            | <b>3,999</b>     | 4,440     | <b>140</b>       | 148       |
| Derivative financial instruments                                     | <b>4,710</b>     | 5,593     | <b>4,436</b>     | 5,026     |
| Advances to customers  | <b>480,574</b>   | 472,637   | <b>425,629</b>   | 423,074   |
| Financial investments  | <b>208,931</b>   | 199,033   | <b>105,080</b>   | 102,985   |
| Amounts due from subsidiaries  | <b>–</b>         | –         | <b>85,222</b>    | 93,445    |
| Other assets   | <b>13,442</b>    | 11,754    | <b>9,066</b>     | 8,419     |
| Financial guarantees and other credit related contingent liabilities | <b>11,694</b>    | 11,392    | <b>9,764</b>     | 9,916     |
| Loan commitments and other credit related commitments                | <b>354,837</b>   | 347,019   | <b>316,338</b>   | 314,108   |
|  | <b>1,289,626</b> | 1,232,890 | <b>1,100,393</b> | 1,075,538 |

**(ii) Collateral and other credit enhancements****Loans and advances**

Although collateral can be an important mitigant of credit risk, it is the Group’s practice to lend on the basis of the customer’s ability to meet their obligations out of their cash flow resources rather than rely on the value of security offered. Depending on the customer’s standing and the type of product, facilities may be provided unsecured. However, for certain lending decisions a charge over collateral is usually obtained, and is important for the credit decision and pricing, and it is the Bank’s practice to obtain that collateral and sell it in the event of default as a source of repayment. Such collateral has a significant financial effect and the objective of the disclosure below is to quantify these forms. We may manage our risk further by employing other types of collateral and credit risk enhancements but these are harder to evaluate and subject to a greater uncertainty in the event of default, these have been described below.

We have quantified below the value of fixed charges we hold over a specific asset (or assets) of a borrower for which we have a practical ability and history of enforcing in satisfying a debt in the event of a borrower failing to meet their contractual obligations and where the asset is cash or can be realised in the form of cash by sale in an established market.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(ii) Collateral and other credit enhancements** (continued)**Personal lending**

For personal lending the collateral held has been analysed below separately for residential mortgages and other personal lending due to the different nature of collateral held on the portfolios.

**Residential mortgages**

The following table shows residential mortgage lending including off-balance sheet loan commitments by level of collateralisation.

*Residential mortgages loans and advances*

|   | 2011    | 2010    |
|---|---------|---------|
| Uncollateralised  | –       | –       |
| Fully collateralised  |         |         |
| – Less than 25% LTV   | 19,790  | 18,472  |
| – 25% to 50% LTV  | 72,383  | 64,035  |
| – 51% to 75% LTV  | 49,482  | 65,794  |
| – 76% to 90% LTV  | 4,058   | 6,055   |
| – 91% to 100% LTV   | 863     | 759     |
|   | 146,576 | 155,115 |
| Partially collateralised loans and advances                                       |         |         |
| – Greater than 100% LTV   | 1       | 2       |
| Total residential mortgages   | 146,577 | 155,117 |
| Value of specific collateral held for partially collateralised loans and advances | 1       | 2       |

The collateral included in the table above consists of fixed first charges on residential real estate.

The loan-to-value (“LTV”) ratio in the table above is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date as a percentage of the current value of collateral. The current value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation excludes any adjustments for obtaining and selling the collateral.

**Other personal lending**

The remainder of our personal lending consists primarily of motor vehicle finance, credit cards, instalment loan, overdraft or revolving loan. Motor vehicle lending is generally collateralised by the motor vehicle financed. Credit cards are generally unsecured. Instalment loan, overdraft and revolving loan could be partially secured by cash or marketable securities.



**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(ii) Collateral and other credit enhancements** (continued)**Corporate and commercial and financial (non-bank) lending**

For corporate and commercial and financial (non-bank) lending the collateral held has been analysed below separately for commercial real estate and other corporate and commercial and financial (non-bank) lending due to the different nature of collateral held on the portfolios.

**Commercial real estate**

The following table shows commercial real estate lending including off-balance sheet loan commitments by level of collateralisation.

*Commercial real estate loans and advances*

|   | 2011   | 2010   |
|---|--------|--------|
| Rated – CRR/EL 1 to 7   |        |        |
| Uncollateralised  | 8,713  | 5,926  |
| Fully collateralised  | 46,718 | 40,992 |
| Partially collateralised  | 3,879  | 2,509  |
| Value of specific collateral held for partially collateralised loans and advances | 2,929  | 2,093  |
| Rated – CRR/EL 8 to 10  |        |        |
| Uncollateralised  | –      | –      |
| Fully collateralised  | 7      | 3      |
| Partially collateralised  | –      | –      |
| Value of specific collateral held for partially collateralised loans and advances | –      | –      |

The collateral included in the table above consists of fixed first charges on real estate.

The value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation will exclude any adjustments for obtaining and selling the collateral.

**Other corporate and commercial and financial (non-bank) lending**

The following table shows corporate, commercial and financial (non-bank) lending including off-balance sheet loan commitments by level of collateralisation.

*Corporate, commercial and financial (non-bank) loans and advances*

|   | 2011  | 2010  |
|---|-------|-------|
| Rated – CRR/EL 8 to 10  |       |       |
| Uncollateralised  | 1,169 | 1,241 |
| Fully collateralised  | 520   | 822   |
| Partially collateralised  | 147   | 215   |
| Value of specific collateral held for partially collateralised loans and advances | 75    | 106   |

The collateral used in the assessment of the above relates primarily to charges held over business assets in the commercial and industrial sector and charges over marketable financial instruments in the financial sector.

The value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation will exclude any adjustments with respect of obtaining and selling the collateral.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(ii) Collateral and other credit enhancements** (continued)**Loans and advances to banks**

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

*Loans and advances to banks*

|   | 2011           | 2010    |
|---|----------------|---------|
| Uncollateralised  | <b>107,742</b> | 110,564 |
| Fully collateralised  | –              | –       |
| Partially collateralised  | –              | –       |
| Value of specific collateral held for partially collateralised loans and advances | –              | –       |

**Derivatives**

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

**Other**

The table below describes other types of collateral held, other credit enhancements employed and methods used to mitigate credit risk arising from financial assets presented in the maximum exposure to credit risk table on page 200.

|   |   |
|---|---|
| Cash and balances with banks and other financial institutions   | Generally no collateral or other credit enhancements held.  |
| Items in the course of collection from other banks  | Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt of cash, securities or equities. Daily settlement limits are established for counterparties to cover the aggregate of our transactions with each one on any single day.<br><br>We generally mitigate settlement risk on many transactions, particularly those involving securities and equities, by settling through assured payment systems or on a delivery-versus-payment basis. |
| Trading assets, Financial assets designated at fair value, Financial investments  | Debt securities, treasury and other eligible bills consist of government, bank or other financial institution issued securities for which either government guarantees are held or no collateral is held.   |
| Other assets  | Generally no collateral or other credit enhancements held.  |
| Advances to customers, Financial guarantees and similar contracts, Loan commitment and other credit related commitments | Depending on the customer's standing and the type of products, facilities may be secured or unsecured. The general types of collaterals and other credit enhancements are highlighted in page 199.  |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality**

Four broad classifications describe the credit quality of the Group's lending and debt securities portfolios. These classifications each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external ratings attributed by external agencies to debt securities.

There is no direct correlation between the internal and external ratings at granular level, except insofar as both fall within one of the four classifications.

| Quality classification | Wholesale lending and derivatives | Retail lending  | Debt securities/other   |
|------------------------|-----------------------------------|---|-------------------------|
| Strong                 | CRR 1 to CRR 2                    | EL 1 to EL 2*   | A- and above            |
| Medium                 | CRR 3 to CRR 5                    | EL 3 to EL 5*   | B+ to BBB+ and unrated  |
| Sub-standard           | CRR 6 to CRR 8                    | EL 6 to EL 8*   | B and below             |
| Impaired               | CRR 9 to CRR 10                   | EL 9 to EL 10<br>and all EL 1 to EL 8 exposures<br>past due 90 days and above | Individually identified |

\* All retail exposures past due 90 days and above are classified as "impaired".

**Quality classification definitions:**

- Strong: Exposures demonstrate a strong capacity to meet financial commitments, with low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.
- Medium: Exposures require closer monitoring, with satisfactory to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery process.
- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail accounts show longer delinquency periods of up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate through security realisation or other recovery processes.
- Impaired: Exposures have been assessed, individually or collectively, as impaired. The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ("Expected loss") grade, whereby in the higher quality grades the grading assignment will reflect the offsetting impact by credit risk mitigation in one form or another.

The Group's policy in respect of impairment on loans and advances and debt securities is set out in note 4 on the financial statements. Analysis of impairment allowances as at 31 December 2011 and the movement of such allowances during the year are disclosed in note 35.

**Granular risk rating scales:**

The CRR ("Customer Risk Rating") 10-grade scale maps to a more granular underlying 23-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

Impairment is not measured for debt securities held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through income statement. Consequently, all such balances are reported under "neither past due nor impaired".

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)*Distribution of financial instruments by credit quality*

|  | Group                         |         |              |                       |          |                       |         |
|--|-------------------------------|---------|--------------|-----------------------|----------|-----------------------|---------|
|  | Neither past due nor impaired |         |              | Past due not impaired | Impaired | Impairment allowances | Total   |
|  | Strong                        | Medium* | Sub-standard |                       |          |                       |         |
| 2011   |                               |         |              |                       |          |                       |         |
| Items in the course of collection from other banks | 4,319                         | 194     | –            | –                     | –        | –                     | 4,513   |
| Trading assets:                                    |                               |         |              |                       |          |                       |         |
| – treasury and eligible bills                      | 54,220                        | –       | –            | –                     | –        | –                     | 54,220  |
| – debt securities                                  | 9,418                         | 20      | –            | –                     | –        | –                     | 9,438   |
| – loans and advances to banks                      | –                             | 501     | –            | –                     | –        | –                     | 501     |
| – loans and advances to customers                  | 5                             | –       | –            | –                     | –        | –                     | 5       |
|  | 63,643                        | 521     | –            | –                     | –        | –                     | 64,164  |
| Financial assets designated at fair value:         |                               |         |              |                       |          |                       |         |
| – treasury and eligible bills                      | –                             | –       | –            | –                     | –        | –                     | –       |
| – debt securities                                  | 3,962                         | 37      | –            | –                     | –        | –                     | 3,999   |
| – loans and advances to banks                      | –                             | –       | –            | –                     | –        | –                     | –       |
| – loans and advances to customers                  | –                             | –       | –            | –                     | –        | –                     | –       |
|  | 3,962                         | 37      | –            | –                     | –        | –                     | 3,999   |
| Derivatives  | 3,094                         | 1,555   | 61           | –                     | –        | –                     | 4,710   |
| Loans and advances held at amortised cost:         |                               |         |              |                       |          |                       |         |
| – loans and advances to banks                      | 124,140                       | 13,644  | –            | –                     | –        | –                     | 137,784 |
| – loans and advances to customers                  | 280,312                       | 194,278 | 2,842        | 3,225                 | 1,584    | (1,667)               | 480,574 |
|  | 404,452                       | 207,922 | 2,842        | 3,225                 | 1,584    | (1,667)               | 618,358 |
| Financial investments:                             |                               |         |              |                       |          |                       |         |
| – treasury and similar bills                       | 43,296                        | –       | –            | –                     | –        | –                     | 43,296  |
| – debt securities                                  | 157,242                       | 8,393   | –            | –                     | –        | –                     | 165,635 |
|  | 200,538                       | 8,393   | –            | –                     | –        | –                     | 208,931 |
| Other assets:                                      |                               |         |              |                       |          |                       |         |
| – acceptances and endorsements                     | 1,512                         | 2,988   | 197          | –                     | –        | –                     | 4,697   |
| – other  | 2,168                         | 2,016   | 6            | 42                    | –        | –                     | 4,232   |
|  | 3,680                         | 5,004   | 203          | 42                    | –        | –                     | 8,929   |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)

|   | Neither past due nor impaired |         |                  | Group<br>Past due<br>not<br>impaired | Impaired | Impairment<br>allowances | Total   |
|---|-------------------------------|---------|------------------|--------------------------------------|----------|--------------------------|---------|
|   | Strong                        | Medium* | Sub-<br>standard |                                      |          |                          |         |
| 2010  |                               |         |                  |                                      |          |                          |         |
| Items in the course of<br>collection from other banks | 4,589                         | 84      | –                | –                                    | –        | –                        | 4,673   |
| Trading assets:                                       |                               |         |                  |                                      |          |                          |         |
| – treasury and eligible bills                         | 20,204                        | –       | –                | –                                    | –        | –                        | 20,204  |
| – debt securities                                     | 5,063                         | 56      | –                | –                                    | –        | –                        | 5,119   |
| – loans and advances to banks                         | 700                           | –       | –                | –                                    | –        | –                        | 700     |
| – loans and advances<br>to customers                  | 24                            | –       | –                | –                                    | –        | –                        | 24      |
|   | 25,991                        | 56      | –                | –                                    | –        | –                        | 26,047  |
| Financial assets<br>designated at fair value:         |                               |         |                  |                                      |          |                          |         |
| – treasury and eligible bills                         | –                             | –       | –                | –                                    | –        | –                        | –       |
| – debt securities                                     | 4,438                         | 2       | –                | –                                    | –        | –                        | 4,440   |
| – loans and advances to banks                         | –                             | –       | –                | –                                    | –        | –                        | –       |
| – loans and advances<br>to customers                  | –                             | –       | –                | –                                    | –        | –                        | –       |
|   | 4,438                         | 2       | –                | –                                    | –        | –                        | 4,440   |
| Derivatives   | 4,235                         | 1,284   | 74               | –                                    | –        | –                        | 5,593   |
| Loans and advances held<br>at amortised cost:         |                               |         |                  |                                      |          |                          |         |
| – loans and advances to banks                         | 135,797                       | 13,077  | –                | –                                    | –        | –                        | 148,874 |
| – loans and advances<br>to customers                  | 271,974                       | 194,139 | 2,990            | 3,380                                | 1,990    | (1,836)                  | 472,637 |
|   | 407,771                       | 207,216 | 2,990            | 3,380                                | 1,990    | (1,836)                  | 621,511 |
| Financial investments:                                |                               |         |                  |                                      |          |                          |         |
| – treasury and similar bills                          | 18,010                        | –       | –                | –                                    | –        | –                        | 18,010  |
| – debt securities                                     | 175,887                       | 5,136   | –                | –                                    | –        | –                        | 181,023 |
|   | 193,897                       | 5,136   | –                | –                                    | –        | –                        | 199,033 |
| Other assets:   |                               |         |                  |                                      |          |                          |         |
| – acceptances and endorsements                        | 1,034                         | 2,688   | 29               | –                                    | –        | –                        | 3,751   |
| – other   | 1,752                         | 1,538   | 5                | 35                                   | –        | –                        | 3,330   |
|   | 2,786                         | 4,226   | 34               | 35                                   | –        | –                        | 7,081   |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)

## (iii) Credit quality (continued)

|   | Bank                          |         |                  |                             |          |                          |         |
|---|-------------------------------|---------|------------------|-----------------------------|----------|--------------------------|---------|
|   | Neither past due nor impaired |         |                  | Past due<br>not<br>impaired | Impaired | Impairment<br>allowances | Total   |
|   | Strong                        | Medium* | Sub-<br>standard |                             |          |                          |         |
| 2011  |                               |         |                  |                             |          |                          |         |
| Items in the course of<br>collection from other banks | 4,319                         | 194     | -                | -                           | -        | -                        | 4,513   |
| Trading assets:                                       |                               |         |                  |                             |          |                          |         |
| - treasury and eligible bills                         | 54,220                        | -       | -                | -                           | -        | -                        | 54,220  |
| - debt securities                                     | 5,773                         | 20      | -                | -                           | -        | -                        | 5,793   |
| - loans and advances to banks                         | -                             | 501     | -                | -                           | -        | -                        | 501     |
| - loans and advances<br>to customers                  | 5                             | -       | -                | -                           | -        | -                        | 5       |
|   | 59,998                        | 521     | -                | -                           | -        | -                        | 60,519  |
| Financial assets<br>designated at fair value:         |                               |         |                  |                             |          |                          |         |
| - treasury and eligible bills                         | -                             | -       | -                | -                           | -        | -                        | -       |
| - debt securities                                     | 140                           | -       | -                | -                           | -        | -                        | 140     |
| - loans and advances to banks                         | -                             | -       | -                | -                           | -        | -                        | -       |
| - loans and advances<br>to customers                  | -                             | -       | -                | -                           | -        | -                        | -       |
|   | 140                           | -       | -                | -                           | -        | -                        | 140     |
| Derivatives   | 2,978                         | 1,420   | 38               | -                           | -        | -                        | 4,436   |
| Loans and advances held<br>at amortised cost:         |                               |         |                  |                             |          |                          |         |
| - loans and advances to banks                         | 68,279                        | 6,673   | -                | -                           | -        | -                        | 74,952  |
| - loans and advances<br>to customers                  | 257,965                       | 163,570 | 1,577            | 2,522                       | 1,404    | (1,409)                  | 425,629 |
|   | 326,244                       | 170,243 | 1,577            | 2,522                       | 1,404    | (1,409)                  | 500,581 |
| Financial investments:                                |                               |         |                  |                             |          |                          |         |
| - treasury and similar bills                          | 43,296                        | -       | -                | -                           | -        | -                        | 43,296  |
| - debt securities                                     | 59,860                        | 1,924   | -                | -                           | -        | -                        | 61,784  |
|   | 103,156                       | 1,924   | -                | -                           | -        | -                        | 105,080 |
| Other assets:   |                               |         |                  |                             |          |                          |         |
| - acceptances and endorsements                        | 867                           | 2,157   | 28               | -                           | -        | -                        | 3,052   |
| - other   | 674                           | 823     | 2                | 2                           | -        | -                        | 1,501   |
|   | 1,541                         | 2,980   | 30               | 2                           | -        | -                        | 4,553   |



**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)

|  | Neither past due nor impaired |         |              | Bank                  |          |                       |         |
|--|-------------------------------|---------|--------------|-----------------------|----------|-----------------------|---------|
|  | Strong                        | Medium* | Sub-standard | Past due not impaired | Impaired | Impairment allowances | Total   |
| 2010   |                               |         |              |                       |          |                       |         |
| Items in the course of collection from other banks | 4,589                         | 84      | –            | –                     | –        | –                     | 4,673   |
| Trading assets:                                    |                               |         |              |                       |          |                       |         |
| – treasury and eligible bills                      | 20,204                        | –       | –            | –                     | –        | –                     | 20,204  |
| – debt securities                                  | 4,240                         | 56      | –            | –                     | –        | –                     | 4,296   |
| – loans and advances to banks                      | 700                           | –       | –            | –                     | –        | –                     | 700     |
| – loans and advances to customers                  | 24                            | –       | –            | –                     | –        | –                     | 24      |
|  | 25,168                        | 56      | –            | –                     | –        | –                     | 25,224  |
| Financial assets designated at fair value:         |                               |         |              |                       |          |                       |         |
| – treasury and eligible bills                      | –                             | –       | –            | –                     | –        | –                     | –       |
| – debt securities                                  | 148                           | –       | –            | –                     | –        | –                     | 148     |
| – loans and advances to banks                      | –                             | –       | –            | –                     | –        | –                     | –       |
| – loans and advances to customers                  | –                             | –       | –            | –                     | –        | –                     | –       |
|  | 148                           | –       | –            | –                     | –        | –                     | 148     |
| Derivatives  | 3,744                         | 1,220   | 62           | –                     | –        | –                     | 5,026   |
| Loans and advances held at amortised cost:         |                               |         |              |                       |          |                       |         |
| – loans and advances to banks                      | 80,171                        | 7,165   | –            | –                     | –        | –                     | 87,336  |
| – loans and advances to customers                  | 247,256                       | 171,341 | 1,984        | 2,463                 | 1,462    | (1,432)               | 423,074 |
|  | 327,427                       | 178,506 | 1,984        | 2,463                 | 1,462    | (1,432)               | 510,410 |
| Financial investments:                             |                               |         |              |                       |          |                       |         |
| – treasury and similar bills                       | 17,225                        | –       | –            | –                     | –        | –                     | 17,225  |
| – debt securities                                  | 83,325                        | 2,435   | –            | –                     | –        | –                     | 85,760  |
|  | 100,550                       | 2,435   | –            | –                     | –        | –                     | 102,985 |
| Other assets:                                      |                               |         |              |                       |          |                       |         |
| – acceptances and endorsements                     | 681                           | 1,666   | 16           | –                     | –        | –                     | 2,363   |
| – other  | 607                           | 775     | –            | 1                     | –        | –                     | 1,383   |
|  | 1,288                         | 2,441   | 16           | 1                     | –        | –                     | 3,746   |

\* Includes HK\$5,198 million (2010: HK\$1,623 million) and HK\$780 million (2010: HK\$283 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2011, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)*Aging analysis of financial instruments which were past due but not impaired*

Examples of exposures designated past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment; loans fully secured by cash collateral; residential mortgages in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

|  | Group            |                |                |                 |                  | Total |
|--|------------------|----------------|----------------|-----------------|------------------|-------|
|  | Up to<br>29 days | 30-<br>59 days | 60-<br>89 days | 90-<br>180 days | Over<br>180 days |       |
| <b>2011</b>  |                  |                |                |                 |                  |       |
| Items in the course of collection from other banks | -                | -              | -              | -               | -                | -     |
| Trading assets:                                    |                  |                |                |                 |                  |       |
| – treasury and eligible bills                      | -                | -              | -              | -               | -                | -     |
| – debt securities                                  | -                | -              | -              | -               | -                | -     |
| – loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| – loans and advances to customers                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Financial assets designated at fair value:         |                  |                |                |                 |                  |       |
| – treasury and eligible bills                      | -                | -              | -              | -               | -                | -     |
| – debt securities                                  | -                | -              | -              | -               | -                | -     |
| – loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| – loans and advances to customers                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Derivatives  | -                | -              | -              | -               | -                | -     |
| Loans and advances held at amortised cost:         |                  |                |                |                 |                  |       |
| – loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| – loans and advances to customers <sup>#</sup>     | 2,768            | 394            | 63             | -               | -                | 3,225 |
|  | 2,768            | 394            | 63             | -               | -                | 3,225 |
| Financial investments:                             |                  |                |                |                 |                  |       |
| – treasury and similar bills                       | -                | -              | -              | -               | -                | -     |
| – debt securities                                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Other assets:                                      |                  |                |                |                 |                  |       |
| – acceptances and endorsements                     | -                | -              | -              | -               | -                | -     |
| – other  | 27               | 8              | 3              | 2               | 2                | 42    |
|  | 27               | 8              | 3              | 2               | 2                | 42    |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)

|  | Group            |                |                |                 |                  |       |
|--|------------------|----------------|----------------|-----------------|------------------|-------|
|  | Up to<br>29 days | 30-<br>59 days | 60-<br>89 days | 90-<br>180 days | Over<br>180 days | Total |
| 2010   |                  |                |                |                 |                  |       |
| Items in the course of collection from other banks | -                | -              | -              | -               | -                | -     |
| Trading assets:                                    |                  |                |                |                 |                  |       |
| - treasury and eligible bills                      | -                | -              | -              | -               | -                | -     |
| - debt securities                                  | -                | -              | -              | -               | -                | -     |
| - loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| - loans and advances to customers                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Financial assets designated at fair value:         |                  |                |                |                 |                  |       |
| - treasury and eligible bills                      | -                | -              | -              | -               | -                | -     |
| - debt securities                                  | -                | -              | -              | -               | -                | -     |
| - loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| - loans and advances to customers                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Derivatives  | -                | -              | -              | -               | -                | -     |
| Loans and advances held at amortised cost:         |                  |                |                |                 |                  |       |
| - loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| - loans and advances to customers <sup>#</sup>     | 2,892            | 419            | 51             | 13              | 5                | 3,380 |
|  | 2,892            | 419            | 51             | 13              | 5                | 3,380 |
| Financial investments:                             |                  |                |                |                 |                  |       |
| - treasury and similar bills                       | -                | -              | -              | -               | -                | -     |
| - debt securities                                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Other assets:                                      |                  |                |                |                 |                  |       |
| - acceptances and endorsements                     | -                | -              | -              | -               | -                | -     |
| - other  | 17               | 5              | 2              | 5               | 6                | 35    |
|  | 17               | 5              | 2              | 5               | 6                | 35    |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)

|  | Bank             |                |                |                 |                  | Total        |
|--|------------------|----------------|----------------|-----------------|------------------|--------------|
|  | Up to<br>29 days | 30-<br>59 days | 60-<br>89 days | 90-<br>180 days | Over<br>180 days |              |
| <b>2011</b>  |                  |                |                |                 |                  |              |
| Items in the course of collection from other banks | -                | -              | -              | -               | -                | -            |
| Trading assets:                                    |                  |                |                |                 |                  |              |
| – treasury and eligible bills                      | -                | -              | -              | -               | -                | -            |
| – debt securities                                  | -                | -              | -              | -               | -                | -            |
| – loans and advances to banks                      | -                | -              | -              | -               | -                | -            |
| – loans and advances to customers                  | -                | -              | -              | -               | -                | -            |
|  | -                | -              | -              | -               | -                | -            |
| Financial assets designated at fair value:         |                  |                |                |                 |                  |              |
| – treasury and eligible bills                      | -                | -              | -              | -               | -                | -            |
| – debt securities                                  | -                | -              | -              | -               | -                | -            |
| – loans and advances to banks                      | -                | -              | -              | -               | -                | -            |
| – loans and advances to customers                  | -                | -              | -              | -               | -                | -            |
|  | -                | -              | -              | -               | -                | -            |
| Derivatives  | -                | -              | -              | -               | -                | -            |
| Loans and advances held at amortised cost:         |                  |                |                |                 |                  |              |
| – loans and advances to banks                      | -                | -              | -              | -               | -                | -            |
| – loans and advances to customers <sup>#</sup>     | <b>2,219</b>     | <b>256</b>     | <b>47</b>      | -               | -                | <b>2,522</b> |
|  | <b>2,219</b>     | <b>256</b>     | <b>47</b>      | -               | -                | <b>2,522</b> |
| Financial investments:                             |                  |                |                |                 |                  |              |
| – treasury and similar bills                       | -                | -              | -              | -               | -                | -            |
| – debt securities                                  | -                | -              | -              | -               | -                | -            |
|  | -                | -              | -              | -               | -                | -            |
| Other assets:                                      |                  |                |                |                 |                  |              |
| – acceptances and endorsements                     | -                | -              | -              | -               | -                | -            |
| – other  | <b>1</b>         | <b>1</b>       | -              | -               | -                | <b>2</b>     |
|  | <b>1</b>         | <b>1</b>       | -              | -               | -                | <b>2</b>     |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iii) Credit quality** (continued)

|  | Bank             |                |                |                 |                  |       |
|--|------------------|----------------|----------------|-----------------|------------------|-------|
|  | Up to<br>29 days | 30-<br>59 days | 60-<br>89 days | 90-<br>180 days | Over<br>180 days | Total |
| 2010   |                  |                |                |                 |                  |       |
| Items in the course of collection from other banks | -                | -              | -              | -               | -                | -     |
| Trading assets:                                    |                  |                |                |                 |                  |       |
| - treasury and eligible bills                      | -                | -              | -              | -               | -                | -     |
| - debt securities                                  | -                | -              | -              | -               | -                | -     |
| - loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| - loans and advances to customers                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Financial assets designated at fair value:         |                  |                |                |                 |                  |       |
| - treasury and eligible bills                      | -                | -              | -              | -               | -                | -     |
| - debt securities                                  | -                | -              | -              | -               | -                | -     |
| - loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| - loans and advances to customers                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Derivatives  | -                | -              | -              | -               | -                | -     |
| Loans and advances held at amortised cost:         |                  |                |                |                 |                  |       |
| - loans and advances to banks                      | -                | -              | -              | -               | -                | -     |
| - loans and advances to customers <sup>#</sup>     | 2,173            | 236            | 39             | 13              | 2                | 2,463 |
|  | 2,173            | 236            | 39             | 13              | 2                | 2,463 |
| Financial investments:                             |                  |                |                |                 |                  |       |
| - treasury and similar bills                       | -                | -              | -              | -               | -                | -     |
| - debt securities                                  | -                | -              | -              | -               | -                | -     |
|  | -                | -              | -              | -               | -                | -     |
| Other assets:                                      |                  |                |                |                 |                  |       |
| - acceptances and endorsements                     | -                | -              | -              | -               | -                | -     |
| - other  | 1                | -              | -              | -               | -                | 1     |
|  | 1                | -              | -              | -               | -                | 1     |

<sup>#</sup> The majority of the loans and advances to customers that are operating within revised terms following restructuring are excluded from this table.

**Impaired loans and advances**

Special attention is paid to problem loans and appropriate action is initiated to protect the Group's position on a timely basis and to ensure that loan impairment methodologies result in losses being recognised when they are incurred.

The Group's policy for recognising and measuring impairment allowances on both individually assessed advances and those which are collectively assessed on a portfolio basis is described in note 4(f) to the financial statements.

Analysis of impairment allowances at 31 December 2011 and the movement of such allowances during the year are disclosed in note 35.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(a) Credit risk** (continued)**(iv) Collateral and other credit enhancements obtained**

The Group obtained assets by taking possession of collateral held as security, or calling other credit enhancement.

The carrying amount outstanding as at the year end was as follows:

|                                      | <b>Group</b> |      | <b>Bank</b> |      |
|--------------------------------------|--------------|------|-------------|------|
|                                      | <b>2011</b>  | 2010 | <b>2011</b> | 2010 |
| Nature of assets:                    |              |      |             |      |
| Residential properties               | <b>3</b>     | 12   | <b>-</b>    | 7    |
| Commercial and industrial properties | <b>-</b>     | -    | <b>-</b>    | -    |
| Other                                | <b>-</b>     | -    | <b>-</b>    | -    |
|                                      | <b>3</b>     | 12   | <b>-</b>    | 7    |

**(b) Liquidity risk**

Liquidity relates to the ability of a company to meet its obligations as they fall due. The Group maintains a stable and diversified funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets. The objective of the Group's liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due.

Management of liquidity is carried out both at Group and Bank level as well as in individual branches and subsidiaries. The Group requires branches and subsidiaries to maintain a strong liquidity position and to manage the liquidity structure of their assets, liabilities and commitments so that cash flows are approximately balanced and all funding obligations are met when due.

It is the responsibility of the Group's management to ensure compliance with local regulatory requirements and limits set by Executive Committee. Liquidity is managed on a daily basis by the Bank's treasury functions and overseas treasury sites.

Compliance with liquidity requirements is monitored by the Asset and Liability Management Committee ("ALCO") and is reported to the Risk Management Committee, Executive Committee and the Board of Directors. This process includes:

- projecting cash flows 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;
- managing contingent liquidity commitment exposures within pre-determined limits;
- managing debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- monitoring of depositor concentration contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systematic or other crises, while minimising adverse long-term implications for the business.

Current accounts and savings deposits payable on demand or at short notice form a significant part of the Group's overall funding. The Group places considerable importance on the stability of these deposits, which is achieved through the Group's retail banking activities and by maintaining depositor confidence in the Group's capital strength. Professional markets are accessed for the purposes of providing additional funding, maintaining a presence in local money markets and optimising asset and liability maturities. Although the contractual repayments of many customer accounts are on demand or short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.



**61. FINANCIAL RISK MANAGEMENT** (continued)**(b) Liquidity risk** (continued)

The average liquidity ratio for the year, calculated in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance, is as follows:

|  | Group        |       |
|--|--------------|-------|
|  | 2011         | 2010  |
| The Bank and its subsidiaries designated by the Hong Kong Monetary Authority | <b>33.6%</b> | 38.1% |

The below tables are an analysis of undiscounted cash flows on the Group's financial liabilities including future interest payments on the basis of their earliest possible contractual maturity.

The balances in the below table will not agree with the balances in the balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and all future coupon payments (except for trading liabilities and trading derivatives). Also, loans commitments are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the "On demand" time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loans commitments expire without being drawn upon. The undiscounted cash flows potentially payable under loan commitments and financial guarantee are classified on the basis of the earliest date they can be called.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(b) Liquidity risk** (continued)**Group**

|   | <b>Repayable<br/>on<br/>demand</b> | <b>Three<br/>months<br/>or less<br/>but not on<br/>demand</b> | <b>Over<br/>three<br/>months<br/>but within<br/>one year</b> | <b>Over<br/>one year<br/>but within<br/>five years</b> | <b>Over<br/>five<br/>years</b> | <b>Total</b>   |
|---|------------------------------------|---|--|--|--------------------------------|----------------|
| <b>At 31 December 2011</b>                                    |                                    |   |  |  |                                |                |
| Current, savings and other deposit accounts                   | 503,663                            | 163,776   | 33,036   | 1,119  | –                              | 701,594        |
| Deposits from banks   | 2,072                              | 11,320  | 618  | –  | –                              | 14,010         |
| Financial liabilities designated at fair value                | 1                                  | –   | –  | –  | 433                            | 434            |
| Trading liabilities   | 59,712                             | –   | –  | –  | –                              | 59,712         |
| Derivative financial instruments                              | 3,508                              | 156   | 320  | 904  | 79                             | 4,967          |
| Certificates of deposit and<br>other debt securities in issue | –                                  | 1,633   | 1,535  | 6,280  | –                              | 9,448          |
| Other financial liabilities                                   | 6,319                              | 7,071   | 1,800  | 62   | 19                             | 15,271         |
| Subordinated liabilities                                      | –                                  | 94  | 2,511  | 939  | 10,497                         | 14,041         |
|   | <b>575,275</b>                     | <b>184,050</b>  | <b>39,820</b>  | <b>9,304</b>   | <b>11,028</b>                  | <b>819,477</b> |
| Commitments   | 240,159                            | 42,488  | 1,823  | 982  | –                              | 285,452        |
| Financial guarantee contracts                                 | 5,325                              | 51  | 1  | –  | –                              | 5,377          |
|   | <b>245,484</b>                     | <b>42,539</b>   | <b>1,824</b>   | <b>982</b>   | <b>–</b>                       | <b>290,829</b> |
| <b>At 31 December 2010</b>                                    |                                    |   |  |  |                                |                |
| Current, savings and other deposit accounts                   | 536,442                            | 116,288   | 29,956   | 1,660  | –                              | 684,346        |
| Deposits from banks   | 6,387                              | 9,084   | –  | 117  | –                              | 15,588         |
| Financial liabilities designated at fair value                | 2                                  | –   | –  | –  | 455                            | 457            |
| Trading liabilities   | 42,581                             | –   | –  | –  | –                              | 42,581         |
| Derivative financial instruments                              | 3,709                              | 104   | 400  | 616  | (18)                           | 4,811          |
| Certificates of deposit and<br>other debt securities in issue | –                                  | 553   | 135  | 2,489  | –                              | 3,177          |
| Other financial liabilities                                   | 6,719                              | 5,643   | 1,499  | 70   | 25                             | 13,956         |
| Subordinated liabilities                                      | –                                  | 54  | 3,609  | 2,843  | 6,655                          | 13,161         |
|   | <b>595,840</b>                     | <b>131,726</b>  | <b>35,599</b>  | <b>7,795</b>   | <b>7,117</b>                   | <b>778,077</b> |
| Commitments   | 222,111                            | 37,081  | 179  | 575  | –                              | 259,946        |
| Financial guarantee contracts                                 | 4,094                              | –   | 2  | –  | –                              | 4,096          |
|   | <b>226,205</b>                     | <b>37,081</b>   | <b>181</b>   | <b>575</b>   | <b>–</b>                       | <b>264,042</b> |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(b) Liquidity risk** (continued)

|   | Bank                      |  |   |  |                       |                |
|---|---------------------------|--|---|--|-----------------------|----------------|
|   | Repayable<br>on<br>demand | Three<br>months<br>or less<br>but not on<br>demand | Over<br>three<br>months<br>but within<br>one year | Over<br>one year<br>but within<br>five years | Over<br>five<br>years | Total          |
| <b>At 31 December 2011</b>                                    |                           |  |   |  |                       |                |
| Current, savings and other deposit accounts                   | 489,952                   | 151,649  | 19,671  | 500  | –                     | 661,772        |
| Deposits from banks   | 2,065                     | 9,311  | 618   | –  | –                     | 11,994         |
| Financial liabilities designated at fair value                | –                         | –  | –   | –  | –                     | –              |
| Trading liabilities   | 36,077                    | –  | –   | –  | –                     | 36,077         |
| Derivative financial instruments                              | 3,319                     | 102  | 177   | 488  | 79                    | 4,165          |
| Certificates of deposit and<br>other debt securities in issue | –                         | 1,633  | 1,535   | 6,280  | –                     | 9,448          |
| Amounts due to subsidiaries                                   | 6,143                     | 4,651  | 3   | –  | –                     | 10,797         |
| Other financial liabilities                                   | 5,917                     | 5,890  | 971   | 8  | 19                    | 12,805         |
| Subordinated liabilities                                      | –                         | 94   | 2,511   | 939  | 10,497                | 14,041         |
|   | <b>543,473</b>            | <b>173,330</b>                                     | <b>25,486</b>                                     | <b>8,215</b>                                 | <b>10,595</b>         | <b>761,099</b> |
| Commitments   | 216,941                   | 29,772   | 79  | 1  | –                     | 246,793        |
| Financial guarantee contracts                                 | 3,654                     | 51   | 1   | –  | –                     | 3,706          |
|   | <b>220,595</b>            | <b>29,823</b>                                      | <b>80</b>   | <b>1</b>                                     | <b>–</b>              | <b>250,499</b> |
| <b>At 31 December 2010</b>                                    |                           |  |   |  |                       |                |
| Current, savings and other deposit accounts                   | 526,177                   | 105,993  | 16,276  | 1,106  | –                     | 649,552        |
| Deposits from banks   | 6,386                     | 9,084  | –   | 117  | –                     | 15,587         |
| Financial liabilities designated at fair value                | –                         | –  | –   | –  | –                     | –              |
| Trading liabilities   | 30,106                    | –  | –   | –  | –                     | 30,106         |
| Derivative financial instruments                              | 3,803                     | 91   | 280   | 381  | (21)                  | 4,534          |
| Certificates of deposit and<br>other debt securities in issue | –                         | 553  | 135   | 2,489  | –                     | 3,177          |
| Amounts due to subsidiaries                                   | 4,222                     | 4,675  | 2   | –  | –                     | 8,899          |
| Other financial liabilities                                   | 6,596                     | 4,514  | 770   | 1  | 910                   | 12,791         |
| Subordinated liabilities                                      | –                         | 54   | 3,609   | 2,843  | 6,655                 | 13,161         |
|   | <b>577,290</b>            | <b>124,964</b>                                     | <b>21,072</b>                                     | <b>6,937</b>                                 | <b>7,544</b>          | <b>737,807</b> |
| Commitments   | 190,235                   | 36,455   | 75  | 1  | –                     | 226,766        |
| Financial guarantee contracts                                 | 2,992                     | –  | 2   | –  | –                     | 2,994          |
|   | <b>193,227</b>            | <b>36,455</b>                                      | <b>77</b>   | <b>1</b>                                     | <b>–</b>              | <b>229,760</b> |

The Basel Committee on Banking Supervision has issued the final rules in two documents “A global regulatory framework for more resilient banks and banking systems” and “International framework for liquidity risk measurement, standards and monitoring” in December 2010, widely referred to as Basel III rules, on the areas of capital and liquidity. The Hong Kong Monetary Authority has then issued a consultation paper in January 2012 on the implementation of Basel III Liquidity Standards in Hong Kong. Under the consultation paper, a new minimum standard, the Liquidity Coverage Ratio, will be developed to promote the short-term resilience of banks to potential liquidity disruptions. A Net Stable Funding Ratio will also be introduced to promote the longer term resilience of banks. These will be phased in 2015 and 2018 respectively after the observation periods.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk

Market risk is the risk that foreign exchange rates, interest rates, equity and commodity prices and indices will move and result in profits or losses for the Group. 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.

The Group separates exposures to market risk into either trading or non-trading portfolios. Trading portfolios include those positions arising from market-making, customer-related business, proprietary position-taking and strategic foreign exchange. Non-trading portfolios primarily arise from the effective interest rate management of the Group's retail and commercial banking assets and liabilities.

The management of market risk is principally undertaken in Treasury using risk limits approved by the Risk Management Committee. Limits are set for each portfolio, product and risk type, with market liquidity being a principal factor in determining the level of limits set. The Group has dedicated standards, policies and procedures in place to control and monitor the market risk. An independent market risk control function is responsible for measuring market risk exposures, monitoring and reporting these exposures against the prescribed limits on a daily basis. The market risks which arise on each business are assessed and transferred to either Treasury for management, or to separate books managed under the supervision of ALCO.

#### *Value at risk ("VAR")*

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR.

VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence. Historical simulation uses scenarios derived from historical market rates and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The assumed holding period is a 1-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

VAR is calculated daily. The Group validates the accuracy of its VAR models by back-testing the actual daily profit and loss results which include both end of day market movements and intra-day trading outcomes, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the Group would expect to see losses in excess of VAR only one per cent of the time over a 1-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at 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.

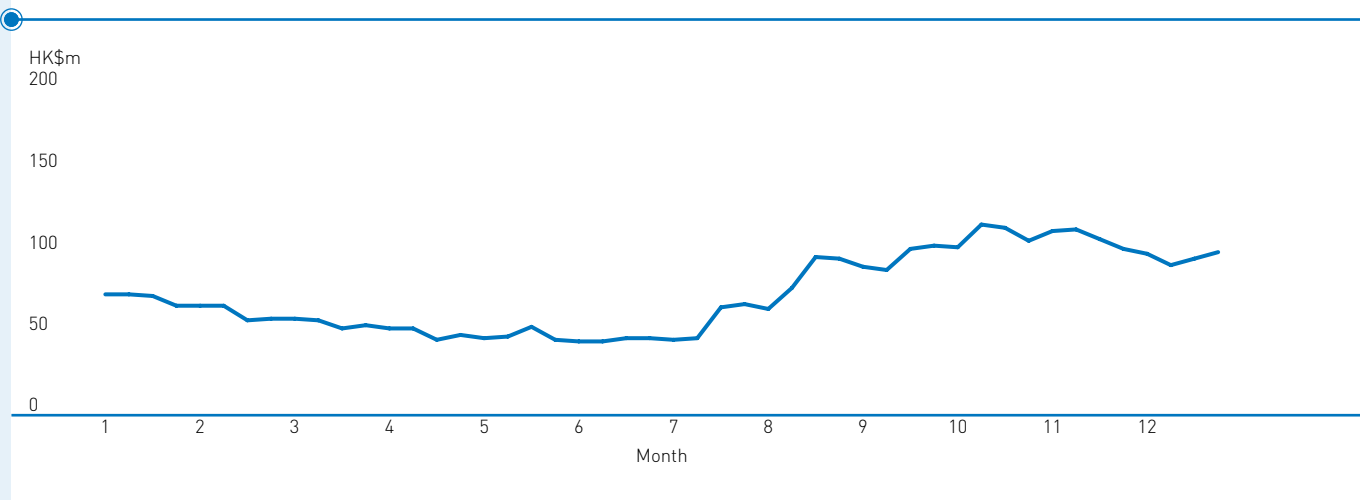
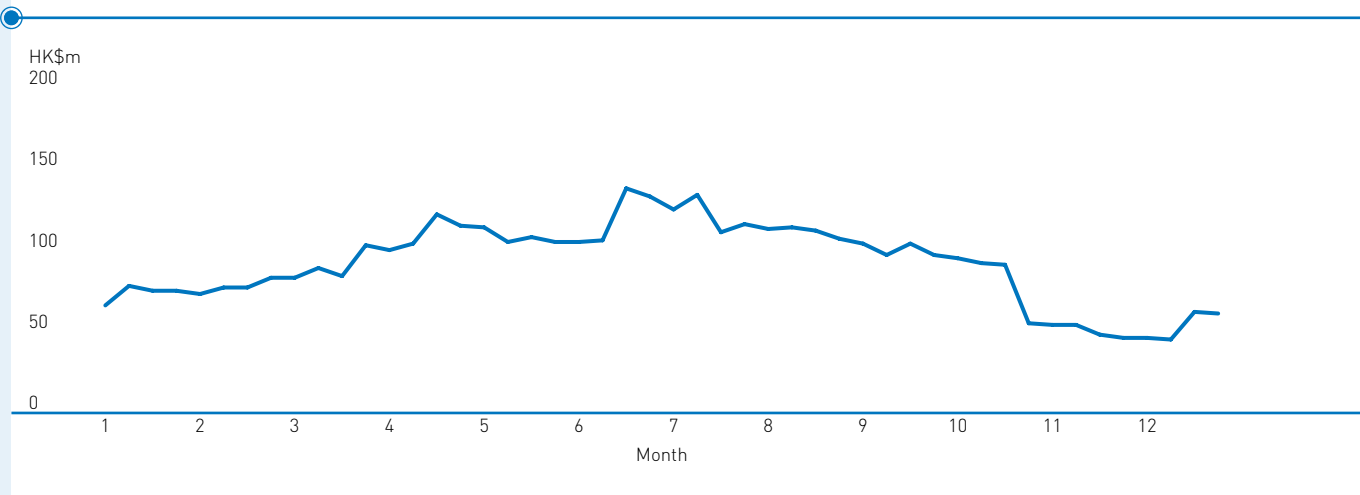
The Group recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. Additionally, the Group applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions. The Group's stress testing regime provides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

**61. FINANCIAL RISK MANAGEMENT** (continued)**(c) Market risk** (continued)

The Group's VAR, both trading and non-trading, for total positions of all interest rate risk and foreign exchange risk positions and on individual risk portfolios during 2011 and 2010 are shown in the table below.

|   | At 31<br>December<br>2011 | Minimum<br>during<br>the year | Maximum<br>during<br>the year | Average<br>for the year |
|---|---------------------------|-------------------------------|-------------------------------|-------------------------|
| Total VAR                               | 91                        | 37                            | 110                           | 66                      |
| Total trading VAR                       | 10                        | 5                             | 18                            | 10                      |
| VAR for foreign exchange risk (trading) | 5                         | 2                             | 9                             | 6                       |
| VAR for interest rate risk:             |                           |                               |                               |                         |
| – trading                               | 10                        | 3                             | 16                            | 8                       |
| – non-trading                           | 27                        | 15                            | 30                            | 21                      |

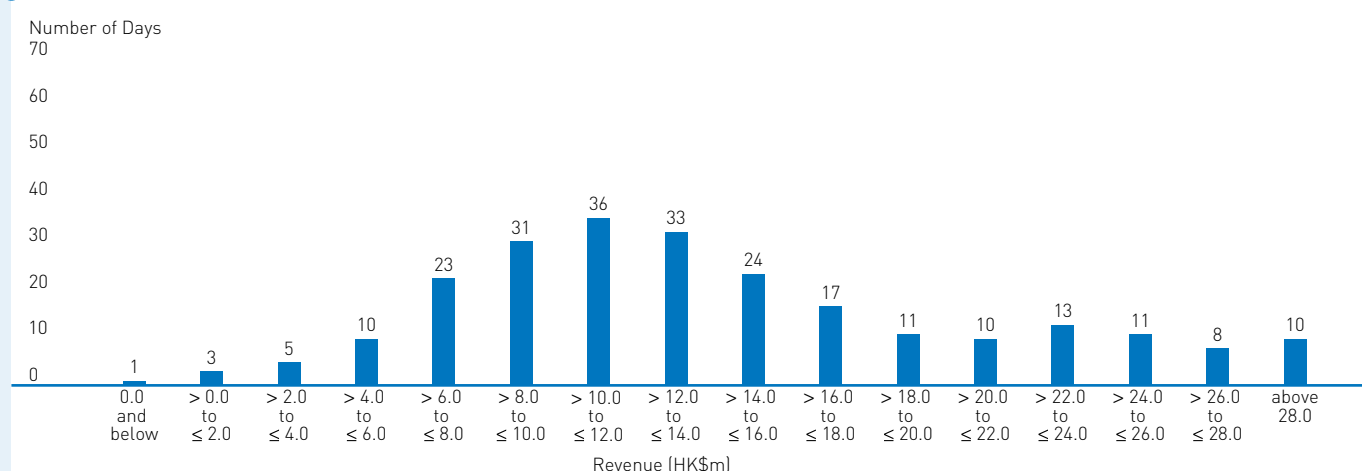
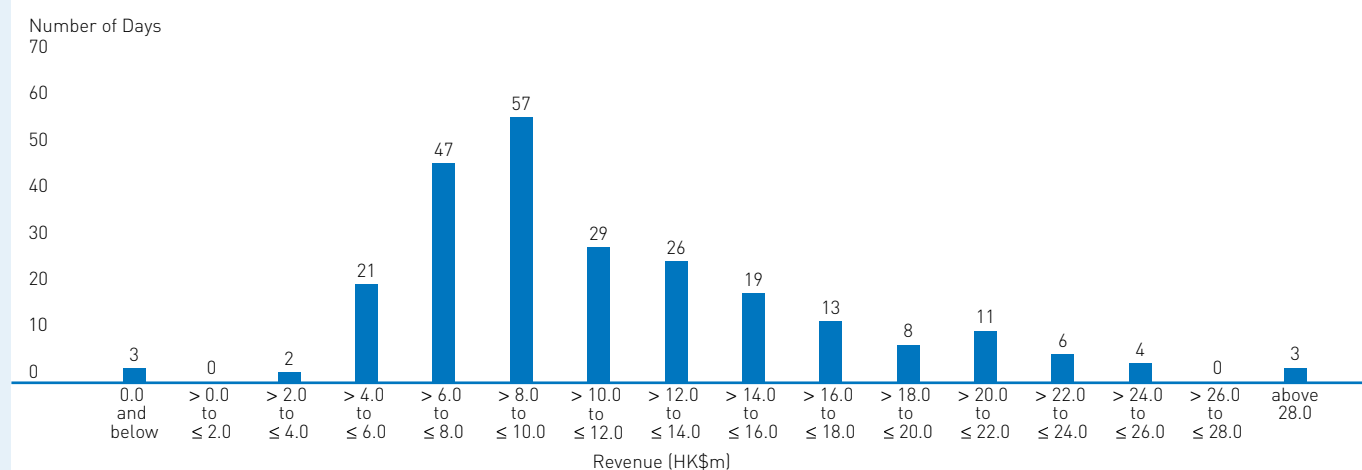
|   | At 31<br>December<br>2010 | Minimum<br>during<br>the year | Maximum<br>during<br>the year | Average<br>for the year |
|---|---------------------------|-------------------------------|-------------------------------|-------------------------|
| Total VAR                               | 69                        | 53                            | 149                           | 99                      |
| Total trading VAR                       | 9                         | 5                             | 25                            | 10                      |
| VAR for foreign exchange risk (trading) | 5                         | 1                             | 10                            | 3                       |
| VAR for interest rate risk:             |                           |                               |                               |                         |
| – trading                               | 6                         | 5                             | 23                            | 10                      |
| – non-trading                           | 18                        | 17                            | 100                           | 62                      |

**TOTAL VALUE AT RISK FOR 2011****TOTAL VALUE AT RISK FOR 2010**

**61. FINANCIAL RISK MANAGEMENT** (continued)**(c) Market risk** (continued)

The average daily revenue earned from market risk-related treasury activities in 2011, including non-trading book net interest income and funding related to trading positions, was HK\$14 million (2010: HK\$11 million). The standard deviation of these daily revenues was HK\$7 million, compared with HK\$6 million for 2010.

An analysis of the frequency distribution of daily revenue shows that out of 246 trading days in 2011, losses were recorded on 1 day (2010: 3 days) and the maximum daily loss was HK\$6 million (2010: HK\$35 million). The most frequent result was a daily revenue of between HK\$6 million and HK\$18 million, with 164 occurrences (2010: 191 occurrences). The highest daily revenue was HK\$41 million (2010: HK\$32 million).

**DAILY DISTRIBUTION OF MARKET RISK REVENUE FOR 2011****DAILY DISTRIBUTION OF MARKET RISK REVENUE FOR 2010**

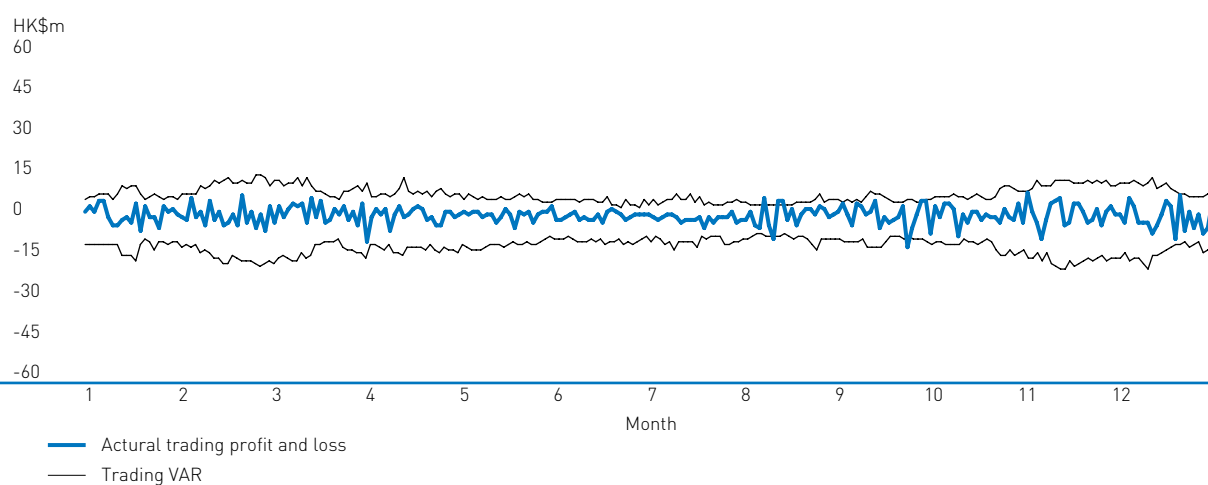
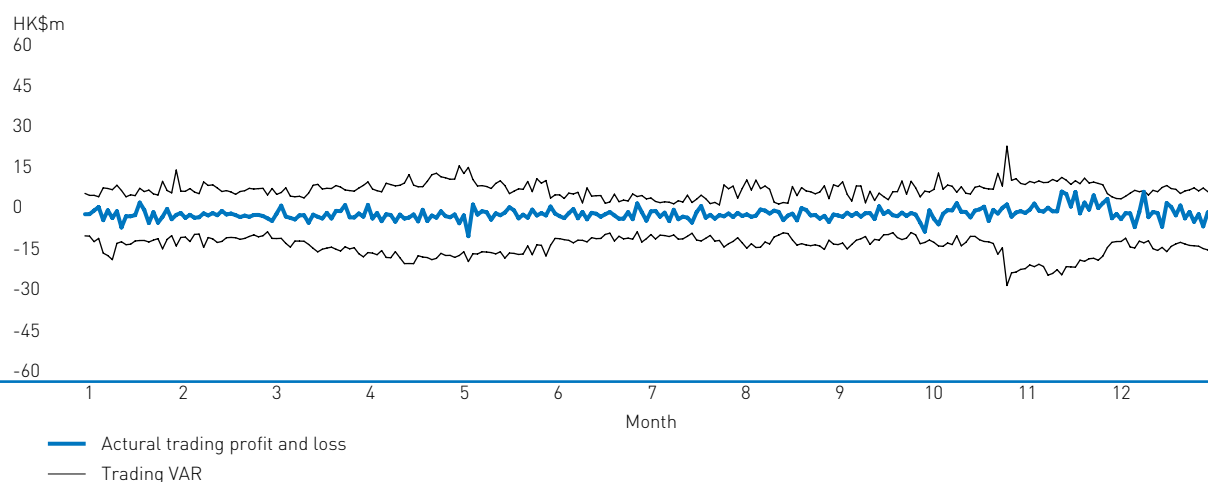


**61. FINANCIAL RISK MANAGEMENT** (continued)**(c) Market risk** (continued)

Back-testing of the Trading VAR model for interest rate and foreign exchange uses cleaned profits and losses from trading operations and compares these to total trading VAR, foreign exchange and interest rate level VAR on a daily basis.

The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2011 and 2010 are shown in the table below.

**A COMPARISON OF TRADING VAR WITH ACTUAL TRADING PROFIT AND LOSS FOR 2011****A COMPARISON OF TRADING VAR WITH ACTUAL TRADING PROFIT AND LOSS FOR 2010**

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

#### Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios which include structural interest rate exposures. Treasury manages interest rate risks within the limits approved by the Risk Management Committee and under the monitoring of both ALCO and Risk Management Committee.

#### Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point ("PVBP") limits and option limits, and a list of permissible instruments authorised by the Risk Management Committee, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

#### Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Structural interest rate risk arises from the different repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts.

Analysis of these risks 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. The 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 and structural interest rate risks are transferred to Treasury or to separate books managed under the supervision of the ALCO.

The transfer of market risk to books managed by Treasury or supervised by ALCO is usually achieved by a series of internal deals between the business units and these 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. ALCO regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by the Risk Management Committee.

#### Net interest income

A principal part of the Group's management of interest rate 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.

The table below sets out the impact on future net interest income of a 100 basis points parallel fall or rise in all-in yield curves at the beginning of year from 1 January 2012 and 25 basis points parallel fall or rise in all-in yield curves at the beginning of each quarter during the 12 month period from 1 January 2012.

Assuming no management actions, such a series of incremental parallel rises in all-in yield curves would increase planned net interest income for the year to 31 December 2012 by HK\$1,477 million for 100 basis points case and by HK\$972 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK\$2,049 million for 100 basis points case and by HK\$1,507 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and takes into account the change in pricing of retail products relative to change in market interest rates.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(c) Market risk** (continued)*Projected Net Interest Income*

The sensitivity of projected net interest income is described as follows:

|   | 100bp<br>parallel<br>increase | 100bp<br>parallel<br>decrease | 25bp<br>increase<br>at the<br>beginning<br>of each<br>quarter | 25bp<br>decrease<br>at the<br>beginning<br>of each<br>quarter |
|---|-------------------------------|-------------------------------|---|---|
| <b>Change in 2012 projected net interest income</b> |                               |                               |   |   |
| – HKD   | 867                           | (1,466)                       | 646   | (1,216)   |
| – US\$  | 426                           | (386)                         | 272   | (271)   |
| – other   | 184                           | (197)                         | 54  | (20)  |
| Total   | 1,477                         | (2,049)                       | 972   | (1,507)   |
| <b>Change in 2011 projected net interest income</b> |                               |                               |   |   |
| – HKD   | 861                           | (1,113)                       | 562   | (963)   |
| – US\$  | 309                           | (447)                         | 113   | (262)   |
| – other   | 133                           | (146)                         | 87  | (55)  |
| Total   | 1,303                         | (1,706)                       | 762   | (1,280)   |

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. 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 would be taken by Treasury or in the business units to mitigate the impact of this interest rate risk. In reality, Treasury seeks proactively to 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.

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 Treasury.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(c) Market risk** (continued)*Sensitivity of reserves*

The Group monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all-in yield curves. The table below describes the sensitivity to these movements at the balance sheet dates indicated below and the maximum and minimum month figures during the year then ended:

|  | At 31<br>December<br>2011 | Maximum<br>impact | Minimum<br>impact |
|--|---------------------------|-------------------|-------------------|
| + 100 basis points parallel move in all-in yield curves        | (973)                     | (1,047)           | (827)             |
| As a percentage of shareholders' funds at 31 December 2011 (%) | (1.2)                     | (1.3)             | (1.0)             |
| – 100 basis points parallel move in all-in yield curves        | 256                       | 292               | 246               |
| As a percentage of shareholders' funds at 31 December 2011 (%) | 0.3                       | 0.4               | 0.3               |

|  | At 31<br>December<br>2010 | Maximum<br>impact | Minimum<br>impact |
|--|---------------------------|-------------------|-------------------|
| + 100 basis points parallel move in all-in yield curves        | (803)                     | (1,173)           | (803)             |
| As a percentage of shareholders' funds at 31 December 2010 (%) | (1.1)                     | (1.7)             | (1.1)             |
| – 100 basis points parallel move in all-in yield curves        | 264                       | 303               | 174               |
| As a percentage of shareholders' funds at 31 December 2010 (%) | 0.4                       | 0.4               | 0.2               |

The sensitivities included in the table are illustrative only and are based on simplified scenarios. Moreover, the table shows only those interest rate risk exposures arising in available-for-sale portfolios and from cash flow hedges. These particular exposures form only a part of the Group's overall interest rate exposures.

**Foreign exchange exposure**

The Group's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the Risk Management Committee. Net option position is calculated on the basis of delta-weighted positions of all foreign exchange options contract. Structural foreign exchange positions arising from capital investments in associate, subsidiaries and branches outside Hong Kong, mainly in US dollar and Chinese renminbi as set out below, are managed by ALCO.

At 31 December 2011, the US dollar ("US\$"), Chinese renminbi ("RMB") and Euro ("EUR") were the currencies in which the Group had non-structural foreign currency positions that were not less than 10 per cent of the total net position in all foreign currencies. The Group also had a RMB structural foreign currency position, which was not less than 10 percent of the total net structural position in all foreign currencies.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(c) Market risk** (continued)**Foreign exchange exposure** (continued)

The tables below summarise the net structural and non-structural foreign currency positions of the Group and the Bank.

|  | Group     |           |          |          |          |          |       |          |          |         |                          |                          |
|--|-----------|-----------|----------|----------|----------|----------|-------|----------|----------|---------|--------------------------|--------------------------|
|  | US\$      | RMB       | GBP      | JPY      | EUR      | CAD      | CHF   | AUD      | NZD      | GOL     | Other foreign currencies | Total foreign currencies |
| 2011                                     |           |           |          |          |          |          |       |          |          |         |                          |                          |
| Non-structural position                  |           |           |          |          |          |          |       |          |          |         |                          |                          |
| Spot assets                              | 149,152   | 123,061   | 12,922   | 32,344   | 9,119    | 13,405   | 117   | 46,562   | 7,576    | 4,341   | 941                      | 399,540                  |
| Spot liabilities                         | (128,778) | (124,005) | (15,234) | (1,930)  | (11,097) | (16,447) | (601) | (48,899) | (10,897) | (4,524) | (1,397)                  | (363,809)                |
| Forward purchases                        | 265,328   | 87,981    | 4,121    | 4,122    | 4,699    | 3,358    | 1,089 | 9,464    | 5,134    | 2,248   | 1,393                    | 388,937                  |
| Forward sales                            | (284,172) | (85,934)  | (1,783)  | (34,510) | (3,061)  | (313)    | (635) | (7,265)  | (1,829)  | (2,014) | (956)                    | (422,472)                |
| Net options position                     | 147       | (124)     | -        | 2        | (24)     | -        | -     | 20       | (18)     | -       | -                        | 3                        |
| Net long/(short) non-structural position | 1,677     | 979       | 26       | 28       | (364)    | 3        | (30)  | (118)    | (34)     | 51      | (19)                     | 2,199                    |
| Structural position                      | 206       | 24,850    | -        | -        | -        | -        | -     | -        | -        | -       | 305                      | 25,361                   |
| 2010                                     |           |           |          |          |          |          |       |          |          |         |                          |                          |
| Non-structural position                  |           |           |          |          |          |          |       |          |          |         |                          |                          |
| Spot assets                              | 246,638   | 93,067    | 13,026   | 8,985    | 11,068   | 13,933   | 191   | 43,643   | 9,017    | 2,169   | 974                      | 442,711                  |
| Spot liabilities                         | (155,377) | (88,666)  | (15,470) | (1,912)  | (12,393) | (14,882) | (549) | (41,953) | (11,658) | (3,404) | (3,034)                  | (349,298)                |
| Forward purchases                        | 228,982   | 72,661    | 7,130    | 8,932    | 3,735    | 2,431    | 1,347 | 8,340    | 3,909    | 2,919   | 3,423                    | 343,809                  |
| Forward sales                            | (319,494) | (77,799)  | (4,810)  | (16,151) | (2,497)  | (1,449)  | (964) | (9,885)  | (1,341)  | (1,559) | (1,359)                  | (437,308)                |
| Net options position                     | 133       | (41)      | -        | (5)      | (55)     | (7)      | -     | (71)     | 60       | -       | -                        | 14                       |
| Net long/(short) non-structural position | 882       | (778)     | (124)    | (151)    | (142)    | 26       | 25    | 74       | (13)     | 125     | 4                        | (72)                     |
| Structural position                      | 206       | 20,124    | -        | -        | -        | -        | -     | -        | -        | -       | 238                      | 20,568                   |

|  | Bank      |          |          |          |         |         |       |          |         |         |                          |                          |
|--|-----------|----------|----------|----------|---------|---------|-------|----------|---------|---------|--------------------------|--------------------------|
|  | US\$      | RMB      | GBP      | JPY      | EUR     | CAD     | CHF   | AUD      | NZD     | GOL     | Other foreign currencies | Total foreign currencies |
| 2011                                     |           |          |          |          |         |         |       |          |         |         |                          |                          |
| Non-structural position                  |           |          |          |          |         |         |       |          |         |         |                          |                          |
| Spot assets                              | 132,455   | 43,164   | 7,105    | 32,303   | 6,489   | 7,071   | 76    | 24,082   | 3,901   | 4,341   | 917                      | 261,904                  |
| Spot liabilities                         | (118,352) | (43,874) | (9,329)  | (1,893)  | (8,300) | (9,932) | (561) | (23,528) | (7,050) | (4,524) | (1,372)                  | (228,715)                |
| Forward purchases                        | 244,899   | 71,773   | 4,048    | 4,093    | 4,561   | 3,175   | 1,089 | 6,511    | 4,954   | 2,248   | 1,393                    | 348,744                  |
| Forward sales                            | (258,679) | (69,425) | (1,735)  | (34,475) | (3,020) | (313)   | (635) | (7,265)  | (1,829) | (2,014) | (956)                    | (380,346)                |
| Net options position                     | 147       | (124)    | -        | 2        | (24)    | -       | -     | 20       | (18)    | -       | -                        | 3                        |
| Net long/(short) non-structural position | 470       | 1,514    | 89       | 30       | (294)   | 1       | (31)  | (180)    | (42)    | 51      | (18)                     | 1,590                    |
| Structural position                      | 206       | 24,850   | -        | -        | -       | -       | -     | -        | -       | -       | 305                      | 25,361                   |
| 2010                                     |           |          |          |          |         |         |       |          |         |         |                          |                          |
| Non-structural position                  |           |          |          |          |         |         |       |          |         |         |                          |                          |
| Spot assets                              | 203,809   | 41,067   | 7,591    | 8,883    | 8,411   | 7,568   | 129   | 23,618   | 5,993   | 2,169   | 864                      | 310,102                  |
| Spot liabilities                         | (117,702) | (36,296) | (10,022) | (1,840)  | (9,529) | (8,463) | (504) | (20,171) | (8,544) | (3,404) | (2,924)                  | (219,399)                |
| Forward purchases                        | 205,281   | 59,923   | 7,130    | 8,695    | 3,550   | 2,377   | 1,347 | 6,433    | 3,813   | 2,919   | 3,423                    | 304,891                  |
| Forward sales                            | (292,023) | (64,330) | (4,762)  | (15,805) | (2,467) | (1,449) | (948) | (9,782)  | (1,341) | (1,559) | (1,359)                  | (395,825)                |
| Net options position                     | 133       | (41)     | -        | (5)      | (55)    | (7)     | -     | (71)     | 60      | -       | -                        | 14                       |
| Net long/(short) non-structural position | (502)     | 323      | (63)     | (72)     | (90)    | 26      | 24    | 27       | (19)    | 125     | 4                        | (217)                    |
| Structural position                      | 206       | 20,124   | -        | -        | -       | -       | -     | -        | -       | -       | 238                      | 20,568                   |

The above US Dollars foreign currency exposure included certain US Dollars currency loans with embedded US Dollars forward contract granted to customers under the bank negotiation with the underlying documentary credit denominated in RMB currency amounted to HK\$19,128 millions at 31 December 2011 (31 December 2010: HK\$30,575 millions).

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

#### Equities exposure

The Group's equities exposures in 2011 and 2010 are mainly in long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

### (d) Insurance risk

#### Risk management objectives and policies for management of insurance risk

Through its insurance subsidiaries, the Group offers comprehensive insurance products, including life and non-life insurance, to both personal and commercial customers. These insurance operating subsidiaries are subject to the supervision of the Office of the Commissioner of Insurance ("OCI") and are required to observe the relevant compliance requirements stipulated by the Insurance Commissioner.

The Group is exposed to the uncertainty surrounding the timing and severity of insurance claims under its insurance contracts. The Group also has exposure to market risk through its insurance and investment activities.

The Group manages its insurance risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues.

The Group uses several methods to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. The principal risk is that the frequency and severity of claims is greater than expected. Insurance events are, by their nature, random, and the actual number and size of events during any one year may vary from those estimated using established statistical techniques.

#### Asset/liability management

The Group actively manages its assets using an approach that considers asset quality, risk profile, diversification, asset/liability matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Market and Liquidity Risk Committee of the Group's insurance subsidiaries review and approve target portfolios on a periodic basis, establishes investment guidelines and limits, while Asset and Liability Management Committee provides oversight of the asset/liability management process.

The Group establishes target asset portfolios for each major insurance product category according to specific product requirements and local regulatory requirement. The investment strategy and asset allocations consider yield, duration, sensitivity, market risk, volatility, liquidity, asset concentration, foreign exchange and credit quality. The estimates and assumptions used in determining the approximate amounts and timing of payments to or on behalf of policyholders for insurance liabilities are regularly re-evaluated. Many of these estimates and assumptions are inherently subjective and could impact the Group's ability to achieve its asset/liability management goals and objectives.



**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

The following table shows the composition of assets and liabilities for each major insurance product category.

**Balance sheet of insurance subsidiaries by type of contract**

|   | Life<br>linked<br>contracts <sup>1</sup> | Life<br>non-linked<br>contracts <sup>2</sup> | Non-life<br>insurance <sup>3</sup> | Other<br>assets <sup>4</sup> | Total <sup>5</sup> |
|---|--|--|------------------------------------|------------------------------|--------------------|
| <b>2011</b>   |  |  |                                    |                              |                    |
| Financial assets:   |  |  |                                    |                              |                    |
| – financial assets designated at fair value                     | 192                                      | 7,764  | –                                  | –                            | 7,956              |
| – derivatives   | –  | 94   | –                                  | –                            | 94                 |
| – financial investments   | –  | 56,714                                       | –                                  | 3,831                        | 60,545             |
| – other financial assets  | 114                                      | 5,919  | 459                                | 1,039                        | 7,531              |
| Total financial assets  | 306                                      | 70,491                                       | 459                                | 4,870                        | 76,126             |
| Reinsurance assets  | –  | 42   | 113                                | 14                           | 169                |
| Present value of in-force long-term insurance contracts         | –  | –  | –                                  | 5,188                        | 5,188              |
| Other assets  | –  | 783  | 12                                 | 2,104                        | 2,899              |
| Total assets  | 306                                      | 71,316                                       | 584                                | 12,176                       | 84,382             |
| Liabilities under investment contracts designated at fair value | 120                                      | 314  | –                                  | –                            | 434                |
| Liabilities under insurance contracts                           | 183                                      | 71,523                                       | 519                                | –                            | 72,225             |
| Deferred tax  | –  | –  | –                                  | 856                          | 856                |
| Other liabilities   | –  | –  | 21                                 | 145                          | 166                |
| Total liabilities   | 303                                      | 71,837                                       | 540                                | 1,001                        | 73,681             |
| Shareholders' equity  | –  | –  | –                                  | 10,701                       | 10,701             |
| Total liabilities and shareholders' equity                      | 303                                      | 71,837                                       | 540                                | 11,702                       | 84,382             |
| <b>2010</b>   |  |  |                                    |                              |                    |
| Financial assets:   |  |  |                                    |                              |                    |
| – financial assets designated at fair value                     | 237                                      | 6,586  | –                                  | 142                          | 6,965              |
| – derivatives   | –  | 161  | –                                  | –                            | 161                |
| – financial investments   | –  | 53,591                                       | –                                  | 3,339                        | 56,930             |
| – other financial assets  | 125                                      | 3,270  | 421                                | 657                          | 4,473              |
| Total financial assets  | 362                                      | 63,608                                       | 421                                | 4,138                        | 68,529             |
| Reinsurance assets  | –  | 35   | 103                                | 21                           | 159                |
| Present value of in-force long-term insurance contracts         | –  | –  | –                                  | 4,593                        | 4,593              |
| Other assets  | –  | 729  | 11                                 | 706                          | 1,446              |
| Total assets  | 362                                      | 64,372                                       | 535                                | 9,458                        | 74,727             |
| Liabilities under investment contracts designated at fair value | 136                                      | 321  | –                                  | –                            | 457                |
| Liabilities under insurance contracts                           | 226                                      | 63,722                                       | 477                                | –                            | 64,425             |
| Deferred tax  | –  | –  | –                                  | 733                          | 733                |
| Other liabilities   | –  | –  | 19                                 | 125                          | 144                |
| Total liabilities   | 362                                      | 64,043                                       | 496                                | 858                          | 65,759             |
| Shareholders' equity  | –  | –  | –                                  | 8,968                        | 8,968              |
| Total liabilities and shareholders' equity                      | 362                                      | 64,043                                       | 496                                | 9,826                        | 74,727             |

1 Comprises life linked insurance contracts and linked investment contracts

2 Comprises life non-linked insurance contracts and non-linked investment contracts

3 Comprises non-life insurance contracts

4 Comprises shareholder assets

5 Total assets of life insurance subsidiaries at 31 December 2011 amounted to HK\$82,718 million [31 December 2010: HK\$73,205 million]. Total assets of non-life insurance subsidiaries at 31 December 2011 amounted to HK\$1,664 million [31 December 2010: HK\$1,522 million].

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)**Underwriting strategy**

The Group's underwriting strategy seeks diversity to ensure a balanced portfolio and is based on a large portfolio of similar risks over a number of years and, as such, it is believed that this reduces the variability of the outcome.

**Reinsurance strategy**

The Group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. These reinsurance agreements transfer part of the risk and limit the exposure from each life insured. The amount of each risk retained depends on the Group's evaluation of the specific risk, subject in certain circumstances, to maximum limits based on characteristics of coverage. Under the terms of the reinsurance agreements, the reinsurer agrees to reimburse the ceded amount in the event the claim is paid. However, the Group remains liable to its policyholders with respect to ceded insurance if any reinsurer fails to meet the obligations it assumes. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The Group uses non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

**Nature of risks covered**

The following gives an assessment of the nature of risks inherent in the Group's main products.

**(i) Long-term insurance contracts – non-linked products**

The basic feature of long-term non-linked insurance business is to provide guaranteed death benefit determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender benefit, guaranteed maturity benefit are usually provided. Discretionary participating features allow policyholders to participate in the profits of the life fund by means of annual bonus. The Group has complete contractual discretion on the bonuses declared. In practice the Group considers policyholders' reasonable expectations when setting bonus levels. It is the Group's intention to maintain a smooth dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable taken into account the overall experience on investments, claims, operating expenses and lapses.

**(ii) Long-term insurance contracts – linked products**

The Group writes linked life insurance policies, which typically provide policyholders with life insurance protection and investment in a variety of funds. Premiums received are deposited into the chosen funds after deduction of premium fees. Other charges for the cost of insurance and administration are deducted from the funds accumulated.

**(iii) Long-term investment contracts – non-linked return guaranteed products**

The Group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the Group provides an investment return guarantees for some specific funds. The guarantee risks are managed through investment in good quality fixed rate bonds. Investment strategy is set with the objective of providing return that is sufficient to meet at least the minimum guarantee.

**(iv) Long-term Investment contracts – linked products**

The Group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the Group does not bear investment risk for most of the funds. Although scheme members bear the market risk on the funds, the Group must manage the scheme members' exposure to market risk in a manner consistent with any parameters set out in the policy documents.

**(v) Non-life insurance contracts**

The Group assumes the risk of loss from persons and organisations that are directly subject to the risk. Such risk may relate to property, liability, life, accident, health, financial or other perils that may arise from an insurable event. The Group manages the risks through underwriting limits, approval procedures for transactions that involve new products or that exceed set authority limits, risk diversification, underwriting guidelines, reinsurance and centralised management of reinsurance and monitoring of emerging issues. The Group also assesses and monitors insurance risk exposures both for individual types of risks insured and overall risks.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)**Concentration of insurance risks**

Within the insurance process, concentrations of risk may arise where a particular event or series of events could impact heavily upon the Group's liabilities. Such concentrations may arise from a single insurance contract or through a small number of related contracts, and relate to circumstances where significant liabilities could arise.

The Group is subject to concentration risk arising from accidents relating to common carriers, epidemics, earthquakes and other natural disasters that affect the properties, physical conditions and lives of the policyholders insured by the Group. To mitigate these risks, excess of loss and catastrophe reinsurance arrangements have been made by the Group.

For contracts where death is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics (such as AIDS, SARS or a human form of avian flu) or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. For contracts where survival is the insured risk, the most significant factor is improvement in medical science and social conditions that would increase longevity. The policyholders of the insurance contracts issued by the Group are mainly residents of Hong Kong.

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the Group. Total loss is estimated based on the chosen stress level. Details of the Group's reinsurance strategy are disclosed in the above.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities are therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. Details of the analysis of life insurance liabilities are disclosed in note 48. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

**Analysis of non-life insurance risk – net written insurance premiums**

|                                | 2011       | 2010       |
|--------------------------------|------------|------------|
| Accident and health            | 101        | 102        |
| Fire and other damage          | 126        | 126        |
| Motor                          | 25         | 23         |
| Liability                      | 54         | 45         |
| Marine, aviation and transport | 22         | 21         |
| Other (non-life)               | 21         | 27         |
|                                | <b>349</b> | <b>344</b> |

**Financial risks**

The Group's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk. Each of these financial risks is described below, together with a summary of the ways in which the Group manages these risks arising from underwriting insurance business.

The Group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders for its long-term insurance business. The risk is that the yield on the assets held by the Group to meet these guarantees may fall short of the guaranteed return. The framework for the management of this risk is to adopt a matching approach whereby assets held are managed to meet the liability to policyholders. An additional provision is established where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

The following table analyses the assets held in the Group's insurance underwriting subsidiaries at balance sheet dates by type of liability, and provides a view of the exposure to financial risk:

*Financial assets held by insurance operations*

|  | Group                 |                           |                    |              |        |
|--|-----------------------|---------------------------|--------------------|--------------|--------|
|  | Life linked contracts | Life non-linked contracts | Non-life insurance | Other assets | Total  |
| <b>2011</b>                                |                       |                           |                    |              |        |
| Financial assets designated at fair value: |                       |                           |                    |              |        |
| – debt securities                          | –                     | 3,859                     | –                  | –            | 3,859  |
| – equity securities                        | 192                   | 3,905                     | –                  | –            | 4,097  |
|  | 192                   | 7,764                     | –                  | –            | 7,956  |
| Financial investments                      |                       |                           |                    |              |        |
| Held-to-maturity:                          |                       |                           |                    |              |        |
| – debt securities                          | –                     | 56,714                    | –                  | 3,197        | 59,911 |
|  | –                     | 56,714                    | –                  | 3,197        | 59,911 |
| Available-for-sale:                        |                       |                           |                    |              |        |
| – debt securities                          | –                     | –                         | –                  | 619          | 619    |
| – equity securities                        | –                     | –                         | –                  | 15           | 15     |
|  | –                     | –                         | –                  | 634          | 634    |
| Derivatives                                | –                     | 94                        | –                  | –            | 94     |
| Other financial assets                     | 114                   | 5,919                     | 459                | 1,039        | 7,531  |
|  | 306                   | 70,491                    | 459                | 4,870        | 76,126 |

|  | Group                 |                           |                    |              |        |
|--|-----------------------|---------------------------|--------------------|--------------|--------|
|  | Life linked contracts | Life non-linked contracts | Non-life insurance | Other assets | Total  |
| <b>2010</b>                                |                       |                           |                    |              |        |
| Financial assets designated at fair value: |                       |                           |                    |              |        |
| – debt securities                          | –                     | 4,150                     | –                  | 142          | 4,292  |
| – equity securities                        | 237                   | 2,436                     | –                  | –            | 2,673  |
|  | 237                   | 6,586                     | –                  | 142          | 6,965  |
| Financial investments                      |                       |                           |                    |              |        |
| Held-to-maturity:                          |                       |                           |                    |              |        |
| – debt securities                          | –                     | 53,591                    | –                  | 2,710        | 56,301 |
|  | –                     | 53,591                    | –                  | 2,710        | 56,301 |
| Available-for-sale:                        |                       |                           |                    |              |        |
| – debt securities                          | –                     | –                         | –                  | 616          | 616    |
| – equity securities                        | –                     | –                         | –                  | 13           | 13     |
|  | –                     | –                         | –                  | 629          | 629    |
| Derivatives                                | –                     | 161                       | –                  | –            | 161    |
| Other financial assets                     | 125                   | 3,270                     | 421                | 657          | 4,473  |
|  | 362                   | 63,608                    | 421                | 4,138        | 68,529 |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

The table demonstrates that for linked contracts, the Group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 0.4% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2011 (2010: 0.5%). The table also shows that approximately 84.6% of financial assets was invested in debt securities at 31 December 2011 (2010: 89.3%) with 5.4% (2010: 3.9%) invested in equity securities.

**Market risk**

Market risk can be described as the risk of change in fair value of a financial instrument due to change in interest rate, equity prices and foreign currency rates. Each of these categories is discussed further below.

**Interest rate risk**

The insurance subsidiaries of the Group's exposure to interest rate risk arises mainly from its debt securities holdings. The held-to-maturity debt securities accounts for a significant portion of the debt securities holding which is managed to match expected liability payments. The Group monitors this exposure through periodic reviews of its asset and liability positions. Estimates of cash flows, as well as the impact of interest rate fluctuations relating to the investment portfolio and insurance reserves, are modelled and reviewed regularly. The overall objective of these strategies is to limit the net changes in the value of assets and liabilities arising from interest rate movements.

For participating products, interest rate risk related to non-linked policies can also be mitigated through sharing of risk with policyholders under the discretionary participation feature.

An immediate and permanent movement in interest yield curves as at 31 December 2011 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

|  | 2011                          |                      | 2010                          |                      |
|--|-------------------------------|----------------------|-------------------------------|----------------------|
|  | Impact on profit for the year | Impact on net assets | Impact on profit for the year | Impact on net assets |
| + 100 basis points shift in yield curves | 517                           | 508                  | 239                           | 229                  |
| - 100 basis points shift in yield curves | (335)                         | (326)                | (161)                         | (151)                |

The interest rate sensitivities set out above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The effects are calculated with taking into account the sharing of investment returns with policyholders through the discretionary participating feature. Other than that, they do not incorporate other actions that could be taken by management to mitigate the effect of the interest rate movements, nor do they take into account of any resultant changes in policyholder behaviour.

**Equity risk**

The portfolio of equity securities, which the insurance subsidiaries of the Group carries on the balance sheet at fair value, has exposure to price risk. This risk is defined as the potential loss in market value resulting from an adverse change in prices. The risk is mainly mitigated through dynamic asset allocation and sharing the risk with policyholders through the discretionary participation feature. The Group's objective is to earn competitive relative returns by investing in a diversified portfolio of high quality, liquid securities. Portfolio characteristics are analysed regularly and equity price risk is regularly reviewed. The Group's investment portfolios are diversified across countries and industries, and concentrations in any one company or industry are limited by parameters established by senior management, as well as by statutory requirements.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

The following table illustrates the impact on the aggregated profit for the year and net assets of a reasonably possible 10 per cent variance in equity prices:

|                                       | 2011                          |                      | 2010                          |                      |
|---------------------------------------|-------------------------------|----------------------|-------------------------------|----------------------|
|                                       | Impact on profit for the year | Impact on net assets | Impact on profit for the year | Impact on net assets |
| 10 per cent increase in equity prices | 277                           | 277                  | 205                           | 205                  |
| 10 per cent decrease in equity prices | (396)                         | (396)                | (205)                         | (205)                |

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. They do not allow for the effect of management actions which may mitigate the equity price decline, nor for any resultant changes, such as in policyholder behaviour, that might accompany such a fall.

*Foreign currency risk*

Substantial amounts of the assets and liabilities are denominated in two main currencies, United States dollar and Hong Kong dollar. The Group adopts a policy of predominately matching the assets with liabilities in the same currency, effectively reducing the foreign currency exchange rate exposure. Limits are set to ensure that the net foreign currency exposure is kept to an acceptable level. The Group uses forward exchange contracts to manage its foreign currency risk.

*Credit risk*

The insurance subsidiaries of the Group's portfolio of debt securities, and to a lesser extent short-term and other investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The Group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place. Limits are established to manage credit quality and concentration risk. The following table presents the analysis of treasury bills, other eligible bills and debt securities within the Group's insurance operations.



**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

Treasury bills, other eligible bills and debt securities in insurance operations

|   | Neither past due nor impaired |        |              | Past due not impaired | Impaired | Impairment allowances | Total  |
|---|-------------------------------|--------|--------------|-----------------------|----------|-----------------------|--------|
|   | Strong                        | Medium | Sub-standard |                       |          |                       |        |
| <b>2011</b>   |                               |        |              |                       |          |                       |        |
| <b>Supporting liabilities under non-linked insurance and investment contracts</b> |                               |        |              |                       |          |                       |        |
| Financial assets designated at fair value:  |                               |        |              |                       |          |                       |        |
| – treasury and other eligible bills   | –                             | –      | –            | –                     | –        | –                     | –      |
| – debt securities   | 3,822                         | 37     | –            | –                     | –        | –                     | 3,859  |
|   | 3,822                         | 37     | –            | –                     | –        | –                     | 3,859  |
| Financial investments:  |                               |        |              |                       |          |                       |        |
| – treasury and other similar bills  | –                             | –      | –            | –                     | –        | –                     | –      |
| – debt securities   | 52,081                        | 4,632  | –            | –                     | –        | –                     | 56,713 |
|   | 52,081                        | 4,632  | –            | –                     | –        | –                     | 56,713 |
| <b>Supporting shareholders funds</b>  |                               |        |              |                       |          |                       |        |
| Financial assets designated at fair value:  |                               |        |              |                       |          |                       |        |
| – treasury and other eligible bills   | –                             | –      | –            | –                     | –        | –                     | –      |
| – debt securities   | –                             | –      | –            | –                     | –        | –                     | –      |
|   | –                             | –      | –            | –                     | –        | –                     | –      |
| Financial investments:  |                               |        |              |                       |          |                       |        |
| – treasury and other similar bills  | –                             | –      | –            | –                     | –        | –                     | –      |
| – debt securities   | 3,633                         | 184    | –            | –                     | –        | –                     | 3,817  |
|   | 3,633                         | 184    | –            | –                     | –        | –                     | 3,817  |
| <b>Total</b>  |                               |        |              |                       |          |                       |        |
| Financial assets designated at fair value:  |                               |        |              |                       |          |                       |        |
| – treasury and other eligible bills   | –                             | –      | –            | –                     | –        | –                     | –      |
| – debt securities   | 3,822                         | 37     | –            | –                     | –        | –                     | 3,859  |
|   | 3,822                         | 37     | –            | –                     | –        | –                     | 3,859  |
| Financial investments:  |                               |        |              |                       |          |                       |        |
| – treasury and other similar bills  | –                             | –      | –            | –                     | –        | –                     | –      |
| – debt securities   | 55,714                        | 4,816  | –            | –                     | –        | –                     | 60,530 |
|   | 55,714                        | 4,816  | –            | –                     | –        | –                     | 60,530 |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

|   | Neither past due nor impaired |        |                  | Past<br>due not<br>impaired | Impaired | Impairment<br>allowances | Total  |
|---|-------------------------------|--------|------------------|-----------------------------|----------|--------------------------|--------|
|   | Strong                        | Medium | Sub-<br>standard |                             |          |                          |        |
| 2010  |                               |        |                  |                             |          |                          |        |
| <b>Supporting liabilities under non-linked insurance and investment contracts</b> |                               |        |                  |                             |          |                          |        |
| Financial assets designated at fair value:  |                               |        |                  |                             |          |                          |        |
| – treasury and other eligible bills   | –                             | –      | –                | –                           | –        | –                        | –      |
| – debt securities   | 4,148                         | 2      | –                | –                           | –        | –                        | 4,150  |
|   | 4,148                         | 2      | –                | –                           | –        | –                        | 4,150  |
| Financial investments:  |                               |        |                  |                             |          |                          |        |
| – treasury and other similar bills  | –                             | –      | –                | –                           | –        | –                        | –      |
| – debt securities   | 52,271                        | 1,320  | –                | –                           | –        | –                        | 53,591 |
|   | 52,271                        | 1,320  | –                | –                           | –        | –                        | 53,591 |
| <b>Supporting shareholders funds</b>  |                               |        |                  |                             |          |                          |        |
| Financial assets designated at fair value:  |                               |        |                  |                             |          |                          |        |
| – treasury and other eligible bills   | –                             | –      | –                | –                           | –        | –                        | –      |
| – debt securities   | 142                           | –      | –                | –                           | –        | –                        | 142    |
|   | 142                           | –      | –                | –                           | –        | –                        | 142    |
| Financial investments:  |                               |        |                  |                             |          |                          |        |
| – treasury and other similar bills  | –                             | –      | –                | –                           | –        | –                        | –      |
| – debt securities   | 3,282                         | 44     | –                | –                           | –        | –                        | 3,326  |
|   | 3,282                         | 44     | –                | –                           | –        | –                        | 3,326  |
| <b>Total</b>  |                               |        |                  |                             |          |                          |        |
| Financial assets designated at fair value:  |                               |        |                  |                             |          |                          |        |
| – treasury and other eligible bills   | –                             | –      | –                | –                           | –        | –                        | –      |
| – debt securities   | 4,290                         | 2      | –                | –                           | –        | –                        | 4,292  |
|   | 4,290                         | 2      | –                | –                           | –        | –                        | 4,292  |
| Financial investments:  |                               |        |                  |                             |          |                          |        |
| – treasury and other similar bills  | –                             | –      | –                | –                           | –        | –                        | –      |
| – debt securities   | 55,553                        | 1,364  | –                | –                           | –        | –                        | 56,917 |
|   | 55,553                        | 1,364  | –                | –                           | –        | –                        | 56,917 |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

The Group also has insurance and other receivable amounts subject to credit risk. The most significant of these are reinsurance recoveries. To mitigate the risk of the counterparties not paying the amounts due, the Group has established certain business and financial guidelines for reinsurer approval, incorporating ratings by major agencies and considering currently available market information. The Group also periodically reviews the financial stability of reinsurers and the settlement trend of amount due from reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries was as follows:

*Reinsurers' share of liabilities under insurance contracts*

|                                | Neither past due nor impaired |        |              | Past due not impaired | Impaired | Impairment allowances | Total |
|--------------------------------|-------------------------------|--------|--------------|-----------------------|----------|-----------------------|-------|
|                                | Strong                        | Medium | Sub-standard |                       |          |                       |       |
| <b>2011</b>                    |                               |        |              |                       |          |                       |       |
| Linked insurance contracts     | –                             | –      | –            | –                     | –        | –                     | –     |
| Non-linked insurance contracts | 110                           | 45     | –            | –                     | –        | –                     | 155   |
| Total                          | 110                           | 45     | –            | –                     | –        | –                     | 155   |
| Reinsurance Debtors            | 7                             | 1      | –            | 6                     | –        | –                     | 14    |
| <b>2010</b>                    |                               |        |              |                       |          |                       |       |
| Linked insurance contracts     | –                             | –      | –            | –                     | –        | –                     | –     |
| Non-linked insurance contracts | 108                           | 30     | –            | –                     | –        | –                     | 138   |
| Total                          | 108                           | 30     | –            | –                     | –        | –                     | 138   |
| Reinsurance Debtors            | 7                             | 3      | –            | 11                    | –        | –                     | 21    |

*Liquidity risk*

The Group has to meet daily calls on its cash resources, notably from claims arising on its insurance and investment contracts and early surrender of policies for surrender value. There is therefore a risk that cash will not be available to settle liabilities when due at a reasonable cost. The Group manages this risk by monitoring and setting an appropriate level of operating funds to settle these liabilities. Investment portfolios are also structured with regard to the liquidity requirement of each underlying fund, and early surrender penalties and market adjustment clauses are used to defray costs of unexpected cash requirements.

The following table shows the expected maturity of insurance contract liabilities at balance sheet dates:

*Expected maturity of insurance contract liabilities*

|                             | Expected cash flows (undiscounted) |                                |                                  |               |         |
|-----------------------------|------------------------------------|--------------------------------|----------------------------------|---------------|---------|
|                             | Within 1 year                      | Over 1 year but within 5 years | Over 5 years but within 15 years | Over 15 years | Total   |
| <b>2011</b>                 |                                    |                                |                                  |               |         |
| Non-life insurance          | 291                                | 206                            | 43                               | –             | 540     |
| Life insurance (non-linked) | 3,592                              | 33,943                         | 67,507                           | 42,430        | 147,472 |
| Life insurance (linked)     | 112                                | 50                             | 126                              | 833           | 1,121   |
|                             | 3,995                              | 34,199                         | 67,676                           | 43,263        | 149,133 |
| <b>2010</b>                 |                                    |                                |                                  |               |         |
| Non-life insurance          | 266                                | 187                            | 43                               | –             | 496     |
| Life insurance (non-linked) | 5,281                              | 29,418                         | 61,674                           | 35,696        | 132,069 |
| Life insurance (linked)     | 27                                 | 177                            | 149                              | 892           | 1,245   |
|                             | 5,574                              | 29,782                         | 61,866                           | 36,588        | 133,810 |

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)

Remaining contractual maturity of investment contract liabilities

|  | Liabilities under investment contracts by insurance underwriting subsidiaries |                                 |                               |            |
|--|---|---------------------------------|-------------------------------|------------|
|  | Linked investment contracts   | Non-linked investment contracts | Investment contracts with DPF | Total      |
| <b>2011</b>                            |   |                                 |                               |            |
| Remaining contractual maturity:        |   |                                 |                               |            |
| – due within 1 year                    | 1   | –                               | –                             | 1          |
| – due over 1 year but within 5 years   | –   | –                               | –                             | –          |
| – due over 5 years but within 10 years | –   | –                               | –                             | –          |
| – due over 10 years                    | –   | –                               | –                             | –          |
| – undated                              | 119   | 314                             | –                             | 433        |
|  | <b>120</b>  | <b>314</b>                      | <b>–</b>                      | <b>434</b> |
| <b>2010</b>                            |   |                                 |                               |            |
| Remaining contractual maturity:        |   |                                 |                               |            |
| – due within 1 year                    | 2   | –                               | –                             | 2          |
| – due over 1 year but within 5 years   | –   | –                               | –                             | –          |
| – due over 5 years but within 10 years | –   | –                               | –                             | –          |
| – due over 10 years                    | –   | –                               | –                             | –          |
| – undated                              | 134   | 321                             | –                             | 455        |
|  | <b>136</b>  | <b>321</b>                      | <b>–</b>                      | <b>457</b> |

*Present value of in-force long-term insurance business ("PVIF")*

The Group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2011 was HK\$5,188 million (31 December 2010: HK\$4,593 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at balance sheet dates can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF at balance sheet dates of reasonably possible changes in the main economic and business assumptions:

|  | 2011  | 2010  |
|--|-------|-------|
| + 100 basis points shift in risk-free rate | 619   | 635   |
| – 100 basis points shift in risk-free rate | (401) | (494) |

The effects on PVIF shown above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The effects are calculated with taking into account the sharing of investment returns with policyholders through the discretionary participation feature. Other than that, they do not incorporate other actions that could be taken by management to mitigate effects nor do they take into account of consequential changes in policyholder behaviour.

**61. FINANCIAL RISK MANAGEMENT** (continued)**(d) Insurance risk** (continued)*Non-economic assumptions*

The sensitivity of profit for the year and net assets to reasonably possible changes in assumptions used in respect of insurance businesses is as follows:

|  | Impact on 2011 results |            | Impact on 2010 results |            |
|--|------------------------|------------|------------------------|------------|
|  | Profit for the year    | Net assets | Profit for the year    | Net assets |
| 20 per cent increase in claims costs                     | (9)                    | (9)        | (12)                   | (12)       |
| 20 per cent decrease in claims costs                     | 9                      | 9          | 12                     | 12         |
| 10 per cent increase in mortality and/or morbidity rates | (65)                   | (65)       | (27)                   | (27)       |
| 10 per cent decrease in mortality and/or morbidity rates | 64                     | 64         | 27                     | 27         |
| 50 per cent increase in lapse rates                      | 259                    | 259        | 520                    | 520        |
| 50 per cent decrease in lapse rates                      | (243)                  | (243)      | (531)                  | (531)      |
| 10 per cent increase in expense rates                    | (76)                   | (76)       | (40)                   | (40)       |
| 10 per cent decrease in expense rates                    | 76                     | 76         | 40                     | 40         |

**(e) Operational risk**

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

The Group manages its operational risk through a controls-based environment in which the processes and controls are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by periodic independent review of the internal control systems by internal audit, and by monitoring external operational risk events, which ensure that the Group stays in line with industry best practice and takes account of lessons learned from publicised operational failures within the financial services industry.

The Group has codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance. This explains how the 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 standard covers the following:

- operational risk management responsibility is assigned to senior management within the business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;
- assessments are undertaken of the operational risks facing each business and the risks inherent in its 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's Audit Committee; and
- risk mitigation, including insurance is considered where this is cost-effective.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (e) Operational risk (continued)

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 Group's office is affected by a business disruption event, to incorporate lessons learned in the operational recovery from those circumstances. Plans have been prepared for the continued operation of the Group's business, with reduced staffing levels, should a flu pandemic occur.

Operational risk is mitigated by adequate insurance coverage on assets and business losses. To reduce the impact and interruptions to business activities caused by system failure or natural disaster, back-up systems and contingency business resumption plans are in place for all business and critical operations functions. Operational risk management is coordinated by the Chief Risk Officer and monitored by the Operational Risk Management Committee.

### (f) Capital management

The Group's objective for managing capital is to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times. The Group recognises the impact on shareholder returns of the level of equity capital employed within the Group and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on equity possible with greater leverage.

An annual Group capital plan is prepared and approved by the Board with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The Group manages its own capital within the context of the approved annual Group capital plan, which determines levels of risk-weighted asset growth and the optimal amount and mix of capital required to support planned business growth. As part of the Group's capital management policy, subsidiary with capital generated in excess of planned requirement will return to the Bank, normally by way of dividends. The Group also raised its subordinated debt in accordance with HSBC Group's guidelines regarding market and investor concentration, cost, market conditions, timing and maturity profile.

The Bank is primarily a provider of equity capital to its subsidiaries. These investments are substantially funded by the Bank's own capital issuance and profit retentions. The Bank seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

The principal forms of capital are included in the following balances on the consolidated balance sheet: called up share capital, retained profits, other reserves and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances and the regulatory reserve.

#### Externally imposed capital requirements:

The Hong Kong Monetary Authority supervises the Group on a consolidated and solo-consolidated basis and, as such, receives information on the capital adequacy of, and set capital requirements for, the Group as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. Certain non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

The Basel Committee on Banking Supervision has published a capital adequacy framework "Basel II" for calculating minimum capital requirements. With effect from 1 January 2007, the Hong Kong Monetary Authority adopted Basel II as set out in the Banking (Capital) Rules made under the Banking Ordinances. The Rules, which replace the Third Schedule to the Banking Ordinance, stipulate the calculation methodology for capital adequacy ratio. Basel II is structured around three "pillars": minimum capital requirements, supervisory review process and market discipline. The supervisory objectives for Basel II are to promote safety and soundness in the financial system and maintain at least the current overall level of capital in the system; enhance competitive equality; constitute a more comprehensive approach to addressing risks; and focus on internationally active bank.



## 61. FINANCIAL RISK MANAGEMENT (continued)

### (f) Capital management (continued)

With respect to Pillar One minimum capital requirements, Basel II provides three approaches, of increasing sophistication, to the calculation of credit risk regulatory capital. The most basic, the standardised approach, requires banks to use external credit ratings to determine risk weightings applied to rated counterparties, and groups other counterparties into broad categories and applies standardised risk weightings to these categories. In the next level, the foundation internal ratings-based approach, allows banks to calculate their credit risk regulatory capital requirement on the basis of their internal assessment of the probability that a counterparty will default ("PD"), but with quantification of exposure at default ("EAD") and loss given default ("LGD") estimates being subject to standard supervisory parameters. Finally, the advanced internal ratings-based approach, will allow banks to use their own internal assessment of not only the PD but also the quantification of EAD and LGD.

Expected losses are calculated by multiplying EAD by PD and LGD. The capital resources requirement under the IRB approaches is intended to cover unexpected losses and is derived from a formula specified in the regulatory rules, which incorporates these factors and other variables such as maturity and correlation.

For credit risk, with the Hong Kong Monetary Authority approval, the Group has adopted the advanced internal ratings-based approach for the majority of its non-securitisation business with effect from 1 January 2009, with the remainder on standardised approach.

Basel II also introduces capital requirements for operational risk and, again, contains three levels of sophistication. The capital required under the basic indicator approach is a simple percentages of gross revenues, whereas under the standardised approach it is one of three different percentage of gross revenues allocated to each of eight defined business lines. Finally, the advanced measurement approach uses bank's own statistical analysis and modelling of operational risk data to determine capital requirements. The Group has adopted the standardised approach to the determination of operational risk capital requirements.

For market risk, the Group is required to use a variety of approaches to calculate its market risk capital requirement, including the internal model approach and the standardised approach for different risk categories.

Under Pillar Two, the Group has initiated its internal capital adequacy assessment process ("ICAAP") to comply with the Hong Kong Monetary Authority's requirement set out in the Supervisory Policy Manual "Supervisory Review Process". The Group will also align with HSBC Group guidance in setting up its ICAAP.

To comply with Pillar Three requirements which focuses on disclosure requirements and policies as prescribed by the Banking (Disclosure) Rules, the Group has formulated a disclosure policy which was approved by the Board with an aim of making relevant disclosures in accordance with the disclosure rules.

During the year, the Group has complied with all of the externally imposed capital requirements by the Hong Kong Monetary Authority.

The Basel Committee on Banking Supervision has issued the final rules in two documents "A global regulatory framework for more resilient banks and banking systems" and "International framework for liquidity risk measurement, standards and monitoring" in December 2010, widely referred to as Basel III rules, on the areas of capital and liquidity. The Hong Kong Monetary Authority has then issued a consultation paper in January 2012 on the implementation of Basel III capital standards in Hong Kong. The paper set out, amongst other things, the requirements relating the revised definitions of capital. The revised definitions are proposed to take effect from 2013, with phase-in arrangement from 2013 to 2019 for many items.

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS

### (a) Determination of fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial instruments measured at fair value on an ongoing basis include trading assets and liabilities, instruments designated at fair value, derivatives, and financial investments classified as available-for-sale (including treasury and other eligible bills, debt securities, and equity securities).

#### Control framework

Fair values are subject to a control framework that aims to ensure that they are either determined, or validated, by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with Finance. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of valuation models, independent determination or validation of valuation model inputs and any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, there is independent price determination or validation.

#### Determination of fair value of financial instruments carried at fair value

*Fair values are determined according to the following hierarchy:*

(i) Level 1: Quoted market price

Financial instruments with quoted prices for identical instruments in active markets.

(ii) Level 2: Valuation technique using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(iii) Level 3: Valuation technique with significant non-observable inputs

Financial instruments valued using models where one or more significant inputs are not observable.

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. For these instruments, the fair value derived is more judgemental. "Not observable" in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (historical data may, for example, be used).

Furthermore, the assessment of hierarchy level is based on the lowest level of input that is significant to the fair value of the financial instrument. Consequently, the level of uncertainty in the determination of the unobservable inputs will generally give rise to valuation uncertainty that is less than the fair value itself.

In certain circumstances, the Group applies the fair value option to its own debt in issue. Where available, the fair value will be based upon quoted prices in an active market for the specific instrument concerned. Where unavailable, the fair value will either be based upon quoted prices in an inactive market for the specific instrument concerned, or estimated by comparison with quoted prices in an active market for similar instruments. The fair value of these instruments therefore includes the effect of own credit spread. Gains and losses arising from changes in the credit spread of liabilities issued by Group reverse over the contractual life of the debt.

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are marked at fair value. The credit spread applied to these instruments is derived from the spreads at which the Group issues structured notes. Gains and losses arising from changes in the credit spread of liabilities issued by the Group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer prices as appropriate. Long positions are marked at bid prices; short positions are marked at offer prices.

The fair values of large holdings of non-derivative financial instruments are based on a multiple of the value of a single instrument, and do not include block adjustments for the size of the holding.

The valuation models used where quoted market prices are not available incorporate certain assumptions that the Group anticipates would be used by a market participant to establish fair value. Where the Group believes that there are additional considerations not included within the valuation model, adjustments may be adopted outside the model.

Examples of such adjustments are:

- Credit risk adjustment: an adjustment to reflect the credit worthiness of over-the-counter ("OTC") derivative counterparties.
- Market data/model uncertainty: an adjustment to reflect uncertainties in fair values based on uncertain market data inputs (e.g. as a result of illiquidity) or in areas where the choice of valuation model is particularly subjective.
- Inception profit ("day 1 P&L reserves"): for financial instruments valued at inception, on the basis of one or more significant unobservable inputs, the difference between transaction price and model value (as adjusted) at inception is not recognised in the consolidated income statement, but is deferred and included as part of the fair value.

Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage fees and post-trade costs are included in operating expenses. The future costs of administering the OTC derivative portfolio are also not included in fair value, but are expensed as incurred.

- Debt securities, Treasury and eligible bills, and Equities

These instruments are valued based on quoted market prices from an exchange, dealer, broker, industry group or pricing service, where available. Where unavailable, fair value is determined by reference to quoted market prices for similar instruments, or in the case of certain unquoted equities, valuation techniques using inputs derived from observable and unobservable market data.

- Derivatives

Over-the-counter (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon "no-arbitrage" principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some discrepancies in practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historical data or other sources.

Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors.

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)**Analysis of fair value determination**

The following table provides an analysis of the basis for valuing financial assets and financial liabilities measured at fair value in the consolidated financial statements:

|  | Group                          |                                    |   |                   |                             |         |
|--|--------------------------------|------------------------------------|---|-------------------|-----------------------------|---------|
|  | Valuation techniques           |                                    |   | Third party total | Amounts with HSBC entities* | Total   |
|  | quoted market price<br>Level 1 | using observable inputs<br>Level 2 | with significant non-observable inputs<br>Level 3 |                   |                             |         |
| <b>2011</b>                                    |                                |                                    |   |                   |                             |         |
| <b>Assets</b>                                  |                                |                                    |   |                   |                             |         |
| Trading assets                                 | 59,866                         | 4,305                              | –   | 64,171            | –                           | 64,171  |
| Financial assets designated at fair value      | 758                            | 3,165                              | 634   | 4,557             | 3,539                       | 8,096   |
| Derivative financial instruments               | 541                            | 3,814                              | 71  | 4,426             | 284                         | 4,710   |
| Available-for-sale financial investments       | 59,411                         | 89,718                             | 150   | 149,279           | –                           | 149,279 |
| <b>Liabilities</b>                             |                                |                                    |   |                   |                             |         |
| Trading liabilities                            | 25,605                         | 33,584                             | 523   | 59,712            | –                           | 59,712  |
| Financial liabilities designated at fair value | –                              | 434                                | –   | 434               | –                           | 434     |
| Derivative financial instruments               | 48                             | 4,153                              | –   | 4,201             | 647                         | 4,848   |
| <b>2010</b>                                    |                                |                                    |   |                   |                             |         |
| <b>Assets</b>                                  |                                |                                    |   |                   |                             |         |
| Trading assets                                 | 24,840                         | 1,215                              | –   | 26,055            | –                           | 26,055  |
| Financial assets designated at fair value      | 818                            | 2,245                              | 510   | 3,573             | 3,541                       | 7,114   |
| Derivative financial instruments               | 721                            | 4,161                              | 106   | 4,988             | 605                         | 5,593   |
| Available-for-sale financial investments       | 25,207                         | 117,568                            | 283   | 143,058           | –                           | 143,058 |
| <b>Liabilities</b>                             |                                |                                    |   |                   |                             |         |
| Trading liabilities                            | 18,991                         | 23,037                             | 553   | 42,581            | –                           | 42,581  |
| Financial liabilities designated at fair value | –                              | 457                                | –   | 457               | –                           | 457     |
| Derivative financial instruments               | 96                             | 4,034                              | –   | 4,130             | 553                         | 4,683   |

\* Included structured instruments and derivative contracts transacted with HSBC entities which were mainly classified within level 2 of the valuation hierarchy.

There were no material movements between Level 1 and Level 2 during the year.

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)**Bank**

|  | Valuation techniques           |                                    |   | Third party total | Amounts with HSBC entities* | Total   |
|--|--------------------------------|------------------------------------|---|-------------------|-----------------------------|---------|
|  | quoted market price<br>Level 1 | using observable inputs<br>Level 2 | with significant non-observable inputs<br>Level 3 |                   |                             |         |
| <b>2011</b>                                    |                                |                                    |   |                   |                             |         |
| <b>Assets</b>                                  |                                |                                    |   |                   |                             |         |
| Trading assets                                 | 59,866                         | 660                                | –   | 60,526            | –                           | 60,526  |
| Financial assets designated at fair value      | –                              | 140                                | –   | 140               | –                           | 140     |
| Derivative financial instruments               | 539                            | 3,308                              | –   | 3,847             | 589                         | 4,436   |
| Available-for-sale financial investments       | 59,168                         | 45,930                             | 44  | 105,142           | –                           | 105,142 |
| <b>Liabilities</b>                             |                                |                                    |   |                   |                             |         |
| Trading liabilities                            | 25,605                         | 10,051                             | 421   | 36,077            | –                           | 36,077  |
| Financial liabilities designated at fair value | –                              | –                                  | –   | –                 | –                           | –       |
| Derivative financial instruments               | 42                             | 3,468                              | –   | 3,510             | 592                         | 4,102   |
| <b>2011</b>                                    |                                |                                    |   |                   |                             |         |
| <b>Assets</b>                                  |                                |                                    |   |                   |                             |         |
| Trading assets                                 | 24,840                         | 392                                | –   | 25,232            | –                           | 25,232  |
| Financial assets designated at fair value      | –                              | 148                                | –   | 148               | –                           | 148     |
| Derivative financial instruments               | 717                            | 3,784                              | –   | 4,501             | 525                         | 5,026   |
| Available-for-sale financial investments       | 24,176                         | 78,894                             | 36  | 103,106           | –                           | 103,106 |
| <b>Liabilities</b>                             |                                |                                    |   |                   |                             |         |
| Trading liabilities                            | 18,991                         | 10,831                             | 284   | 30,106            | –                           | 30,106  |
| Financial liabilities designated at fair value | –                              | –                                  | –   | –                 | –                           | –       |
| Derivative financial instruments               | 95                             | 3,742                              | –   | 3,837             | 691                         | 4,528   |

\* Included structured instruments and derivative contracts transacted with HSBC entities which were mainly classified within level 2 of the valuation hierarchy.

There were no material movements between Level 1 and Level 2 during the year.

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)*Reconciliation of fair value measurements in Level 3 of the fair value hierarchy*

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

|   | Group                  |                     |   |             |                     |   |             |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|
|   | Assets                 |                     |   |             | Liabilities         |   |             |
|   | Available-<br>for-sale | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives |
| At 1 January 2011   | 283                    | -                   | 510   | 106         | 553                 | -   | -           |
| Total gains or losses recognised<br>in profit and loss  | -                      | -                   | (1)   | (154)       | (5)                 | -   | -           |
| Total gains or losses recognised<br>in other comprehensive income   | 9                      | -                   | -   | -           | -                   | -   | -           |
| Purchases   | -                      | -                   | 355   | -           | -                   | -   | -           |
| Issues/deposit taking   | -                      | -                   | -   | -           | 933                 | -   | -           |
| Sales   | -                      | -                   | (63)  | -           | -                   | -   | -           |
| Settlements   | -                      | -                   | (22)  | 119         | (935)               | -   | -           |
| Transfers out   | (142)                  | -                   | (150)   | -           | (160)               | -   | -           |
| Transfers in  | -                      | -                   | 5   | -           | 122                 | -   | -           |
| Exchange adjustments  | -                      | -                   | -   | -           | 15                  | -   | -           |
| At 31 December 2011   | 150                    | -                   | 634   | 71          | 523                 | -   | -           |
| Total gains or losses recognised<br>in profit or loss relating to those<br>assets and liabilities held at the<br>balance sheet date | 13                     | -                   | 2   | (154)       | 5                   | -   | -           |



**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)

|   | Group                  |                     |   |             |                     |   |             |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|
|   | Assets                 |                     |   |             | Liabilities         |   |             |
|   | Available-<br>for-sale | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives |
| At 1 January 2010   | 448                    | –                   | 696   | –           | 756                 | –   | –           |
| Total gains or losses recognised<br>in profit and loss  | (1)                    | –                   | 47  | 14          | 14                  | –   | –           |
| Total gains or losses recognised<br>in other comprehensive income   | 12                     | –                   | –   | –           | –                   | –   | –           |
| Purchases   | 20                     | –                   | 165   | –           | –                   | –   | –           |
| Issues/deposit taking   | –                      | –                   | –   | –           | 1,528               | –   | –           |
| Sales   | –                      | –                   | (21)  | –           | –                   | –   | –           |
| Settlements   | (9)                    | –                   | (80)  | 92          | (2,110)             | –   | –           |
| Transfers out   | (397)                  | –                   | (425)   | –           | (685)               | –   | –           |
| Transfers in  | 210                    | –                   | 128   | –           | 1,044               | –   | –           |
| Exchange adjustments  | –                      | –                   | –   | –           | 6                   | –   | –           |
| At 31 December 2010   | 283                    | –                   | 510   | 106         | 553                 | –   | –           |
| Total gains or losses recognised<br>in profit or loss relating to those<br>assets and liabilities held at the<br>balance sheet date | 16                     | –                   | 52  | 13          | 8                   | –   | –           |

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)**Bank**

|   | Assets                 |                     |   |             | Liabilities         |   |             |  |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|--|
|   | Available-<br>for-sale | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives |  |
|   |                        |                     |   |             |                     |   |             |  |
| At 1 January 2011   | 36                     | -                   | -   | -           | 284                 | -   | -           |  |
| Total gains or losses recognised<br>in profit and loss  | -                      | -                   | -   | -           | -                   | -   | -           |  |
| Total gains or losses recognised<br>in other comprehensive income   | 8                      | -                   | -   | -           | -                   | -   | -           |  |
| Purchases   | -                      | -                   | -   | -           | -                   | -   | -           |  |
| Issues/deposit taking   | -                      | -                   | -   | -           | 721                 | -   | -           |  |
| Sales   | -                      | -                   | -   | -           | -                   | -   | -           |  |
| Settlements   | -                      | -                   | -   | -           | (584)               | -   | -           |  |
| Transfers out   | -                      | -                   | -   | -           | -                   | -   | -           |  |
| Transfers in  | -                      | -                   | -   | -           | -                   | -   | -           |  |
| Exchange adjustments  | -                      | -                   | -   | -           | -                   | -   | -           |  |
| At 31 December 2011   | 44                     | -                   | -   | -           | 421                 | -   | -           |  |
| Total gains or losses recognised<br>in profit or loss relating to those<br>assets and liabilities held at the<br>balance sheet date | 6                      | -                   | -   | -           | -                   | -   | -           |  |

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)

|   | Bank                   |                     |   |             |                     |   |             |  |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|--|
|   | Assets                 |                     |   |             | Liabilities         |   |             |  |
|   | Available-<br>for-sale | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives | Held for<br>trading | Designated<br>at fair value<br>through<br>profit<br>or loss | Derivatives |  |
| At 1 January 2010   | 33                     | –                   | –   | –           | 602                 | –   | –           |  |
| Total gains or losses recognised<br>in profit and loss  | –                      | –                   | –   | –           | 11                  | –   | –           |  |
| Total gains or losses recognised<br>in other comprehensive income   | 3                      | –                   | –   | –           | –                   | –   | –           |  |
| Purchases   | –                      | –                   | –   | –           | –                   | –   | –           |  |
| Issues/deposit taking   | –                      | –                   | –   | –           | 1,018               | –   | –           |  |
| Sales   | –                      | –                   | –   | –           | –                   | –   | –           |  |
| Settlements   | –                      | –                   | –   | –           | (1,662)             | –   | –           |  |
| Transfers out   | –                      | –                   | –   | –           | (685)               | –   | –           |  |
| Transfers in  | –                      | –                   | –   | –           | 1,000               | –   | –           |  |
| Exchange adjustments  | –                      | –                   | –   | –           | –                   | –   | –           |  |
| At 31 December 2010   | 36                     | –                   | –   | –           | 284                 | –   | –           |  |
| Total gains or losses recognised<br>in profit or loss relating to those<br>assets and liabilities held at the<br>balance sheet date | 5                      | –                   | –   | –           | 9                   | –   | –           |  |

For available-for-sale securities and financial assets designated at fair value, the transfers into and out of Level 3 were due to change in valuation observability of certain debt securities during the year.

For held-for-trading liabilities, transfers into and out of Level 3 were primarily due to change in observability of equity correlation during the year.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under "Trading income".

Fair value changes on assets designated at fair value are presented in the income statement under "Net income/(loss) from financial instruments designated at fair value".

Realised gains and losses from available-for-sale securities are presented under "Gains less losses from financial investments and fixed assets" in the income statement while unrealised gains and losses are presented in "Fair value changes taken to/(from) equity" within "Available-for-sale investment reserve" in other comprehensive income.

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)**Effects of changes in significant non-observable assumptions to reasonably possible alternatives**

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

|   | Group                         |                      |   |                      |
|---|-------------------------------|----------------------|---|----------------------|
|   | Reflected in income statement |                      | Reflected in other comprehensive income |                      |
|   | favourable changes            | unfavourable changes | favourable changes                      | unfavourable changes |
| <b>2011</b>   |                               |                      |   |                      |
| Derivatives/trading assets/trading liabilities        | 8                             | (8)                  | –                                       | –                    |
| Financial assets/liabilities designated at fair value | 63                            | (63)                 | –                                       | –                    |
| Available-for-sale financial investments              | –                             | –                    | 15                                      | (15)                 |
| <b>2010</b>   |                               |                      |   |                      |
| Derivatives/trading assets/trading liabilities        | 1                             | (1)                  | –                                       | –                    |
| Financial assets/liabilities designated at fair value | 51                            | (51)                 | –                                       | –                    |
| Available-for-sale financial investments              | –                             | –                    | 28                                      | (28)                 |

|   | Bank                          |                      |   |                      |
|---|-------------------------------|----------------------|---|----------------------|
|   | Reflected in income statement |                      | Reflected in other comprehensive income |                      |
|   | favourable changes            | unfavourable changes | favourable changes                      | unfavourable changes |
| <b>2011</b>   |                               |                      |   |                      |
| Derivatives/trading assets/trading liabilities        | –                             | –                    | –                                       | –                    |
| Financial assets/liabilities designated at fair value | –                             | –                    | –                                       | –                    |
| Available-for-sale financial investments              | –                             | –                    | 4                                       | (4)                  |
| <b>2010</b>   |                               |                      |   |                      |
| Derivatives/trading assets/trading liabilities        | –                             | –                    | –                                       | –                    |
| Financial assets/liabilities designated at fair value | –                             | –                    | –                                       | –                    |
| Available-for-sale financial investments              | –                             | –                    | 4                                       | (4)                  |

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)**Changes in fair value recorded in the income statement**

The following table details changes in fair values recognised in the income statement during the year, where the fair value is estimated using valuation techniques that incorporate significant assumptions that are not supported by prices from observable current market transactions in the same instrument, and are not based on observable market data:

- the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component;
- instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges.

|   | <b>Group</b> |      | <b>Bank</b> |      |
|---|--------------|------|-------------|------|
|   | <b>2011</b>  | 2010 | <b>2011</b> | 2010 |
| Recorded in the income statement:                     |              |      |             |      |
| Derivatives/trading assets/trading liabilities        | <b>(159)</b> | 28   | –           | 11   |
| Financial assets/liabilities designated at fair value | <b>(1)</b>   | 47   | –           | –    |

**Fair value of financial instruments not carried at fair value**

The fair values of financial instruments that are not recognised at fair value on the balance sheet are calculated as described below.

The calculation of fair value incorporates the Group's estimate of the amount at which financial assets could be exchanged, or financial liabilities settled, between knowledgeable, willing parties in an arm's length transaction. It does not reflect the economic benefits and costs that the Group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available, so comparisons of fair values between entities may not be meaningful and users are advised to exercise caution when using this data.

The following types of financial instruments are measured at amortised cost unless they are held for trading or designated at fair value through profit or loss. Where assets or liabilities are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the assets or liabilities so hedged includes a fair value adjustment for the hedged risk only. Fair values at the date of balance sheet of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

**(i) Loans and advances to customers**

The fair value of advances to customers is estimated using discounted cash flow models, using an estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

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

**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(a) Determination of fair value** (continued)

## (ii) Financial investments

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

## (iii) Deposits and customer accounts

The fair value of deposits and customers account is estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of deposits repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

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

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

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

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held. No block discount or premium adjustments are made.

The fair values of intangible assets, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above because they are not financial instruments.

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

**Assets**

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

**Liabilities**

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

The methods and significant assumptions applied in determining the fair value of financial instruments are set out in note 4(n).



**62. FAIR VALUE OF FINANCIAL INSTRUMENTS** (continued)**(b) Fair value**

The following table provides an analysis of the fair value of financial instruments not measured at fair value in the balance sheet. For all other instruments, the fair value is equal to the carrying value:

|  | Group           |            |                 |            |
|--|-----------------|------------|-----------------|------------|
|  | 2011            |            | 2010            |            |
|  | Carrying amount | Fair value | Carrying amount | Fair value |
| <b>Financial Assets</b>  |                 |            |                 |            |
| Placings with and advances to banks and other financial institutions | 107,742         | 107,707    | 110,564         | 110,570    |
| Advances to customers  | 480,574         | 468,563    | 472,637         | 474,045    |
| Held-to-maturity debt securities                                     | 59,911          | 63,396     | 56,301          | 58,327     |
| <b>Financial Liabilities</b>   |                 |            |                 |            |
| Current, savings and other deposit accounts                          | 699,857         | 699,939    | 683,628         | 683,732    |
| Deposits from banks  | 14,004          | 14,004     | 15,586          | 15,586     |
| Certificates of deposit and other debt securities in issue           | 9,284           | 9,294      | 3,095           | 3,104      |
| Subordinated liabilities   | 11,846          | 13,424     | 11,848          | 12,761     |

|  | Bank            |            |                 |            |
|--|-----------------|------------|-----------------|------------|
|  | 2011            |            | 2010            |            |
|  | Carrying amount | Fair value | Carrying amount | Fair value |
| <b>Financial Assets</b>  |                 |            |                 |            |
| Placings with and advances to banks and other financial institutions | 47,724          | 47,724     | 52,131          | 52,136     |
| Advances to customers  | 425,629         | 413,629    | 423,074         | 424,514    |
| <b>Financial Liabilities</b>   |                 |            |                 |            |
| Current, savings and other deposit accounts                          | 661,012         | 661,093    | 649,144         | 649,249    |
| Deposits from banks  | 11,989          | 11,989     | 15,585          | 15,585     |
| Certificates of deposit and other debt securities in issue           | 9,284           | 9,294      | 3,095           | 3,104      |
| Subordinated liabilities   | 11,846          | 13,424     | 11,848          | 12,761     |

**63. COMPARATIVE FIGURES**

As a result of the adoption of the HKAS 24 (Revised) "Related Party Disclosures", certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2011.

**64. IMMEDIATE AND ULTIMATE HOLDING COMPANIES**

The immediate and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

**65. APPROVAL OF FINANCIAL STATEMENTS**

The financial statements were approved and authorised for issue by the Board of Directors on 27 February 2012.

## INDEPENDENT AUDITOR'S REPORT

### TO THE SHAREHOLDERS OF HANG SENG BANK LIMITED

*(Incorporated in Hong Kong with limited liability)*

We have audited the consolidated financial statements of Hang Seng Bank Limited ("the Bank") and its subsidiaries (together "the Group") set out on pages 97 to 250, which comprise the consolidated and the Bank balance sheets as at 31 December 2011, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information.

### DIRECTORS' RESPONSIBILITY FOR THE CONSOLIDATED FINANCIAL STATEMENTS

The directors of the Bank are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. This report is made solely to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### OPINION

In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Bank and of the Group as at 31 December 2011 and of the Group's profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

### KPMG

Certified Public Accountants

8th Floor, Prince's Building  
10 Chater Road  
Central, Hong Kong

27 February 2012

## SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

These notes set out on pages 252 to 272 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 97 to 250. The consolidated financial statements and these supplementary notes taken together comply with the Banking (Disclosure) Rules (the "Disclosure Rules") made under section 60A of the Banking Ordinance.

### 1. BASIS OF PREPARATION

**(a)** Except where indicated otherwise, the financial information contained in these supplementary notes has been prepared on a consolidated basis in accordance with Hong Kong Financial Reporting Standards. Some parts of these supplementary notes, however, are required by the Disclosure Rules to be prepared on a different basis. In such cases, the Disclosure Rules require that certain information is prepared on a basis which excluded some of the subsidiaries of the Bank.

Further information regarding subsidiaries that are not included in the consolidation for regulatory purpose is set out in note 2 to the supplementary notes to the financial statements.

**(b)** The accounting policies applied in preparing these supplementary notes are the same as those applied in preparing the consolidated financial statements for the year ended 31 December 2011 as set out in note 4 to the financial statements.

### 2. CAPITAL ADEQUACY

#### **(a) Capital adequacy ratios**

The capital adequacy ratios as at 31 December 2011 are computed on the consolidated basis of the Bank and certain of its subsidiaries as specified by the Hong Kong Monetary Authority for its regulatory purposes, and are in accordance with the Banking (Capital) Rules ("the Capital Rules") of the Hong Kong Banking Ordinance.

From 1 January 2009, the Group has migrated to the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. The Group continued to use the standardised (operational risk) approach to calculate its operational risk. For market risk, an internal model approach is adopted for calculating general market risk, while standardised (market risk) approach is adopted for calculating specific interest rate risk and equity risk. There are no changes in the approaches used in 2011. In addition, there is no relevant capital shortfall in any of the Group's subsidiaries which are not included in its consolidation group for regulatory purposes.

**2. CAPITAL ADEQUACY** (continued)**(a) Capital adequacy ratios** (continued)

The capital base after deductions used in the calculation of capital adequacy ratios as at 31 December and reported to Hong Kong Monetary Authority is analysed as follows:

|   | 2011          | 2010          |
|---|---------------|---------------|
| <b>Core capital:</b>  |               |               |
| Paid-up ordinary share capital  | 9,559         | 9,559         |
| – Reserves per balance sheet  | 65,563        | 56,820        |
| – Unconsolidated subsidiaries   | (7,234)       | (6,268)       |
| – Cash flow hedging reserve   | (6)           | (72)          |
| – Regulatory reserve  | (4,226)       | (1,654)       |
| – Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities | (15,860)      | (13,585)      |
| Total reserves included in core capital   | 38,237        | 35,241        |
| – Goodwill and intangible assets  | (977)         | (1,019)       |
| – 50% of unconsolidated investments   | (11,304)      | (9,725)       |
| – 50% of securitisation positions and other deductions  | (158)         | (158)         |
| Deductions  | (12,439)      | (10,902)      |
| <b>Total core capital</b>   | <b>35,357</b> | <b>33,898</b> |
| <b>Supplementary capital:</b>   |               |               |
| – Term subordinated debt  | 11,846        | 11,848        |
| – Property revaluation reserves <sup>1</sup>  | 5,894         | 5,894         |
| – Available-for-sale investments revaluation reserves <sup>2</sup>  | 117           | 396           |
| – Regulatory reserve <sup>3</sup>   | 296           | 182           |
| – Collective impairment allowances <sup>3</sup>   | 54            | 77            |
| – Excess impairment allowances over expected losses <sup>4</sup>  | 1,522         | 306           |
| Supplementary capital before deductions   | 19,729        | 18,703        |
| – 50% of unconsolidated investments   | (11,304)      | (9,725)       |
| – 50% of securitisation positions and other deductions  | (158)         | (158)         |
| Deductions  | (11,462)      | (9,883)       |
| <b>Total supplementary capital</b>  | <b>8,267</b>  | <b>8,820</b>  |
| <b>Capital base</b>   | <b>43,624</b> | <b>42,718</b> |
| <b>Risk-weighted assets</b>   |               |               |
| – credit risk   | 266,567       | 274,969       |
| – market risk   | 2,054         | 1,615         |
| – operational risk  | 35,649        | 36,853        |
|   | 304,270       | 313,437       |
| – Capital adequacy ratio  | 14.3%         | 13.6%         |
| – Core capital ratio  | 11.6%         | 10.8%         |
| <b>Reserves and deductible items</b>  |               |               |
| Published reserves  | 31,640        | 31,741        |
| Profit and loss account   | 6,597         | 3,500         |
| <b>Total reserves included in core capital</b>  | <b>38,237</b> | <b>35,241</b> |
| <b>Total of items deductible 50% from core capital and 50% from supplementary capital</b>                               | <b>22,924</b> | <b>19,766</b> |

<sup>1</sup> Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with Banking (Capital) rules.

<sup>2</sup> Includes adjustments made in accordance with Banking (Capital) rules.

<sup>3</sup> Total regulatory reserve and collective impairment allowances are apportioned between the standardised approach and internal ratings-based approach in accordance with Banking (Capital) rules. Those apportioned to the standardised approach are included in supplementary capital. Those apportioned to the internal ratings-based approach are excluded from supplementary capital.

<sup>4</sup> Excess impairment allowances over expected losses are applicable to non-securitisation exposures calculated by using the internal ratings-based approach.

**2. CAPITAL ADEQUACY** (continued)**(b) Basis of consolidation**

The basis of consolidation for calculation of capital ratios under the Capital Rules follows the basis of consolidation for financial reporting with the exclusion of subsidiaries which are “regulated financial entities” (e.g. insurance and securities companies) as defined by the Capital Rules. Accordingly, the investment costs of these unconsolidated regulated financial entities are deducted from the capital base. The unconsolidated regulated financial entities are:

Hang Seng Bank (Trustee) Limited  
Hang Seng Bank Trustee International Limited  
Hang Seng Futures Limited  
Hang Seng General Insurance (Hong Kong) Company Limited  
Hang Seng Insurance Company Limited  
Hang Seng Insurance (Bahamas) Limited  
Hang Seng Investment Management Limited  
Hang Seng Investment Services Limited  
Hang Seng Life Limited  
Hang Seng (Nominee) Limited  
Hang Seng Securities Limited  
Imenson Limited

The Group operates subsidiaries in a number of countries and territories where capital will be governed by local rules and there may be restrictions on the transfer of regulatory capital and funds between members of the banking group.

### 3. CREDIT RISK CAPITAL REQUIREMENTS

The table below shows the capital requirements for credit risk for each class and subclass of exposures as specified in the Capital Rules.

|   | 2011          | 2010          |
|---|---------------|---------------|
| <b>Subject to internal ratings-based approach</b>   |               |               |
| Sovereign exposures   | 587           | 294           |
| Bank exposures  | 1,766         | 2,592         |
| Corporate exposures   | 14,020        | 13,538        |
| Residential mortgages to individuals and property-holding shell companies                                 | 532           | 527           |
| Qualifying revolving retail exposures   | 1,081         | 970           |
| Small business retail exposures   | 24            | 9             |
| Other retail exposures to individuals   | 309           | 295           |
| Other exposures   | 1,405         | 1,184         |
| Securitisation exposures  | –             | –             |
| Equity exposures  | –             | –             |
| <b>Total capital requirements for credit risk under internal ratings-based approach</b>                   | <b>19,724</b> | <b>19,409</b> |
| <b>Subject to standardised (credit risk) approach</b>   |               |               |
| <b>On-balance sheet</b>   |               |               |
| Sovereign exposures   | –             | –             |
| Public sector entity exposures  | 194           | 174           |
| Multilateral development bank exposures   | –             | –             |
| Bank exposures  | –             | 4             |
| Securities firm exposures   | –             | –             |
| Corporate exposures   | 372           | 938           |
| Collective investment scheme exposures  | 3             | 4             |
| Cash items  | –             | –             |
| Regulatory retail exposures   | 88            | 128           |
| Residential mortgage loans  | 524           | 671           |
| Other exposures which are not past due exposures  | 154           | 354           |
| Past due exposures  | 22            | 22            |
| <b>Total capital requirements for on-balance sheet exposures</b>  | <b>1,357</b>  | <b>2,295</b>  |
| <b>Off-balance sheet</b>  |               |               |
| Direct credit substitutes   | 172           | 187           |
| Transaction-related contingencies   | 1             | 3             |
| Trade-related contingencies   | –             | –             |
| Forward asset purchases   | 3             | 4             |
| Partly paid-up shares and securities  | –             | –             |
| Forward forward deposits placed   | –             | –             |
| Unconditionally cancellable commitments   | –             | –             |
| Other commitments   | 54            | 83            |
| Exchange rate contracts   | 6             | 10            |
| Interest rate contracts   | 2             | 1             |
| Equity contracts  | 5             | 5             |
| OTC derivative transactions and credit derivative contracts subject to valid bilateral netting agreements | 1             | –             |
| Other off-balance exposures which are not elsewhere specified   | –             | –             |
| <b>Total capital requirements for off-balance sheet exposures</b>   | <b>244</b>    | <b>293</b>    |
| <b>Total capital requirements for credit risk under standardised (credit risk) approach</b>               | <b>1,601</b>  | <b>2,588</b>  |
| <b>Total capital requirements for credit risk</b>   | <b>21,325</b> | <b>21,997</b> |

The capital requirement is made by multiplying the Group's risk-weighted amount derived from the relevant calculation approach by 8 per cent. It does not reflect the Group's actual regulatory capital.



#### 4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH

##### (a) The internal rating system

##### (i) Nature of exposures within each internal ratings-based ("IRB") class

The Group adopted advanced IRB approach for the majority of its business with effect from 1 January 2009. The following exposures are subject to IRB approach:

- Corporate exposures include exposures to global large corporates, local large corporates, middle market corporates and small and medium-sized enterprises, non-bank financial institutions and specialised lending.
- Sovereign exposures include exposures to sovereign governments, government agencies, central monetary institutions and relevant international organisations.
- Bank exposures include exposures to banks and regulated securities firms.
- Retail exposures include residential mortgages, qualifying revolving retail exposures, small business retail exposures and other retail exposures to individuals.
- Other exposures mainly include notes and coins, premises, plant and equipment and other assets.

##### (ii) Structure of risk rating systems and control mechanisms

The Group's exposure to credit risk arises from a wide range of asset classes, customers and product types. To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies: judgmental, analytical, and hybrids of the two. The main characteristics of the Group's credit risk rating systems are set out below.

A fundamental principle of the Group's policy and approach is that analytical risk rating systems and scorecards are decision tools facilitating management, serving ultimately judgemental decisions for which individual approvers are accountable. In case of automated decision making process, accountability rests with those responsible for the parameters built into those processes/systems and the controls surrounding their use. For individually assessed customers, the credit process provides for at least annual review of the facility granted. Review may be more frequent, as required by circumstances.

The Group adopts a set of standards that govern the process through which risk rating systems are developed, judged fit for purpose, approved and implemented, the conditions under which analytical risk model outcomes can be overridden by approvers; and the process of model performance monitoring and reporting. The framework emphasises on an effective dialogue between business line and risk management, suitable independence of decision takers and a good understanding and robust challenge of senior management.

Analytical risk rating systems are not static and are subject to review and modification in light of the changing environment and the availability or quality of data. Processes are established to capture the relevant data for continuous model improvement.

##### (iii) Application of IRB parameters

The Group-wide credit risk rating framework incorporates probability of default ("PD", representing the likelihood of a default event in a one-year horizon) of an obligor and loss severity expressed in terms of exposures at default ("EAD", an estimate of exposures at time of default) and loss given default ("LGD", the estimates of loss that the Group may incur in the event of default expressed as a percentage of EAD). These measures are used to calculate expected loss and capital requirements. They are also used in conjunction with other inputs to form rating assessments for the purpose of credit approval and for risk management decisions.

For corporate and bank exposures, PD models are developed based on historical loss data, combining financial statistics and expert inputs on various aspects such as industry environment, financial trend and quality assessment on the companies. PD model for sovereign exposures incorporates both quantitative and qualitative data from a wide range of reference sources on economic, political, financial and social conditions. For wholesale business (includes corporate, bank and sovereign exposures), obligor PD is estimated using a Customer Risk Rating of 23 grades, of which 21 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. Credit score generated by a model and/or a scorecard for individual obligor, mapped to the corresponding Customer Risk Rating, is recommended to and reviewed by credit approver taking into account all relevant information (including external rating and market data where available) for risk rating determination.

#### 4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

##### (a) The internal rating system (continued)

##### (iii) Application of IRB parameters (continued)

LGD and EAD estimation for wholesale business is subject to Group framework of basic principles. EAD is estimated to a 12-month horizon and broadly represents the current exposure plus an estimate for future draw down on undrawn facilities and the crystallization of contingent exposures after default. LGD focuses on the facility and collateral structure which takes into account the priority/seniority of the facility, the type and value of the collateral and past experience on the type of counterparty, which is expressed as a percentage of EAD.

The Group uses supervisory slotting criteria approach in rating its regulatory specialised lending exposure. Under this approach, rating will be assigned based on the borrower and transaction characteristics.

For retail business including residential mortgage exposures, qualifying revolving retail exposures, small business retail exposures and other retail exposures to individuals, a wide range of application and behavioural models used in the management of retail portfolios has been supplemented to develop the credit models for measuring PD, EAD and LGD under the IRB approach. The PD models typically incorporates the characteristics of the products and the borrower's account behaviour.

EAD models are developed for retail revolving exposures to predict additional drawdown at the time of default, plus current outstanding balance. For non-revolving retail exposures such as residential mortgage, EAD is mainly estimated based on current outstanding balance.

LGD models for retail exposures are developed based on the Group's internal loss and default experience including recovery values for different types of collaterals for secured retail exposures such as residential mortgage; for unsecured retail exposures such as qualifying revolving retail exposures, LGD models are developed based on past recovery experiences, account behaviours and repayment ability.

For management information and reporting purposes, retail portfolios are segmented into 10 Expected Loss (EL) bands facilitating comparability across retail customer segment and product types. EL band is derived through a combination of PD and LGD.

##### (iv) Model Governance

Model governance is under the Credit Risk Analytics Oversight Committee (CRAOC), whose responsibilities are to oversee the governance, including development, validation and monitoring of risk rating models. The CRAOC is chaired by the Chief Risk Officer and its memberships include heads of business groups and finance function.

Compliance with the Group standards for development, validation and implementation of credit risk models are subject to review by Internal Audit. Internal Audit also conducts regular reviews of the risk rating model application by business groups.

##### (v) Use of internal ratings

While internal estimates derived from applying the IRB approach are employed in the calculation of risk-weighted exposure amounts for the purpose of determining regulatory capital requirements, they are also used in a multitude of contexts within risk management and business processes. Such uses continue to develop and become embedded as experience grows and the repository of quality data improves. They include:

- credit approval: authorities, including those for specific counterparty types and transactions, are delegated to officers and executives in the Group's credit risk function and business division involving lending activities using a risk-based approach, tiered relative to obligor customer risk rating;
- credit risk analytical tools: IRB measures are valuable tools deployed in the assessment of customer and portfolio risk; migration of customer risk rating becomes an important indicator in credit monitoring process;
- pricing: customer relationship managers apply a risk adjusted return on capital methodology in risk-weighted assets and profitability calculators;
- portfolio management: regular reports to Risk Management Committee, Audit Committee containing analyses of risk exposures employing IRB risk metrics, e.g. by customer segment and credit quality grade;
- economic capital: IRB risk measures are essential components of the credit risk economic capital model, which are evaluated in the capital adequacy assessment process of the Group;
- stress testing: IRB risk measures are stressed to understand the sensitivities of the Group's capital and business plans under adverse economic environment; and
- risk appetite: IRB risk capital and risk estimates are elements of the risk appetite and internal risk control measures of the Group.

#### 4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

##### (a) The internal rating system (continued)

##### (vi) Credit risk mitigation

The Group's approach when granting credit facilities is on the basis of capacity to repay, rather than primarily rely on credit risk mitigation. Depending on a customer's standing and the type of product, facilities may be provided on unsecured basis. Nevertheless, mitigation of credit risk is an important aspect of effective management and takes in many forms.

The Group's general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Policies covering the acceptability, structuring, control and valuation with regard to different types of collateral security are established to ensure that they are supported by evidence and continue to fulfil their intended purpose.

The main types of recognised collateral taken by the Group are those as stated in section 80 of the Capital Rules, including (but not limited to) cash on deposit, gold bullion, equities listed in a main index and/or a recognised exchange, collective investment schemes, various recognised debt securities, residential, industrial and commercial property, etc.

The Group's policy provides that netting is only to be applied where it has the legal right to do so. Consistent with the Capital Rules, only bilateral netting arrangements are included for capital adequacy credit risk mitigation calculation.

In terms of the application within IRB approach, credit risk mitigants are considered in two broad categories: first, those which reduce the intrinsic probability of default of an obligor and therefore operate as adjustments to PD estimation, and second, those which affect estimated recoverability of obligations and require adjustment of LGD. The first includes, for example, full parental or group company guarantees; the second, collateral security of various kinds such as cash, equity, properties, fixed assets such as motor vehicles, plant and machinery, stock and debtors, bank and sovereign guarantees, etc.

##### (b) Exposures subject to supervisory estimates

The following table indicates the exposure classes and the respective exposure amounts that are subject to supervisory estimates as at 31 December:

|                           | 2011          | 2010   |
|---------------------------|---------------|--------|
| <b>IRB Exposure Class</b> |               |        |
| Sovereign exposures       | –             | –      |
| Bank exposures            | –             | –      |
| Corporate exposures       | <b>31,995</b> | 28,609 |
| <b>Total EAD</b>          | <b>31,995</b> | 28,609 |

**4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH** (continued)**(c) Exposures by IRB calculation approach**

The table below shows the Group's exposures:

|   | Advanced<br>IRB<br>approach | Supervisory<br>slotting<br>criteria<br>approach | Retail<br>IRB<br>approach | Specific<br>risk-weight<br>approach | Total<br>exposures |
|---|-----------------------------|---|---------------------------|-------------------------------------|--------------------|
| <b>2011</b>   |                             |   |                           |                                     |                    |
| Sovereign exposures   | 108,082                     | –   | –                         | –                                   | 108,082            |
| Bank exposures  | 160,679                     | –   | –                         | –                                   | 160,679            |
| Corporate exposures   | 289,627                     | 31,995  | –                         | –                                   | 321,622            |
| Retail exposures:   |                             |   |                           |                                     |                    |
| – Residential mortgages to individuals and property-holding shell companies | –                           | –   | 132,005                   | –                                   | 132,005            |
| – Qualifying revolving retail exposures                                     | –                           | –   | 69,412                    | –                                   | 69,412             |
| – Small business retail exposures   | –                           | –   | 5,881                     | –                                   | 5,881              |
| – Other retail exposures to individuals                                     | –                           | –   | 8,795                     | –                                   | 8,795              |
| Other exposures   | –                           | –   | –                         | 29,220                              | 29,220             |
|   | <b>558,388</b>              | <b>31,995</b>                                   | <b>216,093</b>            | <b>29,220</b>                       | <b>835,696</b>     |
| <b>2010</b>   |                             |   |                           |                                     |                    |
| Sovereign exposures   | 52,338                      | –   | –                         | –                                   | 52,338             |
| Bank exposures  | 229,460                     | –   | –                         | –                                   | 229,460            |
| Corporate exposures   | 263,358                     | 28,609  | –                         | –                                   | 291,967            |
| Retail exposures:   |                             |   |                           |                                     |                    |
| – Residential mortgages to individuals and property-holding shell companies | –                           | –   | 137,445                   | –                                   | 137,445            |
| – Qualifying revolving retail exposures                                     | –                           | –   | 60,551                    | –                                   | 60,551             |
| – Small business retail exposures   | –                           | –   | 4,100                     | –                                   | 4,100              |
| – Other retail exposures to individuals                                     | –                           | –   | 8,313                     | –                                   | 8,313              |
| Other exposures   | –                           | –   | –                         | 22,418                              | 22,418             |
|   | <b>545,156</b>              | <b>28,609</b>                                   | <b>210,409</b>            | <b>22,418</b>                       | <b>806,592</b>     |

**(d) Exposures by credit risk mitigation used**

The table below shows the Group's exposures (after the effect of any on-balance sheet or off-balance sheet recognised netting) which are covered by recognised guarantees after the application of haircuts required under the Capital Rules. These exposures exclude OTC derivative transactions.

|                     | 2011          | 2010           |
|---------------------|---------------|----------------|
| <b>Portfolio</b>    |               |                |
| Bank exposures      | 11,222        | 28,492         |
| Corporate exposures | 72,685        | 78,647         |
| Retail exposures    | 15,566        | 16,314         |
|                     | <b>99,473</b> | <b>123,453</b> |

For the class of sovereign exposures, there were no exposures covered by recognised guarantees.

**4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH** (continued)**(e) Risk assessment for exposures under IRB approach**

The tables below detail the total EAD of sovereign, bank and corporate exposures by exposure-weighted average risk-weight, exposure-weighted average PD and exposure-weighted average LGD for each obligor grade as at 31 December.

**(i) Sovereign, bank and corporate (other than specialised lending) exposures – analysis by obligor grade**

The exposure at default disclosed below in respect of sovereign, bank and corporate exposures have taken into account the effect of recognised collateral and recognised guarantees.

|  | 2011                           |                                 |   |                     |
|--|--------------------------------|---------------------------------|---|---------------------|
|  | Exposure-weighted average PD % | Exposure-weighted average LGD % | Exposure-weighted average risk-weight % | Exposure at default |
| <b>Sovereign exposure</b>                                  |                                |                                 |   |                     |
| Minimal default risk                                       | 0.01                           | 10.30                           | 0.86                                    | 66,686              |
| Low default risk   | 0.07                           | 45.00                           | 16.34                                   | 41,396              |
|  |                                |                                 |   | <u>108,082</u>      |
| <b>Bank exposure</b>                                       |                                |                                 |   |                     |
| Minimal default risk                                       | 0.03                           | 23.97                           | 4.94                                    | 39,228              |
| Low default risk   | 0.08                           | 35.99                           | 13.87                                   | 98,901              |
| Satisfactory default risk                                  | 0.28                           | 32.82                           | 27.22                                   | 21,969              |
| Fair default risk  | 1.07                           | 38.56                           | 67.77                                   | 456                 |
| Moderate default risk                                      | 2.94                           | 39.05                           | 100.14                                  | 88                  |
| Significant default risk                                   | 5.89                           | 40.72                           | 134.90                                  | 30                  |
| High default risk  | 11.29                          | 40.72                           | 176.35                                  | 7                   |
|  |                                |                                 |   | <u>160,679</u>      |
| <b>Corporate exposure (other than specialised lending)</b> |                                |                                 |   |                     |
| Minimal default risk                                       | 0.04                           | 37.36                           | 13.90                                   | 35,156              |
| Low default risk   | 0.10                           | 43.87                           | 27.62                                   | 89,079              |
| Satisfactory default risk                                  | 0.39                           | 42.07                           | 51.93                                   | 81,908              |
| Fair default risk  | 1.22                           | 42.06                           | 86.44                                   | 36,524              |
| Moderate default risk                                      | 2.82                           | 36.80                           | 102.37                                  | 42,353              |
| Significant default risk                                   | 6.62                           | 47.11                           | 168.85                                  | 2,317               |
| High default risk  | 12.18                          | 34.52                           | 161.18                                  | 343                 |
| Special management   | 28.14                          | 29.76                           | 141.50                                  | 478                 |
| Default  | 100.00                         | 54.49                           | –                                       | 1,469               |
|  |                                |                                 |   | <u>289,627</u>      |

**4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH** (continued)**(e) Risk assessment for exposures under IRB approach** (continued)**(i) Sovereign, bank and corporate (other than specialised lending) exposures – analysis by obligor grade** (continued)

|  | 2010                           |                                 |   |                     |
|--|--------------------------------|---------------------------------|---|---------------------|
|  | Exposure-weighted average PD % | Exposure-weighted average LGD % | Exposure-weighted average risk-weight % | Exposure at default |
| <b>Sovereign exposure</b>                                  |                                |                                 |   |                     |
| Minimal default risk                                       | 0.01                           | 10.38                           | 1.03                                    | 33,968              |
| Low default risk   | 0.07                           | 44.84                           | 18.12                                   | 18,370              |
|  |                                |                                 |   | <u>52,338</u>       |
| <b>Bank exposure</b>                                       |                                |                                 |   |                     |
| Minimal default risk                                       | 0.03                           | 22.45                           | 4.80                                    | 45,397              |
| Low default risk   | 0.10                           | 31.20                           | 13.27                                   | 158,272             |
| Satisfactory default risk                                  | 0.30                           | 32.62                           | 29.18                                   | 21,799              |
| Fair default risk  | 1.33                           | 34.52                           | 64.42                                   | 3,133               |
| Moderate default risk                                      | 2.65                           | 33.38                           | 81.29                                   | 434                 |
| Significant default risk                                   | 5.79                           | 30.55                           | 98.13                                   | 365                 |
| High default risk  | 12.70                          | 46.37                           | 209.15                                  | 60                  |
|  |                                |                                 |   | <u>229,460</u>      |
| <b>Corporate exposure (other than specialised lending)</b> |                                |                                 |   |                     |
| Minimal default risk                                       | 0.04                           | 40.86                           | 14.89                                   | 19,419              |
| Low default risk   | 0.11                           | 42.82                           | 27.66                                   | 89,764              |
| Satisfactory default risk                                  | 0.38                           | 45.15                           | 55.26                                   | 79,364              |
| Fair default risk  | 1.29                           | 42.29                           | 88.19                                   | 32,163              |
| Moderate default risk                                      | 2.97                           | 39.94                           | 112.23                                  | 36,637              |
| Significant default risk                                   | 6.98                           | 43.59                           | 160.10                                  | 1,779               |
| High default risk  | 12.54                          | 41.58                           | 192.26                                  | 1,674               |
| Special management   | 19.31                          | 35.92                           | 187.67                                  | 547                 |
| Default  | 100.00                         | 53.01                           | –                                       | 2,011               |
|  |                                |                                 |   | <u>263,358</u>      |

**(ii) Corporate exposures (specialised lending) – analysis by supervisory rating grade**

|                      | 2011                                    |                     | 2010                                    |                     |
|----------------------|---|---------------------|---|---------------------|
|                      | Exposure-weighted average risk-weight % | Exposure at default | Exposure-weighted average risk-weight % | Exposure at default |
| <b>Obligor Grade</b> |   |                     |   |                     |
| Strong               | 66.24                                   | 24,707              | 66.15                                   | 22,532              |
| Good                 | 88.44                                   | 6,322               | 91.29                                   | 4,332               |
| Satisfactory         | 121.90                                  | 960                 | 121.90                                  | 1,745               |
| Weak                 | 265.00                                  | 6                   | –                                       | –                   |
|                      |   | <u>31,995</u>       |   | <u>28,609</u>       |

**4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH** (continued)**(e) Risk assessment for exposures under IRB approach** (continued)**(iii) Retail exposures – analysis by credit quality**

The table below shows a breakdown of exposures (the EAD of on-balance sheet exposures and off-balance sheet exposures) on a pool basis by credit quality classification:

|              | Residential mortgages | Qualifying revolving retail exposures | Small business retail exposures | Other retail exposures | Total exposures |
|--------------|-----------------------|---------------------------------------|---------------------------------|------------------------|-----------------|
| <b>2011</b>  |                       |                                       |                                 |                        |                 |
| Strong       | 131,446               | 59,660                                | 5,775                           | 6,749                  | 203,630         |
| Medium       | 405                   | 9,427                                 | 88                              | 1,969                  | 11,889          |
| Sub-standard | –                     | 318                                   | –                               | 57                     | 375             |
| Impaired     | 154                   | 7                                     | 18                              | 20                     | 199             |
|              | <b>132,005</b>        | <b>69,412</b>                         | <b>5,881</b>                    | <b>8,795</b>           | <b>216,093</b>  |
| <b>2010</b>  |                       |                                       |                                 |                        |                 |
| Strong       | 136,621               | 51,821                                | 4,085                           | 6,319                  | 198,846         |
| Medium       | 557                   | 8,434                                 | –                               | 1,912                  | 10,903          |
| Sub-standard | –                     | 286                                   | –                               | 52                     | 338             |
| Impaired     | 267                   | 10                                    | 15                              | 30                     | 322             |
|              | <b>137,445</b>        | <b>60,551</b>                         | <b>4,100</b>                    | <b>8,313</b>           | <b>210,409</b>  |

**(iv) Undrawn commitments**

The table below shows the amount of undrawn commitments and exposure-weighted average EAD for sovereign, bank and corporate exposures as at 31 December 2011:

|                     | 2011                |                               | 2010                |                               |
|---------------------|---------------------|-------------------------------|---------------------|-------------------------------|
|                     | Undrawn commitments | Exposure-weighted average EAD | Undrawn commitments | Exposure-weighted average EAD |
| Sovereign exposures | –                   | –                             | –                   | –                             |
| Bank exposures      | 770                 | 292                           | 738                 | 378                           |
| Corporate exposures | 129,997             | 41,817                        | 109,653             | 39,456                        |
|                     | <b>130,767</b>      | <b>42,109</b>                 | <b>110,391</b>      | <b>39,834</b>                 |

**(f) Analysis of actual loss and estimates**

The table below shows the actual losses which represent the net charges (including write-offs and impairment loss allowances) made during the year.

|                             | 2011       | 2010       |
|-----------------------------|------------|------------|
| <b>Exposure Class</b>       |            |            |
| Sovereign                   | –          | –          |
| Bank                        | –          | (10)       |
| Corporate                   | 465        | 346        |
| Residential mortgage        | (33)       | (45)       |
| Qualifying revolving retail | 271        | 332        |
| Other retail                | 60         | 51         |
|                             | <b>763</b> | <b>674</b> |



**4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH** (continued)**(f) Analysis of actual loss and estimates** (continued)

The actual losses in 2011 increased modestly primarily due to higher impairment losses in corporate portfolio.

The table below shows the expected loss which is the estimated future loss over a one-year time horizon for different exposure classes under IRB approach.

|                             | 31 December<br>2010 | 31 December<br>2009 |
|-----------------------------|---------------------|---------------------|
| <b>Exposure Class</b>       |                     |                     |
| Sovereign                   | 6                   | 3                   |
| Bank                        | 101                 | 77                  |
| Corporate                   | 2,165               | 2,203               |
| Residential mortgage        | 99                  | 156                 |
| Qualifying revolving retail | 390                 | 347                 |
| Other retail                | 125                 | 158                 |
|                             | <b>2,886</b>        | <b>2,944</b>        |

Overall estimated expected losses in 2011 remained stable compared to 2010.

It should be noted that actual loss and expected loss are measured and calculated using different methodologies which may not be directly comparable. The limitation arises mainly from the fundamental differences in the definition of "loss" under expected loss calculation which is derived based on regulatory rules and actual loss includes write-offs and impairment loss allowances.

The tables below set out the comparison of the predicted risk estimates of the Group's credit risk models against actual outcomes of the wholesale and retail exposures.

**(i) Wholesale exposures**

*Risk estimates as at 31 December 2010 against actual outcome for the year 2011*

|                    | PD          |                | LGD         |                | EAD         |                |
|--------------------|-------------|----------------|-------------|----------------|-------------|----------------|
|                    | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% |
| Sovereign exposure | –           | 0.06           | –           | 22.47          | –           | 100.00         |
| Bank exposure      | –           | 0.54           | –           | 27.83          | –           | 99.22          |
| Corporate exposure | 0.28        | 1.38           | 60.69       | 45.22          | 39.76       | 81.29          |

*Risk estimates as at 31 December 2009 against actual outcome for the year 2010*

|                    | PD          |                | LGD         |                | EAD         |                |
|--------------------|-------------|----------------|-------------|----------------|-------------|----------------|
|                    | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% |
| Sovereign exposure | –           | 0.04           | –           | 13.34          | –           | 100.00         |
| Bank exposure      | –           | 0.71           | –           | 28.55          | –           | 98.22          |
| Corporate exposure | 0.23        | 1.54           | 34.95       | 44.75          | 80.22       | 79.08          |

The actual PD rate is measured by using the number of obligor defaulted during the reporting period whereas the estimated PD rate is the long run average default rate estimated at the beginning of the reporting period. The PD estimated by internal model is calibrated to the Group's long run default experience. Hence, actual default rate in a particular year ("point-in-time") will typically differ from the estimated PD which is the "through the cycle" estimates as economies move above or below cyclical norms.

#### 4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

##### (f) Analysis of actual loss and estimates (continued)

###### (i) Wholesale exposures (continued)

The estimated LGD is the exposure weighted average LGD for the portfolio, adjusted by a downturn factor, as of the beginning of the reporting period whereas the actual LGD is computed using the resolved default cases accumulated in 2011 which covers cases defaulted before 2011. No default and loss has been observed for Bank and Sovereign exposures during the reporting period.

The estimated EAD% represents the ratio of total model estimated exposure values to total limits for the portfolio at the beginning of the reporting period. The actual EAD% compares the realised EAD of the defaulted and resolved cases accumulated in 2011 which covers cases defaulted before 2011 to the limits 1 year prior to default.

Due to the difference in the portfolio mix between the defaulted and resolved population and the overall corporate portfolio estimated at the beginning of the reporting period, the actual and estimated results can differ.

###### (ii) Retail exposures

*Risk estimates as at 31 December 2010 against actual outcome for the year 2011*

|   | PD          |                | LGD         |                | EAD         |                |
|---|-------------|----------------|-------------|----------------|-------------|----------------|
|   | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% |
| Residential mortgages to individuals and property-holding shell companies | 0.17        | 0.52           | 0.66        | 11.09          | 92.05       | 100.00         |
| Qualifying revolving retail exposures                                     | 0.31        | 0.57           | 83.22       | 94.43          | 81.40       | 86.48          |
| Small business retail exposures   | 0.26        | 0.47           | 0.27        | 11.93          | 96.88       | 100.00         |
| Other retail exposures to individuals                                     | 1.97        | 2.25           | 90.46       | 87.50          | 76.66       | 93.22          |

Remarks: The portfolio which was newly approved to use internal ratings-based approach in 2011 is excluded in the above analysis.

*Risk estimates as at 31 December 2009 against actual outcome for the year 2010*

|   | PD          |                | LGD         |                | EAD         |                |
|---|-------------|----------------|-------------|----------------|-------------|----------------|
|   | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% | Actual<br>% | Estimated<br>% |
| Residential mortgages to individuals and property-holding shell companies | 0.20        | 0.66           | 0.61        | 10.39          | 89.46       | 100.00         |
| Qualifying revolving retail exposures                                     | 0.36        | 0.61           | 89.82       | 85.40          | 87.90       | 95.26          |
| Small business retail exposures   | 0.40        | 0.60           | 0.29        | 11.58          | 93.31       | 100.00         |
| Other retail exposures to individuals                                     | 1.79        | 2.60           | 63.99       | 63.43          | 68.69       | 93.97          |

The actual and estimated PD rate are measured in the same ways as wholesale exposure.

The actual LGD for the retail exposures takes into account the 24-months recovery period and represents the realised LGD for cases defaulted during 2009 which were recovered within 24 months after default. The estimated LGD is the exposure weighted average LGD for the defaulted cases estimated prior to default. The actual exposure weighted average LGD for other retail exposures to individuals in 2011 are slightly higher than the estimation but the actual loss is lower than the predicted loss in terms of amount.

The estimated EAD% represents the ratio of total model estimated EAD to total limits for cases defaulted during 2011 whereas the actual EAD% compares the exposure values of the cases defaulted in 2011 at the time of default against the maximum limit 1 year prior to default.

## **5. CREDIT RISK UNDER THE STANDARDISED (CREDIT RISK) APPROACH**

### **(a) Ratings from External Credit Assessment Institutions (“ECAIs”)**

The Group uses the following ECAIs to calculate its capital adequacy requirements under the standardised (credit risk) approach prescribed in the Capital Rules:

- Fitch Ratings
- Moody’s Investors Service
- Standard & Poor’s Ratings Services, and
- Rating and Investment Information, Inc.

Where exposures have been rated by the above-mentioned ECAIs, they are categorised under the following class of exposures:

- Sovereign exposures
- Public sector entity exposures
- Multilateral development bank exposures
- Bank exposures
- Securities firm exposures
- Corporate exposures
- Collective investment scheme exposures

The process used to map ECAIs issuer ratings or ECAIs issue specific ratings in the Group’s banking book is consistent with those prescribed in the Capital Rules.

### **(b) Credit risk mitigation**

As stated in sections 98 and 99 of the Capital Rules, certain guarantees and credit derivative contracts are recognised for credit risk mitigation purposes. The main types of guarantees are from sovereigns, corporate and banks. With corporate guarantees, in order for it to be recognised as a credit risk mitigants, it must have a credit rating of A- or better by Standard & Poor’s Ratings Services, Fitch Ratings and Rating and Investment Information, Inc, or a credit rating of A3 or better by Moody’s Investors Service.

## 5. CREDIT RISK UNDER THE STANDARDISED (CREDIT RISK) APPROACH (continued)

## (c) Credit risk exposures under the standardised (credit risk) approach

|   | Total exposures* | Exposures after recognised credit risk mitigation |         | Risk-weighted amounts |         | Total risk-weighted amounts | Total exposures covered by recognised collateral | Total exposures covered by recognised guarantees or recognised credit derivative contracts |
|---|------------------|---|---------|-----------------------|---------|-----------------------------|--|--|
|   |                  | Rated   | Unrated | Rated                 | Unrated |                             |  |  |
| <b>2011</b>   |                  |   |         |                       |         |                             |  |  |
| <b>Class of exposures</b>   |                  |   |         |                       |         |                             |  |  |
| <b>On-balance sheet</b>   |                  |   |         |                       |         |                             |  |  |
| Sovereign   | -                | -   | 756     | -                     | -       | -                           | -  | -  |
| Public sector entity  | 18,574           | 18,451  | 125     | 2,398                 | 25      | 2,423                       | -  | -  |
| Multilateral development bank   | 21,613           | 21,613  | -       | -                     | -       | -                           | -  | -  |
| Bank  | 9                | -   | 9       | -                     | 4       | 4                           | -  | -  |
| Securities firm   | -                | -   | -       | -                     | -       | -                           | -  | -  |
| Corporate   | 6,430            | -   | 4,643   | -                     | 4,643   | 4,643                       | 1,065  | 722  |
| Collective investment scheme  | 42               | -   | 42      | -                     | 42      | 42                          | -  | -  |
| Cash items  | -                | -   | -       | -                     | -       | -                           | -  | -  |
| Regulatory retail   | 2,256            | -   | 1,469   | -                     | 1,102   | 1,102                       | 753  | 34   |
| Residential mortgage loan   | 12,363           | -   | 12,330  | -                     | 6,554   | 6,554                       | 31   | 2  |
| Other exposures which are not past due exposures  | 4,734            | -   | 1,923   | -                     | 1,923   | 1,923                       | 2,811  | -  |
| Past due exposures  | 199              | -   | 199     | -                     | 280     | 280                         | 18   | -  |
|   | 66,220           | 40,064  | 21,496  | 2,398                 | 14,573  | 16,971                      | 4,678  | 758  |
| <b>Off-balance sheet</b>  |                  |   |         |                       |         |                             |  |  |
| Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts | 3,051            | -   | 2,876   | -                     | 2,865   | 2,865                       | 175  | 9  |
| OTC derivative contracts  | 183              | 2   | 181     | -                     | 175     | 175                         | -  | -  |
| Credit derivative contracts   | -                | -   | -       | -                     | -       | -                           | -  | -  |
| Other off-balance sheet exposures not elsewhere specified   | -                | -   | -       | -                     | -       | -                           | -  | -  |
|   | 3,234            | 2   | 3,057   | -                     | 3,040   | 3,040                       | 175  | 9  |
| Total   | 69,454           | 40,066  | 24,553  | 2,398                 | 17,613  | 20,011                      | 4,853  | 767  |
| Exposures deducted from capital base  | -                |   |         |                       |         |                             |  |  |

\* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

**5. CREDIT RISK UNDER THE STANDARDISED (CREDIT RISK) APPROACH** (continued)**(c) Credit risk exposures under the standardised (credit risk) approach** (continued)

|   | Total exposures* | Exposures after recognised credit risk mitigation |         | Risk-weighted amounts |         | Total risk-weighted amounts | Total exposures covered by recognised collateral | Total exposures covered by recognised guarantees or recognised credit derivative contracts |
|---|------------------|---|---------|-----------------------|---------|-----------------------------|--|--|
|   |                  | Rated   | Unrated | Rated                 | Unrated |                             |  |  |
| 2010  |                  |   |         |                       |         |                             |  |  |
| Class of exposures  |                  |   |         |                       |         |                             |  |  |
| <b>On-balance sheet</b>   |                  |   |         |                       |         |                             |  |  |
| Sovereign   | –                | –   | 1,147   | –                     | –       | –                           | –  | –  |
| Public sector entity  | 16,103           | 16,003  | 104     | 2,153                 | 21      | 2,174                       | –  | –  |
| Multilateral development bank   | 21,761           | 21,761  | –       | –                     | –       | –                           | –  | –  |
| Bank  | 185              | –   | 185     | –                     | 46      | 46                          | –  | –  |
| Securities firm   | –                | –   | –       | –                     | –       | –                           | –  | –  |
| Corporate   | 13,959           | 16  | 11,726  | 3                     | 11,726  | 11,729                      | 1,098  | 1,119  |
| Collective investment scheme  | 53               | –   | 53      | –                     | 53      | 53                          | –  | –  |
| Cash items  | –                | –   | –       | –                     | –       | –                           | –  | –  |
| Regulatory retail   | 2,997            | –   | 2,131   | –                     | 1,599   | 1,599                       | 838  | 28   |
| Residential mortgage loan   | 14,682           | –   | 14,644  | –                     | 8,392   | 8,392                       | 34   | 4  |
| Other exposures which are not past due exposures  | 7,747            | –   | 4,426   | –                     | 4,426   | 4,426                       | 3,321  | –  |
| Past due exposures  | 188              | –   | 188     | –                     | 272     | 272                         | 11   | –  |
|   | 77,675           | 37,780  | 34,604  | 2,156                 | 26,535  | 28,691                      | 5,302  | 1,151  |
| <b>Off-balance sheet</b>  |                  |   |         |                       |         |                             |  |  |
| Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts | 3,637            | 19  | 3,457   | –                     | 3,471   | 3,471                       | 161  | 3  |
| OTC derivative contracts  | 224              | 2   | 222     | –                     | 211     | 211                         | –  | –  |
| Credit derivative contracts   | –                | –   | –       | –                     | –       | –                           | –  | –  |
| Other off-balance sheet exposures not elsewhere specified   | –                | –   | –       | –                     | –       | –                           | –  | –  |
|   | 3,861            | 21  | 3,679   | –                     | 3,682   | 3,682                       | 161  | 3  |
| Total   | 81,536           | 37,801  | 38,283  | 2,156                 | 30,217  | 32,373                      | 5,463  | 1,154  |
| Exposures deducted from capital base  | –                |   |         |                       |         |                             |  |  |

\* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

**6. COUNTERPARTY CREDIT RISK-RELATED EXPOSURES**

**(a)** In respect of counterparty credit risk exposures which arises from over-the-counter (“OTC”) derivative transactions and repo-style transactions (referred as “relevant transaction”) hereunder, credit limit to counterparty credit risk arising from the relevant transaction is assigned, monitored and reported in accordance with the Group risk methodology. The credit limit established takes into account the gross contract amount and the future potential exposure measured on the basis of 95 percentile potential worst case loss estimates for the product involved. This method of calculating credit limit applies to all counterparties.

Credit equivalent amount and risk-weighted amount of relevant transaction is determined following the regulatory capital requirements. Risk-weighted amount is calculated in accordance with the counterparty risk weighting as per internal ratings-based approach/standardised (credit risk) approach under the Capital Rules.

The policy for secured collateral on derivatives is guided by the Group’s internal Best Practice Guidelines ensuring the due-diligence necessary to fully understand the effectiveness of netting and collateralisation by jurisdiction, counterparty, product and agreement type is fully assessed and that the due-diligence standards are high and consistently applied. The Group’s policies for establishing provisions are discussed in note 4(f) – Loan impairment.

**6. COUNTERPARTY CREDIT RISK-RELATED EXPOSURES** (continued)**(b) Counterparty credit risk exposures**

The following tables show the counterparty credit risk exposures under the internal-ratings based approach and standardised (credit risk) approach. There was no outstanding repo-style transactions and credit derivative contracts at 31 December 2011 (2010: Nil).

**(i) Counterparty credit risk exposures under the internal-ratings based approach**

|   | 2011         | 2010  |
|---|--------------|-------|
| <b>OTC derivative transactions:</b>   |              |       |
| Gross total positive fair value which are not repo-style transactions                     | <b>3,985</b> | 4,589 |
| Credit equivalent amount  | <b>7,728</b> | 6,799 |
| Value of recognised collateral by type:   |              |       |
| Debt securities   | -            | -     |
| Others  | -            | -     |
|   | <b>-</b>     | -     |
| Credit equivalent amount or net credit exposures net of recognised collateral held        | <b>7,728</b> | 6,799 |
| Risk-weighted amount  | <b>3,824</b> | 2,657 |
| Notional amount of recognised credit derivative contracts which provide credit protection | -            | -     |

**(ii) Counterparty credit risk exposures under the standardised (credit risk) approach**

|   | 2011       | 2010 |
|---|------------|------|
| <b>OTC derivative transactions:</b>   |            |      |
| Gross total positive fair value which are not repo-style transactions                     | <b>90</b>  | 98   |
| Credit equivalent amount  | <b>183</b> | 224  |
| Value of recognised collateral by type:   |            |      |
| Debt securities   | -          | -    |
| Others  | -          | -    |
|   | <b>-</b>   | -    |
| Credit equivalent amount or net credit exposures net of recognised collateral held        | <b>183</b> | 224  |
| Risk-weighted amount  | <b>175</b> | 211  |
| Notional amount of recognised credit derivative contracts which provide credit protection | -          | -    |

**(c) Major classes of exposures by counterparty type****(i) Major classes of exposures under the internal ratings-based approach by counterparty type**

|                        | 2011            |                          |                      | 2010            |                          |                      |
|------------------------|-----------------|--------------------------|----------------------|-----------------|--------------------------|----------------------|
|                        | Contract amount | Credit equivalent amount | Risk-weighted amount | Contract amount | Credit equivalent amount | Risk-weighted amount |
| Sovereign              | -               | -                        | -                    | -               | -                        | -                    |
| Public sector entities | -               | -                        | -                    | -               | -                        | -                    |
| Banks                  | <b>775,921</b>  | <b>4,173</b>             | <b>537</b>           | 703,961         | 4,212                    | 521                  |
| Corporates             | <b>152,166</b>  | <b>3,555</b>             | <b>3,287</b>         | 125,370         | 2,587                    | 2,136                |
|                        | <b>928,087</b>  | <b>7,728</b>             | <b>3,824</b>         | 829,331         | 6,799                    | 2,657                |

**6. COUNTERPARTY CREDIT RISK-RELATED EXPOSURES** (continued)**(c) Major classes of exposures by counterparty type** (continued)

## (ii) Major classes of exposures under the standardised (credit risk) approach by counterparty type

|                        | 2011            |                          |                      | 2010            |                          |                      |
|------------------------|-----------------|--------------------------|----------------------|-----------------|--------------------------|----------------------|
|                        | Contract amount | Credit equivalent amount | Risk-weighted amount | Contract amount | Credit equivalent amount | Risk-weighted amount |
| Sovereign              | –               | –                        | –                    | –               | –                        | –                    |
| Public sector entities | 39              | 2                        | –                    | 39              | 2                        | –                    |
| Banks                  | –               | –                        | –                    | –               | –                        | –                    |
| Corporates             | 5,699           | 181                      | 175                  | 9,414           | 222                      | 211                  |
|                        | <b>5,738</b>    | <b>183</b>               | <b>175</b>           | <b>9,453</b>    | <b>224</b>               | <b>211</b>           |

**7. ASSET SECURITISATION**

There was no asset securitisation for which the Group is an originating institution or an investing institution at 31 December 2011 (2010: Nil).

**8. MARKET RISK**

**(a)** The Hong Kong Monetary Authority has granted approval under section 18(2)(a) and 18(5) of the Capital Rules for the Group to use the internal models approach to calculate its market risk for foreign exchange risk and general interest rate risk. Standardised approach is used for the calculation of specific interest rate risk, equity risk and commodity risk.

|  | 2011       | 2010       |
|--|------------|------------|
| Market risk calculated by:                                       |            |            |
| – Internal models approach:                                      |            |            |
| – foreign exchange exposures and general interest rate exposures | 115        | 118        |
| – Standardised approach:   |            |            |
| – specific interest rate exposures                               | 48         | 10         |
| – equity exposures   | 1          | 1          |
| Total capital charge for market risk                             | <b>164</b> | <b>129</b> |

Capital charge means an amount of regulatory capital which the group is required to hold for an exposure to a relevant risk which, if multiplied by 12.5, becomes the risk-weighted amount of that exposure for that risk.

**(b) Methodology for valuation of market risk position under internal model approach**

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. A Historic Simulation approach is used to model foreign currency and interest rate risk, generated by revaluing the portfolio for each of 500 historical scenarios from one-day market movements, and is derived from a clean two-year time series of historic market risk factor data.

**(c) Characteristics and coverage of VAR model**

The VAR models cover all material sources of price risk relating to foreign exchange risk and general interest rate risk. Foreign exchange risk factors include, but are not limited to, foreign currency prices and foreign currency option volatility. General interest rate risk factors include, but are not limited to, interest rate curves and interest rate option volatilities.

Historical simulation approach is used for all outright interest rate and foreign exchange using a 99% confidence interval and a one day time horizon that is scaled up to a ten day holding period.

Historical, hypothetical and technical scenario stress testing is performed on positions on a bi-weekly basis. Back-testing of the interest rate and foreign exchange uses clean and hypothetical profits and losses from trading operations and compares these to overall and individual business level value at risk on a daily basis.



## 9. OPERATIONAL RISK

The Hong Kong Monetary Authority has granted approval under section 25(2) of the Capital Rules for the Group to use the standardised approach to calculate its operational risk.

|                                     | 2011  | 2010  |
|-------------------------------------|-------|-------|
| Capital charge for operational risk | 2,852 | 2,948 |

## 10. EQUITY EXPOSURES IN BANKING BOOK

Investments in equity shares which are intended to be held on a continuing basis, but which do not comprise investments in associates, jointly controlled entities or subsidiaries, are classified as available-for-sale securities and are reported in the balance sheet as "Financial investments". Available-for-sale securities are measured at fair value as described in notes 4(g)(iii) and 4(n) on the financial statements. Included within this category are investments made by the Group for strategic purposes, which are subject to additional internal procedures and approvals to ensure that the investment is in accordance with the Group's strategy and to ensure compliance with all relevant regulatory and legal restrictions. In some cases, additional investments may be made later such that the investee becomes an associate, jointly controlled entity or subsidiary, at which point the investment is reclassified in accordance with the Group's accounting policies.

|  | 2011 | 2010 |
|--|------|------|
| Cumulative realised gains on disposal                        | 42   | 10   |
| Unrealised gains:  |      |      |
| – recognised in reserve but not through the income statement | 174  | 188  |
| – deducted from the supplementary capital                    | –    | –    |

## 11. DISCLOSURE FOR SELECTED EXPOSURE

### (a) Holding of debt securities issued by Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation

The table below shows the Group's exposures to the senior debt securities (AAA rated) issued by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

|                     | Gross principal | Fair value |
|---------------------|-----------------|------------|
| At 31 December 2011 | –               | –          |
| At 31 December 2010 | 37              | 38         |

The Group did not hold any asset-backed securities, mortgage-backed securities and collateralised debt obligations.

### (b) Involvement with Special Purpose Entities (SPEs)

From time to time, the Group enters into certain transactions with customers in the ordinary course of business which involve the establishment of SPEs. The use of SPEs is not a significant part of the Group's activities and the Group is not reliant on SPEs for any material part of its business operations or profitability.

## 12. ANALYSIS OF GROSS ADVANCES TO CUSTOMERS BY CATEGORIES BASED ON INTERNAL CLASSIFICATION USED BY THE GROUP

Gross advances, impaired advances, individually assessed and collectively assessed loan impairment allowances, the amount of new impairment allowances charged to income statement, and the amount of impaired loans and advances written off during the year in respect of industry sectors which constitute not less than 10 per cent of gross advances to customers are analysed as follows:

|  | Group          |                   |  |  |                           |                                      |
|--|----------------|-------------------|--|--|---------------------------|--------------------------------------|
|  | Gross advances | Impaired advances | Individually assessed loan impairment allowances | Collectively assessed loan impairment allowances | New impairment allowances | Advances written off during the year |
| <b>2011</b>                                    |                |                   |  |  |                           |                                      |
| Residential mortgages                          | 129,751        | 108               | (2)  | (34)   | 1                         | –                                    |
| Commercial, industrial and international trade | 114,661        | 1,272             | (884)  | (594)  | 511                       | 339                                  |
| Commercial real estate                         | 52,745         | 4                 | –  | (4)  | 21                        | –                                    |
| Other property-related lending                 | 95,236         | 42                | (4)  | (22)   | 6                         | 18                                   |
| <b>2010</b>                                    |                |                   |  |  |                           |                                      |
| Residential mortgages                          | 135,515        | 149               | –  | (55)   | 1                         | 1                                    |
| Commercial, industrial and international trade | 119,841        | 1,536             | (1,086)  | (506)  | 447                       | 100                                  |
| Commercial real estate                         | 43,804         | –                 | –  | (1)  | 4                         | –                                    |
| Other property-related lending                 | 94,060         | 84                | (23)   | (36)   | 22                        | 66                                   |

## 13. NON-BANK MAINLAND EXPOSURES

The analysis of non-bank Mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the Hong Kong Monetary Authority under the Banking (Disclosure) Rules with reference to the Hong Kong Monetary Authority return for non-bank Mainland exposures, which includes the Mainland exposures extended by the Bank and its overseas branches and overseas subsidiaries only.

|  | On-balance sheet exposure | Off-balance sheet exposure | Total exposures | Individually assessed allowances |
|--|---------------------------|----------------------------|-----------------|----------------------------------|
| <b>2011</b>  |                           |                            |                 |                                  |
| Mainland entities  | 30,082                    | 6,789                      | 36,871          | –                                |
| Companies and individuals outside Mainland where the credit is granted for use in Mainland         | 11,850                    | 1,813                      | 13,663          | 282                              |
| Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure | 341                       | –                          | 341             | –                                |
|  | 42,273                    | 8,602                      | 50,875          | 282                              |
| Exposures incurred by the Bank's mainland subsidiary   | 46,342                    | 10,208                     | 56,550          | 105                              |
|  | 88,615                    | 18,810                     | 107,425         | 387                              |
| <b>2010</b>  |                           |                            |                 |                                  |
| Mainland entities  | 20,940                    | 6,036                      | 26,976          | –                                |
| Companies and individuals outside Mainland where the credit is granted for use in Mainland         | 9,177                     | 2,278                      | 11,455          | 364                              |
| Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure | 738                       | 28                         | 766             | –                                |
|  | 30,855                    | 8,342                      | 39,197          | 364                              |
| Exposures incurred by the Bank's mainland subsidiary   | 36,318                    | 12,566                     | 48,884          | 229                              |
|  | 67,173                    | 20,908                     | 88,081          | 593                              |

## 14. CROSS-BORDER CLAIMS

Cross-border claims include receivables and loans and advances, and balances due from banks and holdings of certificates of deposit, bills, promissory notes, commercial paper and other negotiable debt instruments, as well as accrued interest and overdue interest on these assets. Claims are classified according to the location of the counterparties after taking into account the transfer of risk. For a claim guaranteed by a party situated in a country different from the counterparty, the risk will be transferred to the country of the guarantor. For a claim on the branch of a bank or other financial institutions, the risk will be transferred to the country where its head office is situated. Claims on individual countries or areas, after risk transfer, amounting to 10 per cent or more of the aggregate cross-border claims are shown as follows:

|                                   | Banks<br>& other<br>financial<br>institutions | Public<br>sector<br>entities | Sovereign<br>& other | Total   |
|-----------------------------------|---|------------------------------|----------------------|---------|
| <b>2011</b>                       |   |                              |                      |         |
| Asia-Pacific excluding Hong Kong: |   |                              |                      |         |
| – China                           | 92,136  | –                            | 43,076               | 135,212 |
| – Japan                           | 10,358  | –                            | 29,052               | 39,410  |
| – Other                           | 34,558  | 2,223                        | 10,328               | 47,109  |
|                                   | 137,052                                       | 2,223                        | 82,456               | 221,731 |
| The Americas:                     |   |                              |                      |         |
| – United States                   | 19,388  | –                            | 4,116                | 23,504  |
| – Other                           | 3,827   | 1,958                        | 12,177               | 17,962  |
|                                   | 23,215  | 1,958                        | 16,293               | 41,466  |
| Europe:                           |   |                              |                      |         |
| – United Kingdom                  | 10,525  | 199                          | 3,016                | 13,740  |
| – Other                           | 19,081  | 6,732                        | 9,984                | 35,797  |
|                                   | 29,606  | 6,931                        | 13,000               | 49,537  |
| <b>2010</b>                       |   |                              |                      |         |
| Asia-Pacific excluding Hong Kong: |   |                              |                      |         |
| – China                           | 75,515  | –                            | 23,467               | 98,982  |
| – Japan                           | 4,750   | –                            | 5,174                | 9,924   |
| – Other                           | 24,331  | 1,506                        | 8,886                | 34,723  |
|                                   | 104,596                                       | 1,506                        | 37,527               | 143,629 |
| The Americas:                     |   |                              |                      |         |
| – United States                   | 40,199  | 38                           | 5,405                | 45,642  |
| – Other                           | 2,975   | 1,458                        | 12,920               | 17,353  |
|                                   | 43,174  | 1,496                        | 18,325               | 62,995  |
| Europe:                           |   |                              |                      |         |
| – United Kingdom                  | 24,954  | –                            | 1,523                | 26,477  |
| – Other                           | 41,492  | 6,671                        | 9,949                | 58,112  |
|                                   | 66,446  | 6,671                        | 11,472               | 84,589  |

## ANALYSIS OF SHAREHOLDERS

| As at 31 December 2011           | Shareholders |                     | Shares of HK\$5 each |                     |
|----------------------------------|--------------|---------------------|----------------------|---------------------|
|                                  | Number       | Percentage of total | Number in millions   | Percentage of total |
| <b>Number of shares held</b>     |              |                     |                      |                     |
| 1 – 500                          | 6,693        | 33.05               | 1.6                  | 0.09                |
| 501 – 2,000                      | 6,459        | 31.89               | 7.9                  | 0.41                |
| 2,001 – 5,000                    | 3,389        | 16.73               | 11.6                 | 0.61                |
| 5,001 – 20,000                   | 2,822        | 13.93               | 29.0                 | 1.51                |
| 20,001 – 50,000                  | 577          | 2.85                | 18.1                 | 0.95                |
| 50,001 – 100,000                 | 170          | 0.84                | 12.3                 | 0.64                |
| 100,001 – 200,000                | 78           | 0.39                | 11.0                 | 0.58                |
| Over 200,000                     | 64           | 0.32                | 1,820.3              | 95.21               |
|                                  | 20,252       | 100.00              | 1,911.8              | 100.00              |
| <b>Geographical Distribution</b> |              |                     |                      |                     |
| Hong Kong                        | 19,918       | 98.35               | 1,908.7              | 99.83               |
| Malaysia                         | 70           | 0.34                | 0.4                  | 0.02                |
| Singapore                        | 44           | 0.22                | 2.0                  | 0.10                |
| Macau                            | 28           | 0.14                | 0.1                  | 0.01                |
| Canada                           | 58           | 0.29                | 0.1                  | 0.01                |
| United Kingdom                   | 35           | 0.17                | 0.0                  | 0.00                |
| United States of America         | 40           | 0.20                | 0.3                  | 0.01                |
| Australia                        | 32           | 0.16                | 0.1                  | 0.01                |
| Others                           | 27           | 0.13                | 0.1                  | 0.01                |
|                                  | 20,252       | 100.00              | 1,911.8              | 100.00              |

## SUBSIDIARIES\*

Everlasting International Limited  
 Fulcher Enterprises Company Limited  
 Full Wealth Investment Limited  
 Hang Seng Asset Management Pte Ltd  
 Hang Seng Bank (Bahamas) Limited  
 Hang Seng Bank (China) Limited  
 Hang Seng Bank (Trustee) Limited  
 Hang Seng Bank Trustee International Limited  
 Hang Seng Bullion Company Limited  
 Hang Seng Credit Limited  
 Hang Seng Credit (Bahamas) Limited  
*(in members' voluntary liquidation)*  
 Hang Seng Data Services Limited  
 Hang Seng Finance Limited  
 Hang Seng Finance (Bahamas) Limited  
 Hang Seng Financial Information Limited  
 Hang Seng Futures Limited  
 Hang Seng General Insurance (Hong Kong) Company Limited  
 Hang Seng Indexes Company Limited  
 Hang Seng Insurance Company Limited  
 Hang Seng Insurance (Bahamas) Limited  
 Hang Seng Investment Management Limited  
 Hang Seng Investment Services Limited  
 Hang Seng Life Limited  
 Hang Seng (Nominee) Limited  
 Hang Seng Real Estate Management Limited  
 Hang Seng Security Management Limited  
 Hang Seng Securities Limited  
 Haseba Investment Company Limited  
 Hayden Lake Limited  
 High Time Investments Limited  
 HSI International Limited  
 Imenson Limited  
 Mightyway Investments Limited  
 Silver Jubilee Limited  
 Yan Nin Development Company Limited

\* As defined in Section 2 of Hong Kong Companies Ordinance.

## CORPORATE INFORMATION AND CALENDAR

### CORPORATE INFORMATION

#### Honorary Senior Advisor to the Bank

The Honourable Lee Quo-Wei GBM, JP

### BOARD OF DIRECTORS

#### Chairman

Raymond K F Ch'ien GBS, CBE, JP

#### Vice-Chairman

Margaret Leung JP

#### Directors

John C C Chan GBS, JP

Marvin K T Cheung GBS, OBE, JP

L Y Chiang

Andrew H C Fung JP

Anita Y M Fung

Fred Zulu Hu

Jenkin Hui

Sarah C Legg

Eric K C Li GBS, OBE, JP

Vincent H S Lo GBS, JP

Dorothy K Y P Sit

Richard Y S Tang BBS, JP

Peter T S Wong JP

Michael W K Wu

#### Secretary

C C Li

### REGISTERED OFFICE

83 Des Voeux Road Central, Hong Kong

Telephone: (852) 2198 1111

Facsimile: (852) 2868 4047

Telex: 73311 73323

SWIFT: HASE HK HH

Website: [www.hangseng.com](http://www.hangseng.com)

### STOCK CODE

The Stock Exchange of Hong Kong Limited: 11

### REGISTRAR

Computershare Hong Kong Investor Services Limited

Shops 1712-1716, 17th Floor, Hopewell Centre

183 Queen's Road East, Wanchai, Hong Kong

### DEPOSITARY\*

The Bank of New York Mellon

PO Box 358516

Pittsburgh, PA 15252-8516, USA

Telephone: 1-201-680-6825

Toll free (domestic): 1-888-BNY-ADRS

Website: [www.bnymellon.com/shareowner](http://www.bnymellon.com/shareowner)

Email: [shrrelations@bnymellon.com](mailto:shrrelations@bnymellon.com)

\* The Bank offers investors in the United States a Sponsored Level-1 American Depositary Receipts Programme through The Bank of New York Mellon.

### ANNUAL REPORT 2011

This Annual Report 2011 in both English and Chinese is now available in printed form and on the Bank's website ([www.hangseng.com](http://www.hangseng.com)) and the website of Hong Kong Exchanges and Clearing Limited ("HKEX") ([www.hkexnews.hk](http://www.hkexnews.hk)).

Shareholders who:

- A) browse this Annual Report 2011 on the Bank's website and wish to receive a printed copy; or
- B) receive this Annual Report 2011 in either English or Chinese and wish to receive a printed copy in the other language version,

may send a request form, which can be obtained from the Bank's Registrar or downloaded from the Bank's website ([www.hangseng.com](http://www.hangseng.com)) or HKEX's website ([www.hkexnews.hk](http://www.hkexnews.hk)), to the Bank's Registrar:

Computershare Hong Kong Investor Services Limited

17M Floor, Hopewell Centre

183 Queen's Road East

Wanchai, Hong Kong

Facsimile: (852) 2529 6087

Email: [hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk)

If shareholders who have chosen (or are deemed to have chosen) to read this Annual Report 2011 on the Bank's website have difficulty in reading or gaining access to this Annual Report 2011 via the Bank's website for any reason, the Bank will promptly send this Annual Report 2011 in printed form free of charge upon the shareholders' request.

Shareholders may change their choice of means of receipt or language of the Bank's future corporate communications at any time, free of charge, by giving the Bank c/o the Bank's Registrar reasonable notice in writing or by email to [hangseng@computershare.com.hk](mailto:hangseng@computershare.com.hk).

**CALENDAR****2011 Full Year Results**

|                   |                  |
|-------------------|------------------|
| Announcement date | 27 February 2012 |
|-------------------|------------------|

**2011 Fourth Interim Dividend\***

|                            |                  |
|----------------------------|------------------|
| Announcement date          | 27 February 2012 |
| Book close and record date | 14 March 2012    |
| Payment date               | 29 March 2012    |

**2011 Annual Report**

to be posted to shareholders in late March 2012

**Annual General Meeting**

to be held on 11 May 2012

**2012 Half Year Results**

|                   |              |
|-------------------|--------------|
| Announcement date | 30 July 2012 |
|-------------------|--------------|

**2012 Interim Report**

to be posted to shareholders in late August 2012

***Proposed dates for 2012:*****2012 First Interim Dividend**

|                            |               |
|----------------------------|---------------|
| Announcement date          | 30 April 2012 |
| Book close and record date | 17 May 2012   |
| Payment date               | 31 May 2012   |

**2012 Second Interim Dividend**

|                            |                |
|----------------------------|----------------|
| Announcement date          | 30 July 2012   |
| Book close and record date | 15 August 2012 |
| Payment date               | 30 August 2012 |

**2012 Third Interim Dividend**

|                            |                  |
|----------------------------|------------------|
| Announcement date          | 9 October 2012   |
| Book close and record date | 26 October 2012  |
| Payment date               | 13 November 2012 |

**2012 Full Year Results**

|                   |              |
|-------------------|--------------|
| Announcement date | 4 March 2013 |
|-------------------|--------------|

**2012 Fourth Interim Dividend**

|                            |               |
|----------------------------|---------------|
| Announcement date          | 4 March 2013  |
| Book close and record date | 20 March 2013 |
| Payment date               | 3 April 2013  |

\* The Register of Shareholders of the Bank will be closed on Wednesday, 14 March 2012, during which no transfer of shares can be registered. To qualify for the fourth interim dividend, all transfers, accompanied by the relevant share certificates, must be lodged with the Bank's Registrar, Computershare Hong Kong Investor Services Limited, at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, for registration not later than 4:30 pm on Tuesday, 13 March 2012. The fourth interim dividend will be payable on Thursday, 29 March 2012 to shareholders on the Register of Shareholders of the Bank on Wednesday, 14 March 2012. Shares of the Bank will be traded ex-dividend as from Monday, 12 March 2012.



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**HANG SENG BANK**

**HANG SENG BANK LIMITED**

83 Des Voeux Road Central, Hong Kong

*Member HSBC Group*

