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 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 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 properties (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 62 "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, 55 and 62 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.

(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.

4. Principal accounting policies continued

(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.

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.

4. Principal accounting policies continued

(f) Loan impairment continued

(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.

(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.

4. Principal accounting policies continued

(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 is 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.

(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 upon inception 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 affects 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.

(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.

4. Principal accounting policies continued

(i) Hedge accounting continued

(iii) Hedge effectiveness testing continued

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.

(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 63.

4. Principal accounting policies continued

(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.

(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 properties

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)).

4. Principal accounting policies continued

(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.

(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.

4. Principal accounting policies continued

(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)(ii).

(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.

(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.

4. Principal accounting policies continued

(v) Impairment of assets continued

(ii) Available-for-sale financial assets continued

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).

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.

4. Principal accounting policies continued

(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.

(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.

4. Principal accounting policies continued

(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, is 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.

(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.

4. Principal accounting policies continued

(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.

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.

4. Principal accounting policies continued

(ac) Insurance contracts continued

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Some insurance contracts may contain discretionary participation features whereby the policyholder is entitled to additional payments whose amount and/or timing is at the discretion of the issuer. The discretionary element of these contracts is included in "Liabilities to customers under insurance contracts".

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

(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.

(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

During the year, the Group adopted a number of amendments to HKFRSs:

Amendments to HKFRS 7 "Financial Instruments: Disclosures – Transfers of Financial Assets"

The amendments require additional disclosures about transfers of financial assets that enable users of financial statements:

– to understand the relationship between transferred financial assets that are not derecognised in their entirety and associated liabilities; and

– to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

A new disclosure in respect of these transfers of financial assets is included in note 37. The disclosure for the comparative period in the first year of adoption is not required.

Amendments to HKAS 12 "Income Taxes"

Following the adoption of the amendments, the Group has remeasured the deferred tax relating to investment properties according to the tax consequence on the presumption that they are recovered entirely through sale retrospectively. The corresponding comparatives for prior year have been adjusted accordingly.

(i) For the Group

Figures in HK$m	As reported	Adjustment	Restated
Year ended 31 December 2011			
Share of profits from associates	3,990	42	4,032
Tax expense	2,533	(163)	2,370
Profit attributable to shareholders	16,680	205	16,885
Total comprehensive income	18,624	205	18,829
Earnings per share (HK$)	8.72	0.11	8.83
As at 31 December 2011			
Interest in associates	19,407	220	19,627
Deferred tax liabilities	4,037	(659)	3,378
Retained profits	48,640	879	49,519
As at 1 January 2011			
Interest in associates	15,666	178	15,844
Deferred tax liabilities	3,234	(496)	2,738
Retained profits	42,966	674	43,640

(ii) For the Bank

Figures in HK$m	As reported	Adjustment	Restated
As at 31 December 2011			
Deferred tax liabilities	1,801	(459)	1,342
Retained profits	22,818	459	23,277
As at 1 January 2011			
Deferred tax liabilities	1,617	(357)	1,260
Retained profits	19,637	357	19,994

6. Critical accounting estimates and judgements in applying accounting policies

The results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements. The principal accounting policies are described in Note 4 on the financial statements.

The accounting policies that are deemed critical to our results and financial position, in terms of the materiality of the items to which the policies are applied and the high degree of judgement involved, including the use of assumptions and estimation, are discussed below.

(i) Impairment allowances on loans and advances

Application of the Group's methodology for assessing loan impairment, as set out in note 4(f), involves considerable judgement and estimation.

For individually significant loans, judgement is required in determining first, whether there are indications that an impairment loss may have already been incurred, and then estimating the amount and timing of expected cash flows, which form the basis of the impairment loss that is recorded.

For collectively assessed loans, judgement is involved in selecting and applying the criteria for grouping together loans with similar credit characteristics, as well as in selecting and applying the statistical and other models used to estimate the losses incurred for each group of loans in the reporting period. The benchmarking of loss rates, the assessment of the extent to which historical losses are representative of current conditions and the ongoing refinement of modelling methodologies provide a means of identifying changes that may be required, but the process is inherently one of estimation.

(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 63 "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 has 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 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.

(iii) Impairment of available-for-sale financial assets

Judgment is required in determining whether or not a decline in fair value of an available-for-sale financial investment below its original cost is of such a nature as to constitute impairment, and thus whether an impairment loss needs to be recognised under HKAS 39 "Financial Instruments: Recognition and Measurement" ("HKAS 39").

6. Critical accounting estimates and judgements in applying accounting policies continued

(iv) 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.

(v) 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 42(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 62(d).

(vi) 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 2012

The HKICPA has issued a number of amendments and new standards which are not yet effective for the year ended 31 December 2012 and which have not been adopted in the financial statements. Key changes are summarised as follows:

– 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 expected that the overall impact of HKFRS 10 and HKFRS 11 on the consolidated financial statements is immaterial.

7. Possible impact of amendments and new standards issued but not yet effective for the year ended 31 December 2012 continued

– 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 is required to 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 2012 consolidated financial statements, the change would decrease total operating expenses and pre-tax profit, with no effect on the pension liability.

– 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.

– Amendments to HKFRS 10, HKFRS 12 and HKAS 27 "Investment Entities" issued in October 2012 introduced an exception to the principle that all subsidiaries shall be consolidated. The amendments require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss instead of consolidating all subsidiaries in its consolidated financial statements. The amendments are effective from annual periods on or after 1 January 2014 with early adoption permitted. Based on our initial assessment, we do not expect the amendments to have a material impact on the Group's 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.

7. Possible impact of amendments and new standards issued but not yet effective for the year ended 31 December 2012 continued

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

	2012	2011
Interest income arising from:		
– financial assets that are not at fair value through profit and loss	**21,537**	19,535
– trading assets	**272**	251
– financial assets designated at fair value	**52**	59
	21,861	19,845
of which:		
– interest income from listed investments	**1,426**	1,585
– interest income from unlisted investments	**3,481**	3,387
– interest income from impaired financial assets	**11**	18

(b) Interest expense

	2012	2011
Interest expense arising from:		
– financial liabilities that are not at fair value through profit and loss	**3,375**	3,010
– trading liabilities	**1,540**	1,099
– financial liabilities designated at fair value	**–**	–
	4,915	4,109
of which:		
– interest expense from debt securities in issue maturing after five years	**–**	–
– interest expense from customer accounts maturing after five years	**–**	–
– interest expense from subordinated liabilities	**289**	197

9. Net fee income

	2012	2011
– stockbroking and related services	**941**	1,285
– retail investment funds	**1,130**	905
– insurance agency	**367**	242
– account services	**353**	371
– private banking service fee	**93**	129
– remittances	**301**	273
– cards	**1,865**	1,676
– credit facilities	**356**	253
– trade services	**544**	461
– other	**348**	328
Fee income	**6,298**	5,923
Fee expense	**(1,212)**	(1,087)
	5,086	4,836
of which:		
Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading nor designated at fair value	**2,172**	1,967
– fee income	**3,116**	2,761
– fee expense	**(944)**	(794)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	**618**	685
– fee income	**767**	823
– fee expense	**(149)**	(138)

10. Trading income

	2012	2011
Foreign exchange	**1,986**	1,843
(Losses)/gains from hedging activities:		
– fair value hedge		
– on hedging instruments	**(37)**	(603)
– on the hedged items attributable to the hedged risk	**(22)**	538
– cash flow hedge		
– net hedging income	**–**	–
Securities, derivatives and other trading activities	**136**	18
	2,063	1,796

11. Net income/(loss) from financial instruments designated at fair value

	2012	2011
Net income/(loss) on assets designated at fair value which back insurance and investment contracts	**376**	(160)
Net change in fair value of other financial instruments designated at fair value	**–**	–
	376	(160)
of which dividend income from:		
– listed investments	**49**	16
– unlisted investments	**1**	1
	50	17

12. Dividend income

	2012	2011
Dividend income:		
– listed investments	**3**	4
– unlisted investments	**14**	13
	17	17

13. Net earned insurance premiums

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2012				
Gross written premiums	**221**	**11,219**	**8**	**11,448**
Movement in unearned premiums	**7**	**–**	**–**	**7**
Gross earned premiums	**228**	**11,219**	**8**	**11,455**
Gross written premiums ceded to reinsurers	**(46)**	**(453)**	**–**	**(499)**
Reinsurers' share of movement in unearned premiums	**(9)**	**–**	**–**	**(9)**
Reinsurers' share of gross earned premiums	**(55)**	**(453)**	**–**	**(508)**
Net earned insurance premiums	**173**	**10,766**	**8**	**10,947**
2011				
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

14. Other operating income

	2012	2011
Rental income from investment properties	**197**	174
Movement in present value of in-force long-term insurance business	**815**	595
Others	**169**	152
	1,181	921

15. Net insurance claims incurred and movement in policyholders' liabilities

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2012				
Claims, benefits and surrenders paid	**61**	**2,465**	**108**	**2,634**
Movement in provisions	**11**	**10,111**	**(91)**	**10,031**
Gross claims incurred and movement in policyholders' liabilities	**72**	**12,576**	**17**	**12,665**
Reinsurers' share of claims, benefits and surrenders paid	**(15)**	**(36)**	**–**	**(51)**
Reinsurers' share of movement in provisions	**(1)**	**(378)**	**–**	**(379)**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(16)**	**(414)**	**–**	**(430)**
Net insurance claims incurred and movement in policyholders' liabilities	**56**	**12,162**	**17**	**12,235**
2011				
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	95	11,526	(11)	11,610

16. Loan impairment charges

	Group		Bank	
	2012	2011	**2012**	2011
Net charge for impairment of loans and advances to customers (note 35(b)):				
Individually assessed impairment allowances:				
– new allowances	**(294)**	(359)	**(131)**	(297)
– releases	**224**	221	**135**	112
– recoveries	**13**	35	**4**	22
	(57)	(103)	**8**	(163)
Net charge for collectively assessed impairment allowances	**(329)**	(337)	**(332)**	(322)
Net charge for loan impairment	**(386)**	(440)	**(324)**	(485)

There was no impairment charge (2011: 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 2012 (2011: Nil).

17. Operating expenses

	2012	2011
Employee compensation and benefits:		
– salaries and other costs*	**3,800**	3,566
– retirement benefit costs		
– defined benefit scheme (note 59(a))	**240**	230
– defined contribution scheme (note 59(b))	**97**	92
	4,137	3,888
General and administrative expenses:		
– rental expenses	**559**	497
– other premises and equipment	**964**	959
– marketing and advertising expenses	**617**	559
– other operating expenses	**1,235**	1,176
	3,375	3,191
Depreciation of premises, plant and equipment (note 41(a))	**762**	700
Amortisation of intangible assets (note 42(c))	**115**	119
	8,389	7,898
* of which:		
share-based payments (note 60(e))	**70**	88
Cost efficiency ratio	**34.4%**	35.0%

Included in operating expenses are minimum lease payments under operating leases of HK$585 million (2011: HK$526 million).

18. The emoluments of the five highest paid individuals

(a) The aggregate emoluments

	2012	2011
Salaries, allowances and benefits in kind	**19**	20
Retirement scheme contributions	**2**	2
Variable bonuses	**24**	27
	45	49

(b) The numbers of the five highest paid individuals whose emoluments fell within the following bands were:

	2012 Number of Individuals	2011 Number of Individuals
HK$		
5,000,001 – 5,500,000	**–**	1
5,500,001 – 6,000,000	**–**	1
6,000,001 – 6,500,000	**1**	–
6,500,001 – 7,000,000	**1**	–
7,000,001 – 7,500,000	**–**	1
8,000,001 – 8,500,000	**–**	1
8,500,001 – 9,000,000	**1**	–
11,000,001 – 11,500,000	**1**	–
11,500,001 – 12,000,000	**1**	–
22,000,001 – 22,500,000	**–**	1
	5	5

The emoluments of the five highest paid individuals set out above include the emoluments of three (2011: two) Executive Directors and one Non-executive Director (2011: 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:

	Fees '000	Salaries, allowances and benefits in kind '000	Pension and Pension contribution[5] '000	Variable bonus[6] Cash[7] '000	Variable bonus[6] Shares[7] '000	Total 2012 '000	Total 2011 '000
Executive Directors							
Ms Rose Lee [1] (Appointed on 11 May 2012)	**47**	**3,874**	**251**	**4,329**	**2,886**	**11,387**	–
Mrs Margaret Leung [2] (Resigned on 11 May 2012)	**–**	**2,877**	**299**	**3,608**	**3,608**	**10,392**	22,396
Mr Andrew H C Fung [2] (Appointed on 10 October 2011)	**–**	**3,304**	**179**	**2,409**	**1,032**	**6,924**	2,460
Mr William W C Leung [2] (Resigned on 20 August 2011)	**–**	**–**	**–**	**–**	**–**	**–**	2,640
Non-Executive Directors							
Dr Raymond K F Ch'ien [4]	**575**	**–**	**–**	**–**	**–**	**575**	500
Dr John C C Chan [4]	**480**	**–**	**–**	**–**	**–**	**480**	430
Dr Marvin K T Cheung [4]	**500**	**–**	**–**	**–**	**–**	**500**	500
Ms L Y Chiang [4]	**340**	**–**	**–**	**–**	**–**	**340**	340
Ms Anita Y M Fung [3] (Appointed on 1 November 2011)	**340**	**–**	**–**	**–**	**–**	**340**	56
Dr Fred Zuliu Hu [4] (Appointed on 30 May 2011)	**340**	**–**	**–**	**–**	**–**	**340**	227
Mr Jenkin Hui [4]	**450**	**–**	**–**	**–**	**–**	**450**	400
Ms Sarah C Legg [3] (Appointed on 14 February 2011)	**340**	**–**	**–**	**–**	**–**	**340**	312
Dr Eric K C Li [4]	**600**	**–**	**–**	**–**	**–**	**600**	600
Dr Vincent H S Lo	**340**	**–**	**–**	**–**	**–**	**340**	340
Mr Mark S Mccombe [3] (Appointed on 14 February 2011 and resigned on 9 September 2011)	**–**	**–**	**–**	**–**	**–**	**–**	227
Mrs Dorothy K Y P Sit [2]	**–**	**5,031**	**14**	**2,474**	**1,060**	**8,579**	8,160
Mr Richard Y S Tang [4]	**685**	**–**	**–**	**–**	**–**	**685**	623
Mr Peter T S Wong [3]	**390**	**–**	**–**	**–**	**–**	**390**	340
Mr Michael W K Wu [4]	**340**	**–**	**–**	**–**	**–**	**340**	340
Past Directors	**–**	**–**	**2,251**	**–**	**–**	**2,251**	2,206
	5,767	**15,086**	**2,994**	**12,820**	**8,586**	**45,253**	43,097
2011	5,235	13,020	3,771	11,035	10,036		

Notes:

(1) Fee received by Ms Rose Lee as Non-Executive Director of the Bank for the period from 22 March 2012 to 11 May 2012 in the sum of HK$47,378 was surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy. No Director's fee was payable to Ms Rose Lee in her capacity as Executive Director of the Bank. The sums paid by the Bank to Ms Rose Lee as an executive of the Bank include sums paid by the Bank in respect of the period from 23 April 2012 to 11 May 2012 when Ms Rose Lee worked full-time at the Bank to facilitate a smooth handover before she formally took up the position of Chief Executive of the Bank on 11 May 2012.

(2) In line with the HSBC Group's remuneration policy, no Director's fees were paid to those Directors who were full time employees of the Bank or its subsidiaries.

(3) 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.

(4) Independent Non-Executive Director.

(5) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.3million in 2012. The Bank made contributions during 2012 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.

(6) 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). 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 61.

(7) The bonus – cash portion payable to the above directors was on non-deferred basis except HK$2.16 million (2011: HK$4.67 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$1.44 million (2011: HK$3.11 million) payable to Mrs Margaret Leung which was on non-deferred basis.

20. Auditors' remuneration

	Group		Bank	
	2012	2011	**2012**	2011
Statutory audit services	**13**	13	**8**	8
Non-statutory audit services and others	**8**	7	**6**	6
	21	20	**14**	14

21. Gains less losses from financial investments and fixed assets

	2012	2011
Net gains from disposal of available-for-sale equity securities:		
– reclassified from reserve	**(1)**	25
– net gains arising in the year	**2**	17
	1	42
Net gains from disposal of available-for-sale debt securities	**–**	11
Impairment of available-for-sale equity securities	**–**	–
Losses on disposal of loans and advances	**(4)**	–
Losses on disposal of fixed assets	**(2)**	(3)
	(5)	50

There were no impairment losses or gains less losses on disposal of held-to-maturity debt securities and financial liabilities measured at amortised cost for 2012 and 2011.

22. Net surplus on property revaluation

	2012	2011
Surplus of revaluation on investment properties (note 40(a))	**742**	982
Surplus of revaluation on assets held for sale	**34**	8
Reversal of revaluation deficit on premises (note 41(a))	**–**	2
	776	992

23. Tax expense

(a) Taxation in the consolidated income statement represents:

	2012	2011 (restated)
Current tax – provision for Hong Kong profits tax		
Tax for the year	**2,225**	1,942
Adjustment in respect of prior years	**(75)**	(14)
	2,150	1,928
Current tax – taxation outside Hong Kong		
Tax for the year	**92**	76
Adjustment in respect of prior years	**(2)**	–
	90	76
Deferred tax (note 50(b))		
Origination and reversal of temporary differences	**447**	366
Total tax expense	**2,687**	2,370

The current tax provision is based on the estimated assessable profit for 2012, 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 (2011: 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:

	2012	2011 (restated)
Profit before tax	**22,113**	19,255
Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2011: 16.5%)	**3,649**	3,177
Tax effect of:		
– different tax rates in other countries/areas	**(231)**	(290)
– non-taxable income and non-deductible expenses	**(181)**	(197)
– share of results of associates	**(888)**	(665)
– others	**338**	345
Actual charge for taxation	**2,687**	2,370

24. Profit attributable to shareholders

Of the profit attributable to shareholders, HK$13,044 million (2011: HK$14,247 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:

	2012	2011 (restated)
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	**13,044**	14,247
Dividends declared during the year by subsidiaries from retained profits	**1,080**	82
The Bank's profit for the year	**14,124**	14,329

25. Earnings per share

The calculation of earnings per share for 2012 is based on earnings of HK$19,426 million (HK$16,885 million in 2011 (restated)) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2011).

26. Dividends per share

(a) Dividends attributable to the year:

	2012		2011	
	per share HK$	HK$ million	per share 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	**2.00**	**3,824**	1.90	3,633
	5.30	**10,133**	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:

	2012	2011
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK$1.90 per share (2011: HK$1.90 per share)	**3,633**	3,633

27. Segmental analysis

Hong Kong Financial Reporting Standard 8 requires segmental disclosure to be based on the way that the Group's chief operating decision maker regards and manages the Group, with the amounts reported for each reportable segment being the measures reported to the Group's chief operating decision maker for the purpose of assessing segment performance and making decisions about operating matters. In 2012, there was a change in the reportable segments information reported internally to the Group's most senior executive management for the purposes of resources allocation and performance assessment. To align with the internal reporting information, the Group has presented the following five reportable segments. Corresponding amounts have been restated to ensure information is provided on a basis consistent with the revised segment information. Consolidation adjustments made in preparing the Group's financial statements and inter-segment elimination of income or expenses upon consolidation are included in the "Inter-segment eliminations". All such transactions are undertaken on an arm's length terms.

Hong Kong and other business segment

Retail Banking and Wealth Management activities offer a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance and wealth management. **Corporate and Commercial Banking** activities include the provision of financial services, payments and cash management, international trade finance, insurance, wealth management and tailored financial solutions to corporate and commercial customers. **Treasury** activities are mainly the provision of treasury operation services in credit, interest rates, foreign exchange, money markets and securities services. 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, equity shares and subordinated debt funding.

Mainland China business segment

Mainland China business segment comprises the business of Hang Seng Bank (China) Limited and our share of profit from Mainland associates.

27. Segmental analysis continued

(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 business segments by way of internal capital allocation and fund transfer-pricing mechanisms. Cost allocation is based on the direct costs incurred by the respective business segments and apportionment of management overheads. Bank-owned premises are reported under Other segment. When these premises are utilised by Global Businesses, notional rent will be charged to respective business segments based on market rate to reflect occupancy cost.

	Hong Kong and other business							
	Retail Banking and Wealth Management	Corporate and Commercial Banking	Treasury	Other	Total	Mainland China business	Inter-segment elimination	Total
2012								
Net interest income	8,761	5,289	1,676	(328)	15,398	1,548	–	16,946
Net fee income/(expense)	3,310	1,566	(28)	141	4,989	97	–	5,086
Trading income/(loss)	527	446	988	(12)	1,949	114	–	2,063
Net income/(loss) from financial instruments designated at fair value	381	(5)	–	–	376	–	–	376
Dividend income	–	7	–	10	17	–	–	17
Net earned insurance premiums	10,776	171	–	–	10,947	–	–	10,947
Other operating income	948	31	–	239	1,218	15	(52)	1,181
Total operating income	24,703	7,505	2,636	50	34,894	1,774	(52)	36,616
Net insurance claims incurred and movement in policyholders' liabilities	(12,120)	(115)	–	–	(12,235)	–	–	(12,235)
Net operating income before loan impairment charges	12,583	7,390	2,636	50	22,659	1,774	(52)	24,381
Loan impairment (charges)/releases	(375)	51	1	–	(323)	(63)	–	(386)
Net operating income	12,208	7,441	2,637	50	22,336	1,711	(52)	23,995
Operating expenses*	(4,747)	(1,730)	(273)	(316)	(7,066)	(1,375)	52	(8,389)
Impairment loss on intangible assets	–	–	–	–	–	–	–	–
Operating profit	7,461	5,711	2,364	(266)	15,270	336	–	15,606
Gains less losses from financial investments and fixed assets	–	(3)	–	(1)	(4)	(1)	–	(5)
Gain on disposal of a subsidiary	187	168	–	–	355	–	–	355
Net surplus on property revaluation	–	–	–	776	776	–	–	776
Share of profits from associates	291	2	–	–	293	5,088	–	5,381
Profit before tax	7,939	5,878	2,364	509	16,690	5,423	–	22,113
Share of profit before tax	35.9%	26.6%	10.7%	2.3%	75.5%	24.5%	–	100.0%
Share of profit before tax as a percentage of Hong Kong and other business	47.6%	35.2%	14.2%	3.0%	100.0%			
Operating profit excluding loan impairment charges	7,836	5,660	2,363	(266)	15,593	399	–	15,992
**Depreciation/amortisation included in operating expenses*	(45)	(26)	(4)	(691)	(766)	(111)	–	(877)
Total assets	292,217	289,667	326,257	63,480	971,621	125,232	(19,757)	1,077,096
Total liabilities	621,266	197,590	47,163	38,295	904,314	95,146	(14,687)	984,773
Interest in associates	1,644	8	–	–	1,652	23,003	–	24,655
Non-current assets acquired during the year	57	27	1	167	252	107	–	359

27. Segmental analysis continued

(a) Segment result continued

	Hong Kong and other business							
	Retail Banking and Wealth Management	Corporate and Commercial Banking	Treasury	Other	Total	Mainland China business	Inter-segment elimination	Total
2011 (restated)								
Net interest income	7,923	4,577	1,890	(77)	14,313	1,423	–	15,736
Net fee income/(expense)	3,285	1,321	(21)	139	4,724	112	–	4,836
Trading income/(loss)	322	511	878	(19)	1,692	104	–	1,796
Net (loss)/income from financial instruments designated at fair value	(146)	4	(1)	(17)	(160)	–	–	(160)
Dividend income	–	7	–	10	17	–	–	17
Net earned insurance premiums	10,820	241	–	–	11,061	–	–	11,061
Other operating income/(loss)	719	17	–	233	969	(4)	(44)	921
Total operating income	22,923	6,678	2,746	269	32,616	1,635	(44)	34,207
Net insurance claims incurred and movement in policyholders' liabilities	(11,487)	(123)	–	–	(11,610)	–	–	(11,610)
Net operating income before loan impairment charges	11,436	6,555	2,746	269	21,006	1,635	(44)	22,597
Loan impairment (charges)/releases	(252)	(219)	1	–	(470)	30	–	(440)
Net operating income	11,184	6,336	2,747	269	20,536	1,665	(44)	22,157
Operating expenses*	(4,620)	(1,731)	(247)	(151)	(6,749)	(1,193)	44	(7,898)
Impairment loss on intangible assets	(75)	(3)	–	–	(78)	–	–	(78)
Operating profit	6,489	4,602	2,500	118	13,709	472	–	14,181
Gains less losses from financial investments and fixed assets	20	14	12	5	51	(1)	–	50
Gain on disposal of a subsidiary	–	–	–	–	–	–	–	–
Net surplus on property revaluation	–	–	–	992	992	–	–	992
Share of profits from associates	–	–	–	318	318	3,714	–	4,032
Profit before tax	6,509	4,616	2,512	1,433	15,070	4,185	–	19,255
Share of profit before tax	33.8%	24.0%	13.0%	7.5%	78.3%	21.7%	–	100.0%
Share of profit before tax as a percentage of Hong Kong and other business	43.2%	30.6%	16.7%	9.5%	100.0%			
Operating profit excluding loan impairment charges	6,741	4,821	2,499	118	14,179	442	–	14,621
**Depreciation/amortisation included in operating expenses*	(125)	(29)	(5)	(556)	(715)	(104)	–	(819)
Total assets	259,484	260,616	302,763	65,249	888,112	119,196	(31,643)	975,665
Total liabilities	566,563	179,894	49,242	32,655	828,354	94,633	(26,956)	896,031
Interest in associates	–	–	–	1,418	1,418	18,209	–	19,627
Non-current assets acquired during the year	134	47	3	150	334	88	–	422

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.

	2012	2011 (restated)
Total operating income		
– Hong Kong	**33,682**	31,183
– Mainland	**1,774**	1,635
– Americas	**1,097**	1,339
– Others	**144**	122
– Inter-segment elimination	**(81)**	(72)
	36,616	34,207
Profit before tax		
– Hong Kong	**15,547**	13,677
– Mainland	**5,423**	4,185
– Americas	**1,047**	1,307
– Others	**96**	86
	22,113	19,255
Total assets		
– Hong Kong	**967,288**	882,751
– Mainland	**125,232**	119,196
– Americas	**61,296**	58,573
– Others	**11,768**	9,844
– Inter-segment elimination	**(88,488)**	(94,699)
	1,077,096	975,665
Total liabilities		
– Hong Kong	**901,369**	825,085
– Mainland	**95,146**	94,633
– Americas	**60,129**	56,623
– Others	**11,523**	9,672
– Inter-segment elimination	**(83,394)**	(89,982)
	984,773	896,031
Interest in associates		
– Hong Kong	**1,652**	1,418
– Mainland	**23,003**	18,209
– Americas	**–**	–
– Others	**–**	–
	24,655	19,627
Non-current assets*		
– Hong Kong	**29,872**	27,258
– Mainland	**1,032**	1,000
– Americas	**–**	–
– Others	**1**	1
	30,905	28,259
Contingent liabilities and commitments		
– Hong Kong	**271,065**	248,954
– Mainland	**36,587**	39,550
– Americas	**–**	–
– Others	**4,180**	3,531
	311,832	292,035

* 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 on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2012									
Assets									
Cash and balances with banks	27,082	–	–	–	–	–	–	–	27,082
Placings with and advances to banks	4,179	73,188	54,329	6,987	–	1,699	–	–	140,382
Trading assets	–	–	–	–	–	–	34,399	–	34,399
Financial assets designated at fair value	–	–	–	3,618	213	216	–	4,296	8,343
Derivative financial instruments	–	2	15	103	219	–	4,840	–	5,179
Loans and advances to customers	10,414	40,796	44,088	106,540	178,956	155,368	–	–	536,162
Financial investments:									
– available-for-sale investments	–	20,606	65,917	41,655	54,538	1,656	–	1,405	185,777
– held-to-maturity debt securities	–	46	445	5,420	22,841	38,879	–	–	67,631
Interest in associates	–	–	–	–	–	–	–	24,655	24,655
Investment properties	–	–	–	–	–	–	–	4,860	4,860
Premises, plant and equipment	–	–	–	–	–	–	–	19,262	19,262
Intangible assets	–	–	–	–	–	–	–	6,783	6,783
Other assets	5,706	4,094	2,892	3,098	209	220	–	362	16,581
	47,381	138,732	167,686	167,421	256,976	198,038	39,239	61,623	1,077,096
Liabilities									
Current, savings and other deposit accounts	566,743	102,915	64,682	33,919	888	–	–	–	769,147
Deposits from banks	3,369	13,982	2,491	3	–	–	–	–	19,845
Trading liabilities	–	–	–	–	–	–	59,853	–	59,853
Financial liabilities designated at fair value	1	–	–	–	–	463	–	–	464
Derivative financial instruments	–	–	20	30	1,053	252	2,763	–	4,118
Certificates of deposit and other debt securities in issue:									
– certificates of deposit in issue	–	–	–	7,353	3,938	–	–	–	11,291
Other liabilities	7,745	4,627	2,592	2,960	55	18	–	3,656	21,653
Liabilities to customers under insurance contracts	–	–	–	–	–	–	–	81,670	81,670
Current tax liabilities	–	–	–	588	–	–	–	–	588
Deferred tax liabilities	–	–	–	–	–	–	–	4,323	4,323
Subordinated liabilities	–	–	–	–	–	11,821	–	–	11,821
	577,858	121,524	69,785	44,853	5,934	12,554	62,616	89,649	984,773
of which:									
Certificates of deposit included in:									
– trading assets	–	–	–	–	–	–	400	–	400
– financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– available-for-sale investments	–	380	2,758	3,408	668	–	–	36	7,250
– held-to-maturity debt securities	–	3	–	189	790	2,996	–	–	3,978
	–	383	2,758	3,597	1,458	2,996	400	36	11,628
Debt securities included in:									
– trading assets	–	–	–	–	–	–	32,914	–	32,914
– financial assets designated at fair value	–	–	–	3,618	213	216	–	–	4,047
– available-for-sale investments	–	20,226	63,159	38,248	53,869	1,656	–	1,035	178,193
– held-to-maturity debt securities	–	43	445	5,231	22,051	35,883	–	–	63,653
	–	20,269	63,604	47,097	76,133	37,755	32,914	1,035	278,807
Certificates of deposit in issue included in:									
– trading liabilities	–	–	–	–	–	–	–	–	–
– financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– issue at amortised cost	–	–	–	7,353	3,938	–	–	–	11,291
	–	–	–	7,353	3,938	–	–	–	11,291

28. Analysis of assets and liabilities by remaining maturity continued

	Group								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2011 (restated)									
Assets									
Cash and balances with banks	39,533	–	–	–	–	–	–	–	39,533
Placings with and advances to banks	9,089	47,698	43,687	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
Loans and 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	–	–	–	–	–	–	–	19,627	19,627
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	101,923	110,771	168,007	237,390	170,466	68,702	53,468	975,665
Liabilities									
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	–	–	–	–	–	–	–	3,378	3,378
Subordinated liabilities	–	–	–	2,328	–	9,518	–	–	11,846
	512,239	108,573	74,807	39,008	8,347	10,173	63,220	79,664	896,031
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

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2012									
Assets									
Cash and balances with banks	24,797	–	–	–	–	–	–	–	24,797
Placings with and advances to banks	–	37,961	35,901	984	–	–	–	–	74,846
Trading assets	–	–	–	–	–	–	31,635	–	31,635
Derivative financial instruments	–	2	12	102	184	–	4,334	–	4,634
Loans and advances to customers	10,171	35,059	32,959	90,266	161,518	146,761	–	–	476,734
Amounts due from subsidiaries	885	61,814	6,796	4,214	7,112	322	–	–	81,143
Financial investments:									
– available-for-sale investments	–	19,981	63,601	35,066	24,467	1,656	–	643	145,414
Investments in subsidiaries	–	–	–	–	–	–	–	14,778	14,778
Interest in associates	–	–	–	–	–	–	–	5,172	5,172
Investment properties	–	–	–	–	–	–	–	2,988	2,988
Premises, plant and equipment	–	–	–	–	–	–	–	14,135	14,135
Intangible assets	–	–	–	–	–	–	–	406	406
Other assets	5,572	2,628	1,638	283	11	103	–	31	10,266
	41,425	157,445	140,907	130,915	193,292	148,842	35,969	38,153	886,948
Liabilities									
Current, savings and other deposit accounts	553,445	100,059	56,950	19,912	167	–	–	–	730,533
Deposits from banks	3,289	8,169	2,491	3	–	–	–	–	13,952
Trading liabilities	–	–	–	–	–	–	27,776	–	27,776
Derivative financial instruments	–	–	3	25	430	252	2,807	–	3,517
Certificates of deposit and other debt securities in issue:									
– certificates of deposit in issue	–	–	–	7,353	3,938	–	–	–	11,291
Amounts due to subsidiaries	5,441	9,330	510	–	–	–	–	1	15,282
Other liabilities	7,433	3,914	1,771	848	40	19	–	3,464	17,489
Current tax liabilities	–	–	–	509	–	–	–	–	509
Deferred tax liabilities	–	–	–	–	–	–	–	1,687	1,687
Subordinated liabilities	–	–	–	–	–	11,821	–	–	11,821
	569,608	121,472	61,725	28,650	4,575	12,092	30,583	5,152	833,857
of which:									
Certificates of deposit included in:									
– trading assets	–	–	–	–	–	–	400	–	400
– financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– available-for-sale investments	–	380	2,758	2,836	668	–	–	36	6,678
– held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	380	2,758	2,836	668	–	400	36	7,078
Debt securities included in:									
– trading assets	–	–	–	–	–	–	30,150	–	30,150
– financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– available-for-sale investments	–	19,601	60,843	32,230	23,799	1,656	–	501	138,630
– held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	19,601	60,843	32,230	23,799	1,656	30,150	501	168,780
Certificates of deposit in issue included in:									
– trading liabilities	–	–	–	–	–	–	–	–	–
– financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– issue at amortised cost	–	–	–	7,353	3,938	–	–	–	11,291
	–	–	–	7,353	3,938	–	–	–	11,291

28. Analysis of assets and liabilities by remaining maturity continued

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2011 (restated)									
Assets									
Cash and balances with banks	36,475	–	–	–	–	–	–	–	36,475
Placings with and advances to banks	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
Loans and 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
Liabilities									
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	–	–	–	–	–	–	–	1,342	1,342
Subordinated liabilities	–	–	–	2,328	–	9,518	–	–	11,846
	504,107	108,051	64,927	24,992	7,206	9,740	39,397	5,259	763,679
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

29. Accounting classifications

The tables below set out the Group's classification of financial assets and liabilities:

	Group						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2012							
Cash and balances with banks	–	–	–	–	–	27,082	27,082
Placings with and advances to banks	–	–	–	–	140,382	–	140,382
Derivative financial instruments	4,840	–	339	–	–	–	5,179
Loans and advances to customers	–	–	–	–	536,162	–	536,162
Investment securities	33,344	8,343	185,777	67,631	–	–	295,095
Acceptances and endorsements	–	–	–	–	–	5,264	5,264
Other financial assets	1,055	–	–	–	–	10,013	11,068
Total financial assets	39,239	8,343	186,116	67,631	676,544	42,359	1,020,232
Non-financial assets							56,864
Total assets							1,077,096
Current, savings and other deposit accounts	38,113	–	–	–	–	769,147	807,260
Deposits from banks	–	–	–	–	–	19,845	19,845
Derivative financial instruments	2,763	–	1,355	–	–	–	4,118
Certificates of deposit and other debt securities in issue	248	–	–	–	–	11,291	11,539
Other financial liabilities	21,492	–	–	–	–	12,705	34,197
Subordinated liabilities	–	–	–	–	–	11,821	11,821
Liabilities to customers under investment contracts	–	464	–	–	–	–	464
Acceptances and endorsements	–	–	–	–	–	5,264	5,264
Total financial liabilities	62,616	464	1,355	–	–	830,073	894,508
Non-financial liabilities							90,265
Total liabilities							984,773

29. Accounting classifications continued

	Group						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total (restated)
2011							
Cash and balances with banks	–	–	–	–	–	39,533	39,533
Placings with and advances to banks	–	–	–	–	107,742	–	107,742
Derivative financial instruments	4,531	–	179	–	–	–	4,710
Loans and 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							48,314
Total assets							975,665
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							80,059
Total liabilities							896,031

29. Accounting classifications continued

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2012							
Cash and balances with banks	–	–	–	–	–	24,797	24,797
Placings with and advances to banks	–	–	–	–	74,846	–	74,846
Derivative financial instruments	4,334	–	300	–	–	–	4,634
Loans and advances to customers	–	–	–	–	476,734	–	476,734
Investment securities	30,580	–	145,414	–	–	–	175,994
Amounts due from subsidiaries	–	–	–	–	–	81,143	81,143
Acceptances and endorsements	–	–	–	–	–	2,548	2,548
Other financial assets	1,055	–	–	–	–	7,147	8,202
Total financial assets	35,969	–	145,714	–	551,580	115,635	848,898
Non-financial assets							38,050
Total assets							886,948
Current, savings and other deposit accounts	6,036	–	–	–	–	730,533	736,569
Deposits from banks	–	–	–	–	–	13,952	13,952
Derivative financial instruments	2,807	–	710	–	–	–	3,517
Certificates of deposit and other debt securities in issue	248	–	–	–	–	11,291	11,539
Amounts due to subsidiaries	–	–	–	–	–	15,282	15,282
Other financial liabilities	21,492	–	–	–	–	11,448	32,940
Subordinated liabilities	–	–	–	–	–	11,821	11,821
Acceptances and endorsements	–	–	–	–	–	2,548	2,548
Total financial liabilities	30,583	–	710	–	–	796,875	828,168
Non-financial liabilities							5,689
Total liabilities							833,857

29. Accounting classifications continued

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total (restated)
2011							
Cash and balances with banks	–	–	–	–	–	36,475	36,475
Placings with and advances to banks	–	–	–	–	47,724	–	47,724
Derivative financial instruments	4,368	–	68	–	–	–	4,436
Loans and 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
Total assets							810,545
Current, savings and 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 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							4,675
Total liabilities							763,679

30. Cash and balances with banks

	Group		Bank	
	2012	2011	**2012**	2011
Cash in hand	**11,041**	9,491	**10,754**	9,247
Balances with central banks	**8,973**	7,102	**7,486**	5,027
Balances with banks	**7,068**	22,940	**6,557**	22,201
	27,082	39,533	**24,797**	36,475

31. Placings with and advances to banks

	Group		Bank	
	2012	2011	**2012**	2011
Placings with and advances to banks maturing within one month	**77,367**	56,787	**37,961**	24,950
Placings with and advances to banks maturing after one month but less than one year	**61,316**	49,326	**36,885**	22,774
Placings with and advances to banks maturing after one year	**1,699**	1,629	**–**	–
	140,382	107,742	**74,846**	47,724

There were no overdue advances, impaired advances and rescheduled advances to banks at 31 December 2012 by the Group and the Bank (2011: Nil).

32. Trading assets

	Group 2012	Group 2011	Bank 2012	Bank 2011
Treasury bills	**26,808**	54,220	**26,808**	54,220
Certificates of deposit	**400**	432	**400**	432
Other debt securities	**6,106**	9,006	**3,342**	5,361
Debt securities	**33,314**	63,658	**30,550**	60,013
Investment funds	**30**	7	**30**	7
Total trading securities	**33,344**	63,665	**30,580**	60,020
Other*	**1,055**	506	**1,055**	506
Total trading assets	**34,399**	64,171	**31,635**	60,526
Debt securities:				
– listed in Hong Kong	**3,046**	4,550	**3,046**	4,550
– listed outside Hong Kong	**238**	717	**238**	717
	3,284	5,267	**3,284**	5,267
– unlisted	**30,030**	58,391	**27,266**	54,746
	33,314	63,658	**30,550**	60,013
Investment funds:				
– listed in Hong Kong	**30**	7	**30**	7
Total trading securities	**33,344**	63,665	**30,580**	60,020
Debt securities:				
Issued by public bodies:				
– central governments and central banks	**31,105**	60,800	**29,846**	59,365
– other public sector entities	**80**	82	**80**	82
	31,185	60,882	**29,926**	59,447
Issued by other bodies:				
– banks	**934**	963	**573**	438
– corporate entities	**1,195**	1,813	**51**	128
	2,129	2,776	**624**	566
	33,314	63,658	**30,550**	60,013
Investment funds:				
Issued by corporate entities	**30**	7	**30**	7
Total trading securities	**33,344**	63,665	**30,580**	60,020

* This represents amount receivable from counterparties on trading transactions not yet settled.

33. Financial assets designated at fair value

	Group		Bank	
	2012	2011	**2012**	2011
Certificates of deposit	**–**	1	**–**	–
Other debt securities	**4,047**	3,998	**–**	140
Debt securities	**4,047**	3,999	**–**	140
Equity shares	**1,632**	473	**–**	–
Investment funds	**2,664**	3,624	**–**	–
	8,343	8,096	**–**	140
Debt securities:				
– listed in Hong Kong	**38**	15	**–**	–
– listed outside Hong Kong	**336**	182	**–**	140
	374	197	**–**	140
– unlisted	**3,673**	3,802	**–**	–
	4,047	3,999	**–**	140
Equity shares:				
– listed in Hong Kong	**1,632**	473	**–**	–
Investment funds:				
– listed in Hong Kong	**30**	23	**–**	–
– listed outside Hong Kong	**599**	150	**–**	–
	629	173	**–**	–
– unlisted	**2,035**	3,451	**–**	–
	2,664	3,624	**–**	–
	8,343	8,096	**–**	140
Debt securities:				
Issued by public bodies:				
– central governments and central banks	**181**	140	**–**	140
– other public sector entities	**1**	53	**–**	–
	182	193	**–**	140
Issued by other bodies:				
– banks	**3,687**	3,725	**–**	–
– corporate entities	**178**	81	**–**	–
	3,865	3,806	**–**	–
	4,047	3,999	**–**	140
Equity shares:				
Issued by banks	**370**	109	**–**	–
Issued by public sector entities	**13**	5	**–**	–
Issued by corporate entities	**1,249**	359	**–**	–
	1,632	473	**–**	–
Investment funds:				
Issued by banks	**400**	1,869	**–**	–
Issued by corporate entities	**2,264**	1,755	**–**	–
	2,664	3,624	**–**	–
	8,343	8,096	**–**	140

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 62(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 2012, the amount of cash flow hedging reserve transferred to the income statement comprised HK$68 million (2011: HK$197 million) included in net interest income and HK$260 million (2011: Nil) included in net trading income.

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2012 and 2011. During the years of 2012 and 2011, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur. In 2012, there was no gain recognised due to termination of such forecast transactions (2011: 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**
At 31 December 2012			
Cash inflows from assets	**10,994**	**10,567**	**2,734**
Cash outflows from liabilities	**–**	**–**	**–**
Net cash inflows	**10,994**	**10,567**	**2,734**
At 31 December 2011			
Cash inflows from assets	48,385	34,920	9,681
Cash outflows from liabilities	–	–	–
Net cash inflows	48,385	34,920	9,681

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					
	2012			2011		
	Contract amounts	Derivative assets	Derivative liabilities	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Exchange rate contracts:						
– spot and forward foreign exchange	**607,543**	**2,865**	**1,238**	533,604	1,760	1,090
– currency swaps	**3,819**	**21**	**22**	4,827	82	76
– currency options purchased	**104,562**	**138**	**–**	81,173	401	–
– currency options written	**110,249**	**–**	**158**	86,786	–	415
– other exchange rate contracts	**37**	**–**	**1**	131	3	1
	826,210	**3,024**	**1,419**	706,521	2,246	1,582
Interest rate contracts:						
– interest rate swaps	**192,293**	**1,438**	**1,292**	267,229	2,042	1,590
– other interest rate contracts	**128**	**–**	**–**	8,547	1	–
	192,421	**1,438**	**1,292**	275,776	2,043	1,590
Equity and other contracts:						
– equity swaps	**2,841**	**125**	**16**	4,557	5	290
– equity options purchased	**11,732**	**199**	**–**	11,436	117	–
– equity options written	**2,018**	**–**	**30**	1,673	–	29
– other equity contracts	**–**	**–**	**–**	7	–	–
– spot and forward contracts and others	**1,023**	**54**	**6**	3,359	120	14
	17,614	**378**	**52**	21,032	242	333
Total derivatives held for trading	**1,036,245**	**4,840**	**2,763**	1,003,329	4,531	3,505
Derivatives managed in conjunction with financial assets designated at fair value						
Interest rate contracts:						
– interest rate swaps	**–**	**–**	**–**	140	–	3
Cash flow hedge derivatives						
Exchange rate contracts:						
– currency swaps	**4,263**	**280**	**3**	–	–	–
Interest rate contracts:						
– interest rate swaps	**10,313**	**20**	**2**	48,385	66	21
	14,576	**300**	**5**	48,385	66	21
Fair value hedge derivatives						
Interest rate contracts:						
– interest rate swaps	**27,426**	**39**	**1,350**	27,046	113	1,319
Total derivatives	**1,078,247**	**5,179**	**4,118**	1,078,900	4,710	4,848

34. Derivative financial instruments continued

	Bank					
	2012			2011		
	Contract amounts	**Derivative assets**	**Derivative liabilities**	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Exchange rate contracts:						
– spot and forward foreign exchange	**576,318**	**2,737**	**1,155**	514,440	1,656	972
– currency swaps	**3,068**	**21**	**20**	4,827	82	76
– currency options purchased	**104,762**	**139**	**–**	81,342	401	–
– currency options written	**110,394**	**–**	**316**	86,918	–	560
– other exchange rate contracts	**37**	**–**	**1**	131	3	1
	794,579	**2,897**	**1,492**	687,658	2,142	1,609
Interest rate contracts:						
– interest rate swaps	**142,922**	**1,209**	**1,141**	217,264	1,791	1,371
– other interest rate contracts	**128**	**–**	**–**	8,547	1	–
	143,050	**1,209**	**1,141**	225,811	1,792	1,371
Equity and other contracts:						
– equity swaps	**5,432**	**140**	**137**	8,444	285	294
– equity options purchased	**2,015**	**28**	**–**	1,673	29	–
– equity options written	**2,018**	**–**	**31**	1,673	–	29
– other equity contracts	**–**	**–**	**–**	7	–	–
– spot and forward contracts and others	**1,358**	**60**	**6**	3,359	120	14
	10,823	**228**	**174**	15,156	434	337
Total derivatives held for trading	**948,452**	**4,334**	**2,807**	928,625	4,368	3,317
Derivatives managed in conjunction with financial assets designated at fair value						
Interest rate contracts:						
– interest rate swaps	**–**	**–**	**–**	140	–	3
Cash flow hedge derivatives						
Exchange rate contracts:						
– currency swaps	**4,263**	**280**	**3**	–	–	–
Interest rate contracts:						
– interest rate swaps	**10,190**	**20**	**2**	48,385	66	21
	14,453	**300**	**5**	48,385	66	21
Fair value hedge derivatives						
Interest rate contracts:						
– interest rate swaps	**10,059**	**–**	**705**	10,609	2	761
Total derivatives	**972,964**	**4,634**	**3,517**	987,759	4,436	4,102

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 2012 and 2011 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
2012						
Exchange rate contracts:						
– spot and forward foreign exchange	**544,790**	**4,197**	**728**	**517,479**	**3,759**	**596**
– currency swaps	**7,330**	**481**	**58**	**7,330**	**481**	**58**
– currency options purchased	**104,578**	**1,874**	**1,487**	**104,724**	**1,877**	**1,488**
– other exchange rate contracts	**37**	**–**	**–**	**37**	**–**	**–**
	656,735	**6,552**	**2,273**	**629,570**	**6,117**	**2,142**
Interest rate contracts:						
– interest rate swaps	**230,032**	**2,121**	**472**	**163,171**	**1,666**	**278**
– interest rate options purchased	**–**	**–**	**–**	**–**	**–**	**–**
	230,032	**2,121**	**472**	**163,171**	**1,666**	**278**
Equity and other contracts:						
– equity swaps	**2,841**	**300**	**42**	**5,432**	**478**	**58**
– equity options purchased	**2,015**	**152**	**101**	**2,015**	**152**	**101**
– others	**–**	**–**	**–**	**–**	**–**	**–**
	4,856	**452**	**143**	**7,447**	**630**	**159**

The total fair value of the derivatives at 31 December 2012 was HK$2,965 million (31 December 2011: HK$2,411 million) after taking into account the effect of valid bilateral netting agreement amounting to HK$1,641 million (31 December 2011: HK$1,664 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
2011						
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	–
	585,551	4,916	2,935	572,599	4,674	2,821
Interest rate contracts:						
– interest rate swaps	342,801	2,624	950	276,398	2,099	757
– interest rate options purchased	–	–	–	–	–	–
	342,801	2,624	950	276,398	2,099	757
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	–	–	–	–	–	–
	5,473	371	114	9,361	893	145

35. Loans and advances to customers

(a) Loans and advances to customers

	Group		Bank	
	2012	2011	**2012**	2011
Gross loans and advances to customers	**537,571**	482,241	**477,817**	427,038
Less: loan impairment allowances				
– individually assessed	**(681)**	(896)	**(503)**	(789)
– collectively assessed	**(728)**	(771)	**(580)**	(620)
	536,162	480,574	**476,734**	425,629

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

	Group		Bank	
	2012	2011	**2012**	2011
	%	%	**%**	%
Loan impairment allowances:				
– individually assessed	**0.13**	0.19	**0.11**	0.18
– collectively assessed	**0.13**	0.16	**0.12**	0.15
Total loan impairment allowances	**0.26**	0.35	**0.23**	0.33

35. Loans and advances to customers continued

(b) Loan impairment allowances against loans and advances to customers

	Group		
	Individually assessed	Collectively assessed	Total
2012			
At 1 January	**896**	**771**	**1,667**
Amounts written off	**(277)**	**(416)**	**(693)**
Recoveries of advances written off in previous years	**13**	**47**	**60**
New impairment allowances charged to income statement (note 16)	**294**	**376**	**670**
Impairment allowances released to income statement (note 16)	**(237)**	**(47)**	**(284)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(7)**	**(3)**	**(10)**
Exchange	**(1)**	**–**	**(1)**
At 31 December	**681**	**728**	**1,409**
2011			
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

	Bank		
	Individually assessed	Collectively assessed	Total
2012			
At 1 January	**789**	**620**	**1,409**
Amounts written off	**(276)**	**(416)**	**(692)**
Recoveries of advances written off in previous years	**4**	**47**	**51**
New impairment allowances charged to income statement (note 16)	**131**	**379**	**510**
Impairment allowances released to income statement (note 16)	**(139)**	**(47)**	**(186)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(6)**	**(3)**	**(9)**
At 31 December	**503**	**580**	**1,083**
2011			
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

35. Loans and advances to customers continued

(c) Impaired loans and advances to customers and allowances

	Group		Bank	
	2012	2011	**2012**	2011
Gross impaired loans and advances	**1,340**	1,584	**1,120**	1,404
Individually assessed allowances	**(681)**	(896)	**(503)**	(789)
Net impaired loans and advances	**659**	688	**617**	615
Individually assessed allowances as a percentage of gross impaired loans and advances	**50.8%**	56.6%	**44.9%**	56.2%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	**0.25%**	0.33%	**0.23%**	0.33%

Impaired loans and advances to customers are those loans and advances where objective evidence exists that full repayment of principal or interest is considered unlikely.

	Group		Bank	
	2012	2011	**2012**	2011
Gross individually assessed impaired loans and advances	**1,190**	1,493	**970**	1,313
Individually assessed allowances	**(681)**	(896)	**(503)**	(789)
	509	597	**467**	524
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	**0.22%**	0.31%	**0.20%**	0.31%
Amount of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**498**	423	**320**	346

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 loans and advances to customers, only the amount of collateral up to the gross loans and advances is included.

35. Loans and advances to customers continued

(d) Overdue loans and advances to customers

Loans and advances that are more than three months overdue and their expression as a percentage of gross loans and advances to customers are as follows:

	Group		Bank	
		%		%
2012				
Gross loans and advances which have been overdue with respect to either principal or interest for periods of:				
– more than three months but not more than six months	**114**	**–**	**98**	**–**
– more than six months but not more than one year	**143**	**–**	**56**	**–**
– more than one year	**662**	**0.2**	**583**	**0.2**
	919	**0.2**	**737**	**0.2**
of which:				
– individually impaired allowances	**(515)**		**(345)**	
– covered portion of overdue loans and advances	**241**		**84**	
– uncovered portion of overdue loans and advances	**678**		**653**	
– current market value held against the covered portion of overdue loans and advances	**373**		**157**	
2011				
Gross loans and advances which have been overdue with respect to either principal or interest for periods of:				
– more than three months but not more than six months	228	–	225	–
– more than six months but not more than one year	72	–	52	–
– more than one year	756	0.2	675	0.2
	1,056	0.2	952	0.2
of which:				
– individually impaired allowances	(822)		(743)	
– covered portion of overdue loans and advances	172		147	
– uncovered portion of overdue loans and advances	884		805	
– current market value held against the covered portion of overdue loans and advances	368		312	

Loans and advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid at year-end. Loans and advances repayable by regular instalments are treated as overdue when an instalment payment is overdue and remains unpaid at year-end. Loans and 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 loans and advances have remained continuously outside the approved limit advised to the borrower for more than the overdue period in question.

35. Loans and advances to customers continued

(e) Rescheduled loans and advances to customers

Rescheduled loans and advances to customers and their expression as a percentage of gross loans and advances to customers are as follows:

	Group		Bank	
		%		%
2012	**196**	**–**	**133**	**–**
2011	180	–	90	–

Rescheduled loans and advances to customers are those loans and advances 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 loans and 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 loans and advances to customers" (note 35(d)).

(f) Segmental analysis of loans and advances to customers by geographical area

Loans and 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 a loan is guaranteed by a party located in an area that is different from that of the counterparty.

	Group				
	Gross loans and advances	Individually impaired loans and advances	Overdue loans and advances	Individually assessed allowances	Collectively assessed allowances
At 31 December 2012					
Hong Kong	**447,310**	**948**	**718**	**503**	**561**
Rest of Asia-Pacific	**84,428**	**218**	**201**	**177**	**156**
Others	**5,833**	**24**	**–**	**1**	**11**
	537,571	**1,190**	**919**	**681**	**728**
At 31 December 2011 (restated)					
Hong Kong	404,890	1,315	929	779	603
Rest of Asia-Pacific	72,256	158	127	115	158
Others	5,095	20	–	2	10
	482,241	1,493	1,056	896	771

	Bank				
	Gross loans and advances	Individually impaired loans and advances	Overdue loans and advances	Individually assessed allowances	Collectively assessed allowances
At 31 December 2012					
Hong Kong	**431,548**	**925**	**715**	**502**	**539**
Rest of Asia-Pacific	**43,490**	**21**	**22**	**–**	**38**
Others	**2,779**	**24**	**–**	**1**	**3**
	477,817	**970**	**737**	**503**	**580**
At 31 December 2011					
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
	427,038	1,313	952	789	620

35. Loans and advances to customers continued

(g) Gross loans and advances to customers by industry sector

The analysis of gross loans and advances to customers by industry sector based on categories and definitions used by the Hong Kong Monetary Authority is as follows:

	Group			
	2012		2011	
		% of gross advances covered by collateral		% of gross advances covered by collateral (restated)
Gross loans and advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	**29,771**	**41.5**	28,575	52.6
– property investment	**103,675**	**88.8**	100,659	88.1
– financial concerns	**3,595**	**32.7**	2,648	24.7
– stockbrokers	**325**	**44.0**	1,227	5.5
– wholesale and retail trade	**16,445**	**37.4**	11,511	44.5
– manufacturing	**15,212**	**38.1**	13,121	34.6
– transport and transport equipment	**5,774**	**66.0**	6,309	64.0
– recreational activities	**244**	**45.6**	62	24.9
– information technology	**1,430**	**45.6**	899	2.0
– other	**26,766**	**52.7**	21,859	52.5
	203,237	**67.1**	186,870	69.3
Individuals				
– loans and advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**13,886**	**100.0**	14,405	99.7
– loans and advances for the purchase of other residential properties	**125,176**	**100.0**	107,563	100.0
– credit card loans and advances	**20,389**	**–**	18,547	–
– other	**13,514**	**25.1**	13,887	29.4
	172,965	**82.2**	154,402	81.5
Total gross loans and advances for use in Hong Kong	**376,202**	**74.0**	341,272	74.8
Trade finance	**47,555**	**18.7**	49,552	27.8
Gross loans and advances for use outside Hong Kong	**113,814**	**25.8**	91,417	25.3
Gross loans and advances to customers	**537,571**	**58.9**	482,241	60.6

35. Loans and advances to customers continued

(g) Gross loans and advances to customers by industry sector continued

	Bank			
	2012		2011	
		% of gross advances covered by collateral		% of gross advances covered by collateral (restated)
Gross loans and advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	**29,771**	**41.5**	28,575	52.6
– property investment	**103,243**	**88.9**	100,039	88.2
– financial concerns	**3,595**	**32.7**	2,648	24.7
– stockbrokers	**325**	**44.0**	1,227	5.5
– wholesale and retail trade	**16,445**	**37.4**	11,511	44.5
– manufacturing	**15,212**	**38.1**	13,121	34.6
– transport and transport equipment	**5,398**	**63.8**	5,887	61.4
– recreational activities	**244**	**45.6**	62	24.9
– information technology	**1,430**	**45.6**	899	2.0
– other	**26,290**	**53.7**	21,851	52.5
	201,953	**67.2**	185,820	69.3
Individuals				
– loans and advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**7,904**	**100.0**	6,950	99.3
– loans and advances for the purchase of other residential properties	**124,277**	**100.0**	105,525	100.0
– credit card advances	**20,389**	**–**	18,547	–
– other	**13,510**	**25.1**	13,885	29.4
	166,080	**81.5**	144,907	80.3
Total gross loans and advances for use in Hong Kong	**368,033**	**73.7**	330,727	74.1
Trade finance	**47,555**	**18.7**	49,552	27.8
Gross loans and advances for use outside Hong Kong	**62,229**	**13.7**	46,759	8.6
Gross loans and advances to customers	**477,817**	**60.4**	427,038	61.6

35. Loans and advances to customers continued

(h) Net investments in finance leases

Loans and 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:

	Group		Bank	
	2012	2011	**2012**	2011
Finance leases	**–**	1	**–**	1
Hire purchase contracts	**3,824**	4,102	**3,447**	3,679
	3,824	4,103	**3,447**	3,680

	Group		
	Present value of minimum lease payments receivable	**Interest income relating to future periods**	**Total minimum lease payments receivable**
2012			
Amounts receivable:			
– within one year	**360**	**60**	**420**
– after one year but within five years	**937**	**194**	**1,131**
– after five years	**2,528**	**302**	**2,830**
	3,825	**556**	**4,381**
Loans impairment allowances	**(1)**		
Net investments in finance leases and hire purchase contracts	**3,824**		
2011			
Amounts receivable:			
– within one year	454	64	518
– after one year but within five years	1,027	198	1,225
– after five years	2,647	314	2,961
	4,128	576	4,704
Loans impairment allowances	(25)		
Net investments in finance leases and hire purchase contracts	4,103		

35. Loans and 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
2012			
Amounts receivable:			
– within one year	**329**	**53**	**382**
– after one year but within five years	**806**	**170**	**976**
– after five years	**2,313**	**286**	**2,599**
	3,448	**509**	**3,957**
Loans impairment allowances	**(1)**		
Net investments in finance leases and hire purchase contracts	**3,447**		
2011			
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
	3,705	519	4,224
Loans impairment allowances	(25)		
Net investments in finance leases and hire purchase contracts	3,680		

36. Financial investments

	Group		Bank	
	2012	2011	**2012**	2011
Financial investments:				
– which may be repledged or resold by counterparties	**88**	156	**88**	156
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**253,320**	209,034	**145,326**	104,986
	253,408	209,190	**145,414**	105,142
Held-to-maturity debt securities at amortised cost	**67,631**	59,911	**–**	–
Available-for-sale at fair value:				
– debt securities	**185,443**	149,020	**145,308**	105,080
– equity shares	**295**	217	**106**	62
– investment funds	**39**	42	**–**	–
	253,408	209,190	**145,414**	105,142
Treasury bills	**98,262**	43,296	**98,262**	43,296
Certificates of deposit	**11,228**	9,386	**6,678**	6,006
Other debt securities	**143,584**	156,249	**40,368**	55,778
Debt securities	**253,074**	208,931	**145,308**	105,080
Equity shares	**295**	217	**106**	62
Investment funds	**39**	42	**–**	–
	253,408	209,190	**145,414**	105,142

There were no overdue debt securities at 31 December 2012 (31 December 2011: Nil).

(a) Held-to-maturity debt securities

	Group		Bank	
	2012	2011	**2012**	2011
Listed in Hong Kong	**1,616**	977	**–**	–
Listed outside Hong Kong	**13,578**	10,234	**–**	–
	15,194	11,211	**–**	–
Unlisted	**52,437**	48,700	**–**	–
	67,631	59,911	**–**	–
Issued by public bodies:				
– central governments and central banks	**808**	309	**–**	–
– other public sector entities	**8,345**	8,273	**–**	–
	9,153	8,582	**–**	–
Issued by other bodies:				
– banks	**38,225**	36,304	**–**	–
– corporate entities	**20,253**	15,025	**–**	–
	58,478	51,329	**–**	–
	67,631	59,911	**–**	–
Fair value of held-to-maturity debt securities:				
– listed	**16,602**	11,879	**–**	–
– unlisted	**56,114**	51,517	**–**	–
	72,716	63,396	**–**	–

There were no held-to-maturity debt securities determined to be impaired at 31 December 2012 for the Group and the Bank (31 December 2011: Nil).

36. Financial investments continued

(b) Available-for-sale debt securities

	Group		Bank	
	2012	2011	**2012**	2011
Listed in Hong Kong	**15,009**	20,164	**15,009**	20,158
Listed outside Hong Kong	**34,588**	29,793	**20,844**	16,901
	49,597	49,957	**35,853**	37,059
Unlisted	**135,846**	99,063	**109,455**	68,021
	185,443	149,020	**145,308**	105,080
Issued by public bodies:				
– central governments and central banks	**127,779**	78,350	**116,669**	63,537
– other public sector entities	**15,293**	17,748	**5,095**	9,307
	143,072	96,098	**121,764**	72,844
Issued by other bodies:				
– banks	**38,629**	48,947	**19,802**	28,402
– corporate entities	**3,742**	3,975	**3,742**	3,834
	42,371	52,922	**23,544**	32,236
	185,443	149,020	**145,308**	105,080

At 31 December 2012 and 2011, 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

	Group		Bank	
	2012	2011	**2012**	2011
Listed in Hong Kong	**65**	48	**–**	–
Listed outside Hong Kong	**6**	18	**6**	18
	71	66	**6**	18
Unlisted	**224**	151	**100**	44
	295	217	**106**	62
Issued by banks	**6**	18	**–**	–
Issued by corporate entities	**289**	199	**106**	62
	295	217	**106**	62

There were no available-for-sale equity securities individually determined to be impaired during the year of 2012 and 2011 for the Group and the Bank.

36. Financial investments continued

(d) Available-for-sale investment funds

	Group		Bank	
	2012	2011	**2012**	2011
Unlisted	**39**	42	**–**	–
Issued by corporate entities	**39**	42	**–**	–

There were no available-for-sale investment funds individually determined to be impaired during the year of 2012 and 2011 for the Group and the Bank.

37. Transfers of financial assets not qualifying for derecognition

The Group enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties or to special purpose entities. These transfers may give rise to full or partial derecognition of the financial assets concerned.

– Full derecognition occurs when the Group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, and transfers substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.

– Partial derecognition occurs when the Group sells or otherwise transfers financial assets in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These financial assets are recognised in the balance sheet to the extent of the Group's continuing involvement.

The majority of transferred financial assets that do not qualify for derecognition are securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets transferred to third parties that did not qualify for derecognition during 2012.

Financial assets and associated financial liabilities not qualifying for full derecognition

	Group and Bank			
	2012			
	Carrying amount of transferred assets	Carrying amount of associated liabilities	Fair value of associated liabilities	Net position
Transaction not qualifying for derecognition:				
Securities lending agreements	**88**	**–**	**–**	**88**

As at 31 December 2012, there were no outstanding transferred financial assets in which the Group has a continuing involvement, that were derecognised in their entirety.

38. Investments in subsidiaries

	Bank	
	2012	2011
Unlisted shares, at cost	**14,778**	14,434

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	RMB4,817,500,000
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$5,826,184,570
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.

39. Interest in associates

	Group		Bank	
	2012	2011 (restated)	**2012**	2011
Unlisted investments, at cost	**–**	–	**912**	912
Listed investments, at cost	**–**	–	**4,260**	4,260
Share of net assets	**24,151**	19,095	**–**	–
Intangible asset	**29**	57	**–**	–
Goodwill	**475**	475	**–**	–
	24,655	19,627	**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
Unlisted				
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
Guangzhou GuangZheng Hang Seng Securities Investment Advisory Co., Ltd.	People's Republic of China	Conduct market/ securities analysis and publish research reports	33.00%	RMB44,680,000
Listed				
Industrial Bank Co., Ltd.	People's Republic of China	Banking	12.80%	RMB10,786,000,000

Interest in associates included listed investment of HK$22,099 million (2011: HK$17,199 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$28,409 million (2011: HK$21,307 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. ("Industrial Bank") and Yantai Bank Co., Ltd. ("Yantai Bank") are owned directly by the Bank. Our partnership with Guangzhou Securities Company Limited to set up the joint venture securities investment advisory company – Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company Limited ("GuangZheng Securities") was incorporated in May 2012. The Group has a 33% stake in the joint venture.

The Group's interest in Industrial Bank has been accounted for as an associate using the equity method as the Group has representation in both the Board and Executive Committee of Industrial Bank, and the ability to participate in the decision making process.

For the year ended 31 December 2012, the financial results of Industrial Bank, Yantai Bank and GuangZheng Securities were included in the financial statements based on financial statements drawn up to 30 September 2012, but taking into account any changes in the subsequent period from 1 October 2012 to 31 December 2012 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.

39. 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
2012						
100 per cent	**3,705,017**	**3,524,666**	**180,351**	**103,764**	**62,507**	**41,257**
The Group's effective interest	**478,174**	**454,023**	**24,151**	**13,536**	**8,155**	**5,381**
2011 (restated)						
100 per cent	2,628,083	2,486,515	141,568	66,218	36,056	30,162
The Group's effective interest	340,228	321,133	19,095	8,713	4,681	4,032

There was no impairment loss on our interest in associates for the years ended 31 December 2012 and 2011.

40. Investment properties

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2012, and were updated for any material changes in the valuation as at 31 December 2012. 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	
	2012	2011	**2012**	2011
At 1 January	**4,314**	3,251	**2,806**	2,100
Surplus on revaluation credited to income statement (note 22)	**742**	982	**447**	613
Transfer (to)/from assets held for sale	**(228)**	77	**(228)**	77
Transfer from/(to) premises (note 41(a))	**32**	4	**(37)**	16
At 31 December	**4,860**	4,314	**2,988**	2,806

(b) Terms of lease

	Group		Bank	
	2012	2011	**2012**	2011
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,510**	1,495	**668**	776
– medium leases (10 to 50 years unexpired)	**3,350**	2,819	**2,320**	2,030
Held outside Hong Kong:				
– medium leases (10 to 50 years unexpired)	**–**	–	**–**	–
	4,860	4,314	**2,988**	2,806

40. 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	
	2012	2011	**2012**	2011
Direct operating expenses arising from investment properties	**23**	24	**15**	16
Direct operating expenses from investment properties that generated rental income	**22**	22	**14**	15

The Group's total future minimum lease payments receivable under non-cancellable operating leases are as follows:

	Group		Bank	
	2012	2011	**2012**	2011
Less than one year	**155**	146	**101**	100
Over one year but within five years	**86**	71	**55**	52
	241	217	**156**	152

41. Premises, plant and equipment

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2012, and were updated for any material changes in the valuation as at 31 December 2012. 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**
2012			
Cost or valuation:			
At 1 January	**17,377**	**3,686**	**21,063**
Additions	**–**	**214**	**214**
Disposals	**–**	**(107)**	**(107)**
Elimination of accumulated depreciation on revalued premises	**(497)**	**–**	**(497)**
Surplus on revaluation:			
– credited to premises revaluation reserve	**2,222**	**–**	**2,222**
Transfer to assets held for sale	**(322)**	**–**	**(322)**
Transfer to investment property (note 40(a))	**(32)**	**–**	**(32)**
Other	**–**	**(42)**	**(42)**
At 31 December	**18,748**	**3,751**	**22,499**
Accumulated depreciation:			
At 1 January	**(7)**	**(3,073)**	**(3,080)**
Charge for the year (note 17)	**(492)**	**(270)**	**(762)**
Written off on disposal	**–**	**100**	**100**
Transfer to assets held for sale	**2**	**–**	**2**
Elimination of accumulated depreciation on revalued premises	**497**	**–**	**497**
Other	**–**	**6**	**6**
At 31 December	**–**	**(3,237)**	**(3,237)**
Net book value at 31 December	**18,748**	**514**	**19,262**

41. Premises, plant and equipment continued

(a) Movement of premises, plant and equipment continued

	Group		
	Premises	Plant and equipment	Total
2011			
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 40(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

41. Premises, plant and equipment continued

(a) Movement of premises, plant and equipment continued

	Bank		
	Premises	Plant and equipment	Total
2012			
Cost or valuation:			
At 1 January	12,812	3,161	15,973
Additions	–	122	122
Disposals	–	(91)	(91)
Elimination of accumulated depreciation on revalued premises	(375)	–	(375)
Surplus on revaluation:			
– credited to premises revaluation reserve	1,468	–	1,468
Transfer to assets held for sale	(132)	–	(132)
Transfer from investment property (note 40(a))	37	–	37
Other	–	(42)	(42)
At 31 December	13,810	3,150	16,960
Accumulated depreciation:			
At 1 January	–	(2,724)	(2,724)
Charge for the year	(375)	(197)	(572)
Written off on disposal	–	90	90
Elimination of accumulated depreciation on revalued premises	375	–	375
Other	–	6	6
At 31 December	–	(2,825)	(2,825)
Net book value at 31 December	13,810	325	14,135

41. Premises, plant and equipment continued

(a) Movement of premises, plant and equipment continued

	Bank		
	Premises	Plant and equipment	Total
2011			
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 40(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

(b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2012	2011	**2012**	2011
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,801**	1,615	**1,331**	1,226
– medium leases (10 to 50 years unexpired)	**16,140**	14,963	**12,477**	11,584
– short leases (under 10 years unexpired)	**–**	–	**–**	–
Held outside Hong Kong:				
– long leases (over 50 years unexpired)	**9**	8	**–**	–
– medium leases (10 to 50 years unexpired)	**798**	784	**2**	2
	18,748	17,370	**13,810**	12,812

(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	
	2012	2011	**2012**	2011
Cost less accumulated depreciation at 31 December	**2,884**	3,023	**1,302**	1,300

42. Intangible assets

	Group		Bank	
	2012	2011	**2012**	2011
Present value of in-force long-term insurance business	**6,003**	5,188	**–**	–
Internally developed software	**400**	399	**400**	398
Acquired software	**51**	46	**6**	10
Goodwill	**329**	329	**–**	–
	6,783	5,962	**406**	408

(a) Movement of present value of in-force long-term insurance business ("PVIF")

	Group	
	2012	2011
At 1 January	**5,188**	4,593
Addition from current year new business	**1,198**	1,062
Movement from in-force business	**(383)**	(467)
At 31 December	**6,003**	5,188

The key assumptions used in the computation of "PVIF" are as follows:

	2012	2011
Risk discount rate	**6.3%**	8.3%
Expenses inflation	**3.0%**	3.0%
Average lapse rate:		
– 1st year	**2.7%**	3.4%
– 2nd year onwards	**0.5%**	0.8%

The sensitivity of PVIF valuation to changes in individual assumptions at the balance sheet dates is shown in note 62(d).

(b) Goodwill

	Group		Bank	
	2012	2011	**2012**	2011
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 2012, there was no impairment of goodwill (2011: 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 2012, the PVIF and the expected value of future business. The PVIF 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 42(a) and 62(d).

42. Intangible assets continued

(c) Movement of internally developed application software and acquired software

	Group		Bank	
	2012	2011	**2012**	2011
Cost:				
At 1 January	**978**	817	**921**	776
Additions	**145**	168	**125**	155
Disposals	**(75)**	(10)	**(74)**	(10)
Exchange and others	**42**	3	**42**	–
At 31 December	**1,090**	978	**1,014**	921
Accumulated amortisation:				
At 1 January	**(533)**	(345)	**(513)**	(334)
Charge for the year (note 17)	**(115)**	(119)	**(104)**	(111)
Written off on disposal	**15**	10	**15**	10
Impairment	**–**	(78)	**–**	(78)
Exchange and others	**(6)**	(1)	**(6)**	–
At 31 December	**(639)**	(533)	**(608)**	(513)
Net book value at 31 December	**451**	445	**406**	408

During 2012, there was no impairment on internally developed application software and acquired software (2011: HK$78 million).

43. Other assets

	Group		Bank	
	2012	2011	**2012**	2011
Items in the course of collection from other banks	**5,642**	4,513	**5,642**	4,513
Prepayments and accrued income	**2,999**	2,844	**966**	950
Assets held for sale*				
– repossessed assets	**16**	3	**14**	–
– other assets held for sale	**593**	35	**406**	35
Acceptances and endorsements	**5,264**	4,697	**2,548**	3,052
Retirement benefit assets	**31**	34	**31**	34
Other accounts	**2,036**	1,637	**659**	598
	16,581	13,763	**10,266**	9,182

* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2012 and 2011.

There are no significant impaired, overdue or rescheduled other assets at the year-end.

44. Current, savings and other deposit accounts

	Group		Bank	
	2012	2011	**2012**	2011
Current, savings and other deposit accounts:				
– as stated in balance sheet	**769,147**	699,857	**730,533**	661,012
– structured deposits reported as trading liabilities (note 45)	**38,113**	30,923	**6,036**	7,288
	807,260	730,780	**736,569**	668,300
By type:				
– demand and current accounts	**68,071**	57,977	**68,071**	57,975
– savings accounts	**495,880**	431,863	**483,700**	421,003
– time and other deposits	**243,309**	240,940	**184,798**	189,322
	807,260	730,780	**736,569**	668,300

45. Trading liabilities

	Group		Bank	
	2012	2011	**2012**	2011
Structured certificates of deposit in issue (note 47)	**–**	2,641	**–**	2,641
Other debt securities in issue (note 47)	**248**	542	**248**	542
Structured deposits (note 44)	**38,113**	30,923	**6,036**	7,288
Short positions in securities and others	**21,492**	25,606	**21,492**	25,606
	59,853	59,712	**27,776**	36,077

46. Financial liabilities designated at fair value

	Group		Bank	
	2012	2011	**2012**	2011
Liabilities to customers under investment contracts	**464**	434	**–**	–

47. Certificates of deposit and other debt securities in issue

	Group		Bank	
	2012	2011	**2012**	2011
Certificates of deposit and other debt securities in issue:				
– as stated in balance sheet	**11,291**	9,284	**11,291**	9,284
– structured certificates of deposit in issue reported as trading liabilities (note 45)	**–**	2,641	**–**	2,641
– other structured debt securities in issue reported as trading liabilities (note 45)	**248**	542	**248**	542
	11,539	12,467	**11,539**	12,467
By type:				
– certificates of deposit in issue	**11,291**	11,925	**11,291**	11,925
– other debt securities in issue	**248**	542	**248**	542
	11,539	12,467	**11,539**	12,467

48. Other liabilities

	Group		Bank	
	2012	2011	**2012**	2011
Items in the course of transmission to other banks	**8,153**	7,027	**8,148**	6,977
Accruals	**3,248**	2,956	**2,245**	1,980
Acceptances and endorsements	**5,264**	4,697	**2,548**	3,052
Retirement benefit liabilities	**2,449**	3,260	**2,449**	3,260
Others	**2,539**	2,198	**2,099**	1,691
	21,653	20,138	**17,489**	16,960

49. Liabilities to customers under insurance contracts

	Group					
	2012			2011		
	Gross	**Reinsurance**	**Net**	Gross	Reinsurance	Net
Non-life insurance						
Unearned premiums	–	–	–	245	(77)	168
Notified claims	–	–	–	183	(27)	156
Claims incurred but not reported	–	–	–	37	(8)	29
Other	–	–	–	54	(1)	53
	–	–	–	519	(113)	406
Policyholders' liabilities						
Life (non-linked)	**81,579**	**(414)**	**81,165**	71,523	(42)	71,481
Life (linked)	**91**	**–**	**91**	183	–	183
	81,670	**(414)**	**81,256**	71,706	(42)	71,664
	81,670	**(414)**	**81,256**	72,225	(155)	72,070

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**
2012			
Unearned premiums			
At 1 January	**245**	**(77)**	**168**
Gross written premiums	**221**	**(46)**	**175**
Gross earned premiums	**(228)**	**55**	**(173)**
Exchange and other movements	**(238)**	**68**	**(170)**
At 31 December	**–**	**–**	**–**
Notified and incurred but not reported claims			
At 1 January			
– notified claims	**183**	**(27)**	**156**
– claims incurred but not reported	**37**	**(8)**	**29**
	220	**(35)**	**185**
Claims paid	**(61)**	**15**	**(46)**
Claims incurred	**72**	**(16)**	**56**
	11	**(1)**	**10**
Exchange and other movements	**(231)**	**36**	**(195)**
At 31 December			
– notified claims	**–**	**–**	**–**
– claims incurred but not reported	**–**	**–**	**–**
	–	**–**	**–**
Other	**–**	**–**	**–**
	–	**–**	**–**

49. Liabilities to customers under insurance contracts continued

(a) Non-life insurance continued

	Group		
	Gross	Reinsurance	Net
2011			
Unearned premiums			
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
Notified and incurred but not reported claims			
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
Other	54	(1)	53
	519	(113)	406

49. Liabilities to customers under insurance contracts continued

(b) Policyholders' liabilities

	Group		
	Gross	**Reinsurance**	**Net**
2012			
Life (non-linked)			
At 1 January	**71,523**	**(42)**	**71,481**
Benefits paid	**(2,465)**	**36**	**(2,429)**
Claims incurred and movement in policyholders' liabilities	**12,576**	**(414)**	**12,162**
Exchange and other movements	**(55)**	**6**	**(49)**
At 31 December	**81,579**	**(414)**	**81,165**
Life (linked)			
At 1 January	**183**	**–**	**183**
Benefits paid	**(108)**	**–**	**(108)**
Claims incurred and movement in policyholders' liabilities	**17**	**–**	**17**
Exchange and other movements	**(1)**	**–**	**(1)**
At 31 December	**91**	**–**	**91**
	81,670	**(414)**	**81,256**

	Group		
	Gross	Reinsurance	Net
2011			
Life (non-linked)			
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
Life (linked)			
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
	71,706	(42)	71,664

50. Current tax and deferred tax

(a) Current tax and deferred tax are represented in the balance sheet:

	Group		Bank	
	2012	2011 (restated)	**2012**	2011 (restated)
Current taxation recoverable (included in "Other assets")	**21**	13	**–**	–
Current tax liabilities:				
Provision for Hong Kong profits tax	**576**	293	**499**	260
Provision for taxation outside Hong Kong	**12**	12	**10**	10
	588	305	**509**	270
Deferred tax liabilities	**4,323**	3,378	**1,687**	1,342
	4,911	3,683	**2,196**	1,612

(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:

	Group						
	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**
2012							
At 1 January	**93**	**2,410**	**(88)**	**(31)**	**1**	**993**	**3,378**
(Credited)/charged to income statement (note 23(a))	**(14)**	**(66)**	**1**	**–**	**–**	**526**	**447**
Charged to reserves	**–**	**358**	**–**	**41**	**2**	**99**	**500**
Exchange and others	**–**	**–**	**–**	**(1)**	**–**	**(1)**	**(2)**
At 31 December	**79**	**2,702**	**(87)**	**9**	**3**	**1,617**	**4,323**
2011 (restated)							
At 1 January	106	1,852	(85)	28	14	823	2,738
(Credited)/charged to income statement (note 23(a))	(13)	(52)	(3)	–	–	434	366
Charged/(credited) to reserves	–	610	–	(59)	(13)	(264)	274
At 31 December	93	2,410	(88)	(31)	1	993	3,378

50. 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
2012							
At 1 January	**92**	**1,950**	**(87)**	**(34)**	**1**	**(580)**	**1,342**
(Credited)/charged to income statement	**(18)**	**(58)**	**11**	**–**	**–**	**27**	**(38)**
Charged to reserves	**–**	**243**	**–**	**39**	**2**	**99**	**383**
At 31 December	**74**	**2,135**	**(76)**	**5**	**3**	**(454)**	**1,687**
2011 (restated)							
At 1 January	101	1,511	(84)	25	14	(307)	1,260
Credited to income statement	(9)	(43)	(3)	–	–	(8)	(63)
Charged/(credited) to reserves	–	482	–	(59)	(13)	(265)	145
At 31 December	92	1,950	(87)	(34)	1	(580)	1,342

(c) Deferred tax assets not recognised

At the balance sheet date, the Group has not recognised deferred tax assets in respect of tax losses and revaluation loss on debt securities of subsidiaries amounting to HK$33 million (2011: HK$64 million) which are considered unlikely to be utilised. Of this amount, HK$33 million (2011: HK$30 million) has no expiry date whereas an amount of HK$34 milllion for 2011 is scheduled to expire within five years.

(d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised as at 31 December 2012 (31 December 2011: Nil).

51. Subordinated liabilities

Nominal value	Description	Group 2012	Group 2011	Bank 2012	Bank 2011
Amount owed to third parties					
US$300 million	Callable floating rate subordinated notes due July 2017 (1)	**–**	2,328	**–**	2,328
Amount owed to HSBC Group undertakings					
US$775 million	Floating rate subordinated loan debt due December 2020 (2)	**6,007**	6,022	**6,007**	6,022
US$450 million	Floating rate subordinated loan debt due July 2021 (3)	**3,488**	3,496	**3,488**	3,496
US$300 million	Floating rate subordinated loan debt due July 2022 (1&4)	**2,326**	–	**2,326**	–
		11,821	11,846	**11,821**	11,846
Representing:					
– measured at amortised cost		**11,821**	11,846	**11,821**	11,846

(1) The Bank exercised its option to redeem these subordinated notes at par of US$300m and replenished them with a new issue of US$300m subordinated loan debt in July 2012.
(2) Interest rate at three-month US dollar LIBOR plus 1.79 per cent, payable quarterly, to the maturity date.
(3) Interest rate at three-month US dollar LIBOR plus 2.05 per cent, payable quarterly, to the maturity date.
(4) Interest rate at three-month US dollar LIBOR plus 4.06 per cent, payable quarterly, to the maturity date.

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

52. Share capital

Authorised:

The authorised share capital of the Bank is HK$11,000 million (2011: HK$11,000 million) divided into 2,200 million shares (2011: 2,200 million shares) of HK$5 each.

	2012	2011
Issued and fully paid:		
1,911,842,736 shares (2011: 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 (2011: Nil).

53. 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 2012, 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$4,866 million (2011: HK$4,226 million) and HK$4,497 million (2011: HK$3,896 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$216 million in relation to premises classified as assets held for sale, included in "Other assets" in the consolidated balance sheet at 31 December 2012 (31 December 2011: HK$22 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.

53. 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:

	Bank	
	2012	2011
Retained profits (including proposed dividends)	**31,888**	26,910
Premises revaluation reserve	**10,802**	9,871
Cash flow hedging reserve	**17**	6
Available-for-sale investment reserve:		
– on debt securities	**27**	(174)
– on equity securities	**68**	10
Capital redemption reserve	**99**	99
Other reserves	**631**	585
Total reserves (including proposed dividends)	**43,532**	37,307
Retained profits (including proposed dividends)		
At beginning of the year	**26,451**	23,270
Opening adjustment for the adoption of the amendments to HKAS 12	**459**	357
As restated	**26,910**	23,627
Dividends to shareholders:		
– dividends approved in respect of the previous year	**(3,633)**	(3,633)
– dividends declared in respect of the current year	**(6,309)**	(6,309)
Transfer	**298**	224
Total comprehensive income for the year	**14,622**	13,001
	31,888	26,910
Premises revaluation reserve		
At beginning of the year	**9,871**	7,654
Transfer	**(298)**	(224)
Total comprehensive income for the year	**1,229**	2,441
	10,802	9,871
Cash flow hedging reserve		
At beginning of the year	**6**	72
Total comprehensive income for the year	**11**	(66)
	17	6
Available-for-sale investment reserve		
At beginning of the year	**(164)**	143
Total comprehensive income for the year	**259**	(307)
	95	(164)
Capital redemption reserve		
At beginning of the year	**99**	99
Total comprehensive income for the year	**–**	–
	99	99
Other reserve		
At beginning of the year	**585**	524
Costs of share-based payment arrangements	**47**	61
Total comprehensive income for the year	**(1)**	–
	631	585
Total reserves (including proposed dividends)	**43,532**	37,307

53. Reserves continued

At 31 December 2012, 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$24,773 million (2011 (restated): HK$20,630 million). After considering regulatory capital requirement and business development needs, an amount of HK$3,824 million has been declared as the proposed fourth interim dividends in respect of the financial year ended 31 December 2012 (2011: HK$3,633 million). The difference between the aggregate distributable reserves of HK$24,773 million and the Bank's retained profit of HK$31,888 million as reported above mainly represents the exclusion of unrealised revaluation gain on investment properties and the regulatory reserve of the Bank.

54. Reconciliation of cash flow statement

(a) Reconciliation of operating profit to net cash flow from operating activities

	2012	2011
Operating profit	**15,606**	14,181
Net interest income	**(16,946)**	(15,736)
Dividend income	**(17)**	(17)
Loan impairment charges	**386**	440
Impairment loss of intangible assets	**–**	78
Depreciation	**762**	700
Amortisation of intangible assets	**115**	119
Amortisation of available-for-sale investments	**(47)**	(24)
Amortisation of held-to-maturity debt securities	**1**	5
Loans and advances written off net of recoveries	**(633)**	(607)
Movement in present value of in-force long-term insurance business	**(815)**	(595)
Interest received	**20,086**	18,403
Interest paid	**(4,567)**	(4,439)
Operating profit before changes in working capital	**13,931**	12,508
Change in treasury bills and certificates of deposit with original maturity more than three months	**(39,942)**	(24,344)
Change in placings with and advances to banks maturing after one month	**(11,989)**	4,801
Change in trading assets	**10,132**	(34,947)
Change in financial assets designated at fair value	**140**	150
Change in derivative financial instruments	**(1,199)**	1,048
Change in loans and advances to customers	**(55,425)**	(13,419)
Change in other assets	**(9,595)**	(7,120)
Change in current, savings and other deposit accounts	**69,290**	16,229
Change in deposits from banks	**5,841**	(1,582)
Change in trading liabilities	**141**	17,131
Change in certificates of deposit and other debt securities in issue	**2,007**	6,189
Change in other liabilities	**10,863**	10,659
Elimination of exchange differences and other non-cash items	**2,050**	(4,836)
Cash used in operating activities	**(3,755)**	(17,533)
Taxation paid	**(1,954)**	(2,044)
Net cash outflow from operating activities	**(5,709)**	(19,577)

54. Reconciliation of cash flow statement continued

(b) Analysis of the balances of cash and cash equivalents

	2012	2011
Cash and balances with banks	**27,082**	39,533
Placings with and advances to banks maturing within one month	**74,552**	54,049
Treasury bills	**22,090**	23,738
Certificates of deposit	**1,310**	3,149
	125,034	120,469

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$18,881 million at 31 December 2012 (31 December 2011: HK$20,004 million).

55. 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$5,264 million (2011: HK$4,697 million) and HK$2,548 million (2011: HK$3,052 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
2012						
Direct credit substitutes	**7,259**	**7,041**	**3,805**	**5,233**	**5,016**	**2,284**
Transaction-related contingencies	**1,250**	**128**	**54**	**1,211**	**130**	**59**
Trade-related contingencies	**11,548**	**1,181**	**696**	**8,456**	**870**	**465**
Forward asset purchases	**51**	**51**	**51**	**51**	**51**	**51**
Undrawn formal standby facilities, credit lines and other commitments to lend:						
– not unconditionally cancellable*	**33,261**	**15,258**	**6,189**	**35,913**	**17,274**	**5,838**
– unconditionally cancellable	**247,891**	**82,049**	**24,909**	**216,597**	**75,317**	**18,570**
	301,260	**105,708**	**35,704**	**267,461**	**98,658**	**27,267**

55. 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
2011						
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
	280,280	98,431	32,869	240,739	89,555	26,051

* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of "up to one year" and "over one year" as at 31 December 2012 were HK$8,336 million and HK$24,925 million respectively (31 December 2011: HK$11,487 million and HK$19,824 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.

56. Assets pledged as security for liabilities

At 31 December 2012, 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$21,006 million (Group and Bank at 31 December 2011: HK$25,569 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK$21,073 million (Group and Bank at 31 December 2011: HK$25,881 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.

57. Capital commitments

	Group		Bank	
	2012	2011	**2012**	2011
Expenditure authorised and contracted for	**1,736**	117	**230**	100
Expenditure authorised but not contracted for	**1**	–	**–**	–

58. 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	
	2012	2011	**2012**	2011
Within one year	**567**	512	**435**	377
Between one and five years	**699**	647	**566**	517
Over five years	**2**	11	**–**	–
	1,268	1,170	**1,001**	894

59. 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 2012 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
2012			
Present value of funded obligations (note 59(a)(iii))	**(6,805)**	**(225)**	**–**
Fair value of scheme assets (note 59(a)(iv))	**4,374**	**208**	**31**
Net (liabilities)/assets recognised in the balance sheet (note 59(a)(v))	**(2,431)**	**(17)**	**31**
Reported as "Assets"	**–**	**–**	**31**
Reported as "Liabilities"	**(2,431)**	**(17)**	**–**
	(2,431)	**(17)**	**31**
Obligations covered by scheme assets (%)	**64**	**92**	**N/A**
2011			
Present value of funded obligations (note 59(a)(iii))	(7,066)	(201)	(1)
Fair value of scheme assets (note 59(a)(iv))	3,806	204	32
Net (liabilities)/assets recognised in the balance sheet (note 59(a)(v))	(3,260)	3	31
Reported as "Assets"	–	3	31
Reported as "Liabilities"	(3,260)	–	–
	(3,260)	3	31
Obligations covered by scheme assets (%)	54	101	3,200

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

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 98 per cent (2011: 87 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK$88 million (deficit in 2011: HK$594 million). On a wind-up basis, the actuarial value of the scheme assets represented 102 per cent (2011: 92 per cent) of the members' vested benefits, based on salaries at that date, and the resulting surplus amounted to HK$86 million (deficit in 2011: HK$316 million).

(ii) The composition of the scheme assets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2012			
Equity	**1,457**	**26**	**–**
Bonds	**2,563**	**158**	**–**
Ordinary shares issued by ultimate holding company	**51**	**–**	**–**
Others	**303**	**24**	**31**
	4,374	**208**	**31**
2011			
Equity	1,324	14	–
Bonds	2,307	170	–
Ordinary shares issued by ultimate holding company	35	–	–
Others	140	20	32
	3,806	204	32

(iii) Change in the present value of scheme obligations

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2012			
At 1 January	**7,066**	**201**	**1**
Current service cost	**319**	**–**	**–**
Interest cost	**102**	**3**	**–**
Actuarial (gains)/losses	**(300)**	**36**	**–**
Benefits paid	**(382)**	**(15)**	**(1)**
At 31 December (note 59(a)(i))	**6,805**	**225**	**–**
2011			
At 1 January	5,710	157	2
Current service cost	265	–	–
Interest cost	160	5	–
Actuarial losses/(gains)	1,217	54	(1)
Benefits paid	(286)	(15)	–
At 31 December (note 59(a)(i))	7,066	201	1

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

(iv) Change in the fair value of scheme assets

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2012			
At 1 January	**3,806**	**204**	**32**
Contributions by the Bank	**444**	**–**	**–**
Expected return on scheme assets	**176**	**8**	**–**
Experience gains	**330**	**11**	**–**
Benefits paid	**(382)**	**(15)**	**(1)**
At 31 December (note 59(a)(i))	**4,374**	**208**	**31**
2011			
At 1 January	3,992	222	32
Contributions by the Bank	227	–	–
Expected return on scheme assets	190	9	1
Experience losses	(317)	(12)	(1)
Benefits paid	(286)	(15)	–
At 31 December (note 59(a)(i))	3,806	204	32

The Group and the Bank expect to make HK$255 million of contributions to defined benefit schemes during the following year (2011: HK$416 million).

(v) Movements in the net (liabilities)/assets recognised in the balance sheet are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2012			
At 1 January	**(3,260)**	**3**	**31**
Contributions by the Bank	**444**	**–**	**–**
Net (expense)/income recognised in the income statement (note 59(a)(vi))	**(245)**	**5**	**–**
Net actuarial gains/(losses)	**630**	**(25)**	**–**
At 31 December (note 59(a)(i))	**(2,431)**	**(17)**	**31**
Experience gains/(losses) on scheme liabilities	**157**	**(3)**	**–**
Experience gains on scheme assets	**330**	**11**	**–**
Gains/(losses) from change in actuarial assumptions	**143**	**(33)**	**–**
Net actuarial gains/(losses)	**630**	**(25)**	**–**
2011			
At 1 January	(1,718)	65	30
Contributions by the Bank	227	–	–
Net (expense)/income recognised in the income statement (note 59(a)(vi))	(235)	4	1
Net actuarial losses	(1,534)	(66)	–
At 31 December (note 59(a)(i))	(3,260)	3	31
Experience (losses)/gains on scheme liabilities	(91)	(6)	1
Experience losses on scheme assets	(317)	(12)	(1)
Losses from change in actuarial assumptions	(1,126)	(48)	–
Net actuarial losses	(1,534)	(66)	–

59. 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
2012			
Current service cost	**(319)**	**–**	**–**
Interest cost	**(102)**	**(3)**	**–**
Expected return on scheme assets	**176**	**8**	**–**
Net (expense)/income for the year (notes 17 and 59(a)(v))	**(245)**	**5**	**–**
Actual return on scheme assets	**506**	**19**	**–**
2011			
Current service cost	(265)	–	–
Interest cost	(160)	(5)	–
Expected return on scheme assets	190	9	1
Net (expense)/income for the year (notes 17 and 59(a)(v))	(235)	4	1
Actual return on scheme assets	(127)	(3)	–

The net actuarial gains recognised in the Group's retained profit during 2012 in respect of defined benefit schemes were HK$505 million (net actuarial losses of HK$1,336 million during 2011). The total cumulative amount of actuarial losses recognised in the retained profits was HK$2,733 million (2011: the cumulative amount of actuarial losses was HK$3,238 million). The total effect of the limit on schemes surpluses in 2012 and 2011 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 %	HSBPS %	HSBNTBS %
2012			
Discount rate	**0.6**	**0.6**	**0.6**
Expected rate of return on scheme assets	**5.3**	**5.3**	**1.7**
Expected rate of salary increases	**4.5**	**4.5**	**4.5**
Expected rate of pension increases	**–**	**1.5**	**–**
2011			
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	–

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.

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

(viii) Amounts for the current and previous years

	Group and Bank				
	2012	2011	2010	2009	2008
Defined benefit obligations	**7,030**	7,268	5,869	5,729	7,183
Plan assets	**4,613**	4,042	4,246	4,103	3,681
Net deficits	**(2,417)**	(3,226)	(1,623)	(1,626)	(3,502)
Experience gains/(losses) on scheme liabilities	**154**	(96)	(16)	293	260
Experience gains/(losses) on scheme assets	**341**	(330)	60	348	(1,989)
Gains/(losses) from change in actuarial assumptions	**110**	(1,174)	(33)	1,236	(1,287)

(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:

	2012	2011
Amounts charged to the income statement (note 17)	**97**	92

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 (2011: Nil).

60. 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	– Vesting of awards based on continued employment within the Group of between one and five years from the date of award – Shares awarded without corporate performance conditions – Certain shares awarded subject to a retention requirement until cessation of employment	– Rewards employee performance, potential and retention requirements – To aid recruitment – Part-deferral of annual bonuses
Performance Share Awards	– Vesting of awards based on three independent performance measures (relative corporate performance condition, economic profit and growth in earnings per share) – Performance conditions are measured over a three year period and reviewed annually – Awards are forfeited to the extent the performance conditions have not been met	– Recognises individual performance and potential
Achievement Share Awards	– Additional awards made throughout the three-year vesting period – Original award together with the additional share awards are released after three years of continued employment within the Group – Shares awarded without corporate performance conditions	– Rewards eligible employees for their performance – High performing and/or senior and middle managers are normally eligible to receive achievement shares during their annual pay review

Share Option Plans

Plans	Policy	Purpose
Savings-Related Share Option Plan	– 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 – The exercise price is set at a 20% (2011: 20%) discount to the market value immediately preceding the date of invitation	– 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
Executive Share Option Scheme ("ESOS") and Group Share Option Plan ("GSOP")	– Vesting of awards based on achievement of certain corporate performance condition targets – Exercisable between third and tenth anniversaries of the date of grant – Plan ceased in 2004	– Long-term incentive plan between 2000 and 2004 during which certain employees were awarded share options

60. 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:

Option scheme with exercise price set in Hong Kong dollars

	2012 Weighted average exercise price HK$	**2012** Number ('000)	2011 Weighted average exercise price HK$	2011 Number ('000)
Outstanding at 1 January	**41.31**	**10,886**	41.18	11,292
Granted in the year	**55.47**	**3,145**	63.99	1,493
Exercised in the year	**40.39**	**(5,429)**	62.20	(772)
Lapsed in the year	**41.31**	**(1,159)**	41.18	(1,127)
Outstanding at 31 December	**46.01**	**7,443**	41.31	10,886
Exercisable at 31 December	**–**	**–**	–	–

The weighted average share price at the date of exercise for share options exercised during the year was HK$67.97 (2011: HK$69.24).

The options outstanding at the year end of 2012 had an exercise price in the range of HK$37.88 to HK$63.99 (2011: HK$37.88 to HK$94.51), and a weighted average remaining contractual life of 2.04 years (2011: 1.95 years).

The weighted average fair value of options granted during 2012 was HK$12.87 (2011: HK$15.54).

(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:

	2012 Weighted average exercise price £	**2012** Number ('000)	2011 Weighted average exercise price £	2011 Number ('000)
Outstanding at 1 January	**6.95**	**1,671**	7.10	2,251
Exercised in the year	**6.02**	**(61)**	6.02	(19)
Lapsed in the year	**6.95**	**(466)**	7.10	(561)
Outstanding at 31 December	**6.88**	**1,144**	6.95	1,671
Exercisable at 31 December	**6.88**	**1,144**	6.95	1,671

The weighted average share price at the date of exercise for share options exercised during the year was £6.41 (2011: £6.60).

The options outstanding at the year end of 2012 had an exercise price in the range of £6.02 to £7.22 (2011: £6.02 to £7.32), and a weighted average remaining contractual life of 1.05 years (2011: 1.61 years).

60. Share-based payments continued

(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
2012			
Risk-free interest rate (%)	**0.4**	**0.6**	**1.2**
Expected life (years)	**1**	**3**	**5**
Expected volatility (%)	**25**	**25**	**25**
Share price at grant date (HK$)	**68.60**	**68.60**	**68.60**
2011			
Risk-free interest rate (%)	0.8	1.7	2.5
Expected life (years)	1	3	5
Expected volatility (%)	25	25	25
Share price at grant date (HK$)	82.90	82.90	82.90

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.

60. Share-based payments continued

(d) Restricted Share Awards/Performance Share Awards/Achievement Share Awards

	2012 Number ('000)	2011 Number ('000) (restated)
Outstanding at 1 January	**696**	1,069
Additions during the year	**277**	194
Released in the year	**(639)**	(567)
Outstanding at 31 December	**334**	696

The closing price of the HSBC Holdings plc share at 31 December 2012 was £6.47 (2011: £4.91).

The weighted average remaining vesting period as at 31 December 2012 was 0.51 years (2011: 0.55 years).

(e) Income statement charge

	2012	2011
Share awards plans	**21**	26
Share option plans	**49**	62
Income statement charge (note 17)	**70**	88
Equity-settled share-based payments*	**70**	88
Cash-settled share-based payments	**–**	–
	70	88

* 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.

61. Material related-party transactions

(a) Immediate holding company and its subsidiaries, fellow subsidiary companies, subsidiaries and associates

In 2012, 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.

61. 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	
	2012	2011	**2012**	2011	**2012**	2011
Interest income	**48**	72	**–**	2	**106**	116
Interest expense	**(303)**	(191)	**–**	(2)	**(4)**	1
Other operating income	**138**	123	**(2)**	(3)	**4**	8
Operating expenses*	**(784)**	(743)	**(433)**	(522)	**(22)**	(18)
Amounts due from:						
Cash and balances with banks	**834**	1,220	**6,448**	4,140	**–**	–
Placings with and advances to banks	**13,527**	3,412	**767**	–	**9,244**	6,898
Financial assets designated at fair value	**–**	114	**3,446**	3,425	**–**	–
Derivative financial instruments	**403**	253	**12**	31	**–**	–
Loans and advances to customers	**400**	–	**–**	–	**233**	233
Financial investments	**74**	243	**–**	–	**–**	–
Other assets	**19**	53	**41**	–	**4**	4
	15,257	5,295	**10,714**	7,596	**9,481**	7,135
Amounts due to:						
Current, savings and other deposit accounts	**871**	126	**–**	–	**110**	110
Deposits from banks	**4,960**	829	**44**	–	**1,213**	610
Derivative financial instruments	**536**	581	**121**	66	**–**	–
Subordinated liabilities	**11,821**	9,518	**–**	–	**–**	–
Other liabilities	**378**	373	**79**	62	**–**	–
	18,566	11,427	**244**	128	**1,323**	720
Derivative contracts:						
Contract amount	**91,252**	69,104	**52,041**	20,647	**–**	–
Guarantees:						
Guarantees issued	**–**	–	**–**	–	**116**	116
Committed facilities:						
Committed facilities from	**–**	–	**–**	–	**–**	–
Committed facilities to	**–**	–	**–**	–	**–**	–

* 2012 Operating expenses included payment of HK$44 million (2011: HK$140 million) of software costs which were capitalised as intangible assets in the balance sheet of the Group.

61. 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	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
Amounts due from:								
Cash and balances with banks	**795**	1,140	**6,402**	4,062	**–**	–	**–**	–
Placings with and advances to banks	**13,504**	–	**767**	–	**–**	–	**6,899**	5,309
Financial assets designated at fair value	**–**	–	**–**	–	**–**	–	**–**	–
Derivative financial instruments	**335**	184	**13**	32	**75**	373	**–**	–
Customer advances and other accounts	**400**	–	**–**	–	**–**	–	**–**	–
Amounts due from subsidiaries	**–**	–	**–**	–	**81,143**	85,222	**–**	–
Financial investments	**–**	–	**–**	–	**–**	–	**–**	–
Other assets	**15**	35	**41**	–	**–**	–	**4**	4
	15,049	1,359	**7,223**	4,094	**81,218**	85,595	**6,903**	5,313
Amounts due to:								
Current, savings and other deposit accounts	**840**	52	**–**	–	**–**	–	**78**	110
Deposits from banks	**2,899**	822	**44**	–	**–**	–	**92**	117
Derivative financial instruments	**250**	315	**120**	66	**345**	211	**–**	–
Subordinated liabilities	**11,821**	9,518	**–**	–	**–**	–	**–**	–
Amounts due to subsidiaries	**–**	–	**–**	–	**15,282**	10,797	**–**	–
Other liabilities	**278**	223	**79**	61	**–**	–	**–**	–
	16,088	10,930	**243**	127	**15,627**	11,008	**170**	227
Derivative contracts:								
Contract amount	**66,582**	40,354	**52,001**	20,647	**15,696**	25,874	**–**	–
Guarantees:								
Guarantees issued	**–**	–	**–**	–	**422**	565	**116**	116
Guarantees received	**–**	–	**–**	–	**22**	165	**–**	–
Committed facilities:								
Committed facilities from	**–**	–	**–**	–	**–**	–	**–**	–
Committed facilities to	**–**	–	**–**	–	**5,480**	1,500	**–**	–

61. 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	
	2012	2011	**2012**	2011
Salaries, allowances and benefits in kind	**35**	37	**35**	37
Retirement scheme contributions	**4**	5	**4**	5
Variable bonuses	**30**	31	**30**	31
	69	73	**69**	73

(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	
	2012	2011	**2012**	2011
Interest received	**239**	192	**239**	192
Interest paid	**9**	8	**9**	8
Fees and exchange income received	**34**	15	**34**	15
Loans and advances	**8,594**	10,857	**7,892**	10,210
Deposits	**2,349**	2,784	**2,091**	2,703
Undrawn commitments	**1,516**	1,844	**1,323**	1,412
Maximum aggregate amount of loans and advances during the year	**10,661**	13,714	**9,626**	12,736

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 are no specific impairment allowances on balances with key management personnel at the year-end.

61. 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:

	Group		Bank	
	2012	2011	**2012**	2011
Aggregate amount of relevant transactions outstanding at 31 December	**19**	20	**19**	20
Maximum aggregate amount of relevant transactions during the year	**24**	28	**24**	28

(e) Associates

Information relating to associates and transactions with associates can be found in notes 39 and 61(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 2012 was HK$233 million (2011: HK$233 million).

The Bank has been assisting Industrial Bank Co., Ltd. in developing the credit card business.

(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 60, 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 2012 amounted to HK$618 million comprising HK$625 million relating to share option schemes and negative reserve amounted to HK$7 million relating to share award schemes (2011: 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).

(g) Employee retirement benefits

At 31 December 2012, defined benefit scheme assets amounted to HK$1,059 million (2011: HK$1,152 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK$5 million (2011: HK$5 million).

62. 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 exposures continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major risk appetite or risk control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various Board or management committees, including the Executive Committee, Risk Committee, Asset and Liability Management Committee ("ALCO") and Risk Management Committee ("RMC").

Risk appetite limit is a key component of our management of risk. The Bank's Risk Appetite Statement for 2012 was approved by the Board as advised by the Audit Committee ("AC"), which describes the types and amount of risk that the Bank is prepared to accept in executing our business strategy.

Our risk appetite framework is underpinned by the following core characteristics:

- Strong balance sheet and brand
- Healthy capital position
- Accountable use of shareholders' funds
- Conservative liquidity management
- Risk must be commensurate with returns
- Risk diversification

These core characteristics are applied to define the risk appetite limits on a Bank-wide and individual risk and business level, which cover key risk types and exposures that are faced by the Bank's business activities.The Bank's Risk Management Committee undertook regular reviews and monitors the Bank's risk profile against the limits set out in the Risk Appetite Statement and determine appropriate management action if material deviation from approved limits. Reports are submitted to the Risk Committee and Board from Chief Risk Officer on the actual profile of the Risk Appetite Statement including material deviation and management action where required.

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising 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.

62. Financial risk management continued

(a) Credit risk continued

Impaired loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loan impairment allowances 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.

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.

Repossessed 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 repossessed 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 International Swaps and Derivatives Association ("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.

62. Financial risk management continued

(a) Credit risk continued

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.

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

	Group		Bank	
	2012	2011	**2012**	2011
Cash and balances with banks	**27,082**	39,533	**24,797**	36,475
Placings with and advances to banks	**140,382**	107,742	**74,846**	47,724
Trading assets	**34,369**	64,164	**31,605**	60,519
Financial assets designated at fair value	**4,047**	3,999	**–**	140
Derivative financial instruments	**5,179**	4,710	**4,634**	4,436
Loans and advances to customers	**536,162**	480,574	**476,734**	425,629
Financial investments	**253,074**	208,931	**145,308**	105,080
Amounts due from subsidiaries	**–**	–	**81,143**	85,222
Other assets	**15,429**	13,442	**9,753**	9,066
Financial guarantees and other credit related contingent liabilities	**14,793**	11,694	**12,352**	9,764
Loan commitments and other credit related commitments	**381,583**	354,837	**346,434**	316,338
	1,412,100	1,289,626	**1,207,606**	1,100,393

(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.

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.

62. Financial risk management continued

(a) Credit risk continued

(ii) Collateral and other credit enhancements continued

Residential mortgages

The following table shows residential mortgage lending including off-balance sheet loan commitments by level of collateralisation.

Residential mortgages loans and advances

	2012	2011
Uncollateralised	–	–
Fully collateralised		
– Less than 25% LTV	27,609	19,790
– 25% to 50% LTV	97,740	72,383
– 51% to 75% LTV	39,408	49,482
– 76% to 90% LTV	3,565	4,058
– 91% to 100% LTV	695	863
	169,017	146,576
Partially collateralised loans and advances		
– Greater than 100% LTV	12	1
Total residential mortgages	169,029	146,577
Value of specific collateral held for partially collateralised loans and advances	12	1

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.

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.

62. Financial risk management continued

(a) Credit risk continued

(ii) Collateral and other credit enhancements continued

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

	2012	2011
Rated – CRR/EL 1 to 7		
Uncollateralised	**17,637**	8,713
Fully collateralised	**57,947**	46,718
Partially collateralised	**9,217**	3,879
Value of specific collateral held for partially collateralised loans and advances	**7,678**	2,929
Rated – CRR/EL 8 to 10		
Uncollateralised	**–**	–
Fully collateralised	**8**	7
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

	2012	2011
Rated – CRR/EL 8 to 10		
Uncollateralised	**919**	1,169
Fully collateralised	**642**	520
Partially collateralised	**208**	147
Value of specific collateral held for partially collateralised loans and advances	**66**	75

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.

62. 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

	2012	2011
Uncollateralised	**140,382**	107,742
Fully collateralised	**–**	–
Partially collateralised	**–**	–
Value of specific collateral held for partially collateralised loans and advances	**–**	–

Derivatives

The 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 the Group's 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 181.

Cash and balances with banks	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. The Group generally mitigates 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.
Loans and 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 180.

62. 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 and all EL 1 to EL 8 exposures 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 2012 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".

62. 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						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2012							
Items in the course of collection from other banks	5,418	224	–	–	–	–	5,642
Trading assets:							
– treasury and eligible bills	26,808	–	–	–	–	–	26,808
– debt securities	6,161	345	–	–	–	–	6,506
– loans and advances to banks	1,045	–	–	–	–	–	1,045
– loans and advances to customers	10	–	–	–	–	–	10
	34,024	345	–	–	–	–	34,369
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	3,905	142	–	–	–	–	4,047
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	3,905	142	–	–	–	–	4,047
Derivatives	4,604	539	36	–	–	–	5,179
Loans and advances held at amortised cost:							
– balances/placings with and advances to banks	142,365	14,058	–	–	–	–	156,423
– loans and advances to customers	312,427	218,657	2,031	3,116	1,340	(1,409)	536,162
	454,792	232,715	2,031	3,116	1,340	(1,409)	692,585
Financial investments:							
– treasury and similar bills	98,262	–	–	–	–	–	98,262
– debt securities	146,159	8,653	–	–	–	–	154,812
	244,421	8,653	–	–	–	–	253,074
Other assets:							
– acceptances and endorsements	1,120	4,143	1	–	–	–	5,264
– other	2,187	2,309	4	23	–	–	4,523
	3,307	6,452	5	23	–	–	9,787

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Group						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
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:							
– balances/placings with 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

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2012							
Items in the course of collection from other banks	5,418	224	–	–	–	–	5,642
Trading assets:							
– treasury and eligible bills	26,808	–	–	–	–	–	26,808
– debt securities	3,742	–	–	–	–	–	3,742
– loans and advances to banks	1,045	–	–	–	–	–	1,045
– loans and advances to customers	10	–	–	–	–	–	10
	31,605	–	–	–	–	–	31,605
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	–	–	–	–	–	–	–
Derivatives	4,208	399	27	–	–	–	4,634
Loans and advances held at amortised cost:							
– balances/placings with and advances to banks	81,525	7,364	–	–	–	–	88,889
– loans and advances to customers	288,330	184,735	1,121	2,511	1,120	(1,083)	476,734
	369,855	192,099	1,121	2,511	1,120	(1,083)	565,623
Financial investments:							
– treasury and similar bills	98,262	–	–	–	–	–	98,262
– debt securities	45,215	1,831	–	–	–	–	47,046
	143,477	1,831	–	–	–	–	145,308
Other assets:							
– acceptances and endorsements	599	1,949	–	–	–	–	2,548
– other	632	930	–	1	–	–	1,563
	1,231	2,879	–	1	–	–	4,111

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
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	5,773	20	–	–	–	–	5,793
– loans and advances to banks	–	501	–	–	–	–	501
– loans and advances to customers	5	–	–	–	–	–	5
	59,998	521	–	–	–	–	60,519
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	140	–	–	–	–	–	140
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	140	–	–	–	–	–	140
Derivatives	2,978	1,420	38	–	–	–	4,436
Loans and advances held at amortised cost:							
– balances/placings with and advances to banks	68,279	6,673	–	–	–	–	74,952
– loans and advances 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

* Includes HK$5,233 million (2011: HK$5,198 million) and HK$615 million (2011: HK$780 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2012, 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.

62. 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					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2012						
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:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,663	353	96	4	–	3,116
	2,663	353	96	4	–	3,116
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	14	4	3	2	–	23
	14	4	3	2	–	23

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Group					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2011						
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:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	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

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2012						
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:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,182	248	77	4	–	2,511
	2,182	248	77	4	–	2,511
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	1	–	–	–	–	1
	1	–	–	–	–	1

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2011						
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:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,219	256	47	–	–	2,522
	2,219	256	47	–	–	2,522
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	1	1	–	–	–	2
	1	1	–	–	–	2

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 2012 and the movement of such allowances during the year are disclosed in note 35.

62. 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:

	Group		Bank	
	2012	2011	**2012**	2011
Nature of assets:				
Residential properties	**16**	3	**14**	–
Commercial and industrial properties	**–**	–	**–**	–
Other	**–**	–	**–**	–
	16	3	**14**	–

(b) Liquidity risk

The purpose of liquidity management is to ensure sufficient cash flows to meet all financial commitment and to capitalise on opportunities for business expansion. This includes the Group's ability to meet deposit withdrawals either on demand or at contractual maturity, to repay borrowings as they mature, to comply with the statutory liquidity ratio, and to make new loans and investments as opportunities arise. The Group maintains a stable and diversified funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets.

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 and funding 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 on a regular basis. This process includes:

- maintaining within relevant regulatory requirements of the reporting entity;
- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to core funding 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
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systematic or other crises, while minimising adverse long-term implications for the business.

62. Financial risk management continued

(b) Liquidity risk continued

Primary sources of funding

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.

The management of funding and liquidity risk

Inherent liquidity risk categorisation

The Group placed our operating entities into one of three categories (low, medium and high) to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the host country and factors specific to the operating entities themselves, such as the local market, market share and balance sheet strength. The categorisation involves management judgement and is based on the perceived liquidity risk of an operating entity relative to other entities in the Group. The categorisation is intended to reflect the possible impact of a liquidity event, not the probability of an event. The categorisation is part of our risk appetite and is used to determine the prescribed stress scenario that we require our operating entities to be able to withstand and manage.

Core deposits

A key assumption of our internal framework is the categorisation of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during a liquidity stress. This characterisation takes into account the Group's inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer, the size of customer's total balance and pricing of the deposit. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics.

The three filters considered in assessing whether a deposit in any operating entity is core/non-core are:

- price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;
- size: depositors with total balances above certain monetary thresholds, the excess balances are classified as non-core. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and
- line of business: the element of any deposit remaining after the application of the price and size filter is assessed on the basis of the line of business to which the deposit is associated. The proportion of any customer deposit that can be considered as core under this filter is between 35% and 90%.

Repo transactions and bank deposits cannot be categorised as core deposits.

Advances to core funding ratio

The Group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and mitigate against reliance on short-term professional funding. Limits are placed on operating entities to restrict our ability to increase loans and advances to customers without corresponding growth in core customer deposits or long-term debt funding with a residual maturity beyond one year. This measure is referred to as the "advances to core funding" ratio.

Advances to core funding ratio limits are set by the ALCO. The ratio describes current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. In general, customer loans are assumed to be renewed and are included in the numerator of the advances to core funding ratio, irrespective of the contractual maturity date. Reverse repurchase arrangements are excluded from the advances to core funding ratio.

62. Financial risk management continued

(b) Liquidity risk continued

Stressed coverage ratio

Stressed coverage ratios are derived from stressed cash flow scenario analyses and express the stressed cash inflows as a percentage of stressed cash outflows over one-month and three-month time horizons.

The stressed cash inflows include:

– inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and

– contractual cash inflows from maturing assets that are not already reflected as a use of liquid assets.

In line with the approach adopted for the advances to core funding ratio, customer loans are, in general, assumed not to generate any cash inflows under stress scenarios and are therefore excluded from the numerator of the stressed coverage ratios, irrespective of the contractual maturity date.

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow up to three months being monitored by the Group under the combined market-wide and institution-specific stress scenario.

Compliance with liquidity and funding requirements is monitored by ALCO on a regular basis.

Liquidity behaviouralisation

Liquidity behaviouralisation is applied to reflect our assessment of the expected period for which we are confident that we will have access to our liabilities, even under a severe liquidity stress scenario, and the expected period for which we must assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour. Liquidity behaviouralisation policy is reviewed and approved by ALCO.

Contingent liquidity risk

Operating entities provide customers with committed and standby facilities. These facilities increase the funding requirements of the Group when customers drawdown. The liquidity risk associated with the potential drawdown on non-cancellable committed facilities is factored into our stressed scenarios and limits are set for these facilities.

62. Financial risk management continued

(b) Liquidity risk continued

Contingency funding plan

A contingency funding plan ("LCP") is reviewed and approved by ALCO and the Board at least annually with an objective to ensure the Group can cope with a crisis by having practical and operational plan in place. The LCP states the options available to the Group for garnering liquidity and funding and an agreed course of action should there be an unexpected crisis. It is a real practical tool that can be used to manage liquidity during a crisis event. The LCP includes detailed action steps and properly assigned responsibilities. To serve as a guideline for the Crisis Management Team and its support team to evaluate the liquidity crisis situation and execute action steps during the crisis, the LCP consists of a sound Balance Sheet maturity analysis and spells out all potential funding sources with due consideration of their reliability, priority and the lead time during crisis. It also estimates liquidity shortfalls and liquid assets inflow from stress tests performed by the Bank under institution-specific, market-wide and combined stress scenarios.

Liquidity ratio under the Hong Kong Banking Ordinance

The Hong Kong Banking Ordinance also requires banks operating in Hong Kong to maintain a minimum liquidity ratio. The average liquidity ratio for the year, calculated in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance, is as follows:

	Group	
	2012	2011
The Bank and its subsidiaries designated by the Hong Kong Monetary Authority	**36.9%**	33.6%

Basel III update

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.

62. Financial risk management continued

(b) Liquidity risk continued

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.

	Group					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2012						
Current, savings and other deposit accounts	**567,310**	**168,224**	**34,416**	**937**	**–**	**770,887**
Deposits from banks	**3,369**	**16,501**	**3**	**–**	**–**	**19,873**
Financial liabilities designated at fair value	**1**	**–**	**–**	**–**	**463**	**464**
Trading liabilities	**59,853**	**–**	**–**	**–**	**–**	**59,853**
Derivative financial instruments	**2,763**	**122**	**232**	**965**	**50**	**4,132**
Certificates of deposit and other debt securities in issue	**–**	**34**	**7,404**	**3,952**	**–**	**11,390**
Other financial liabilities	**7,634**	**6,699**	**3,171**	**40**	**18**	**17,562**
Subordinated liabilities	**–**	**128**	**234**	**1,250**	**12,968**	**14,580**
	640,930	**191,708**	**45,460**	**7,144**	**13,499**	**898,741**
Commitments	**263,867**	**35,272**	**143**	**5**	**–**	**299,287**
Financial guarantee contracts	**12,481**	**64**	**–**	**–**	**–**	**12,545**
	276,348	**35,336**	**143**	**5**	**–**	**311,832**
At 31 December 2011						
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 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
	575,275	184,050	39,820	9,304	11,028	819,477
Commitments	240,159	42,488	1,823	982	–	285,452
Financial guarantee contracts	6,531	51	1	–	–	6,583
	246,690	42,539	1,824	982	–	292,035

62. Financial risk management continued

(b) Liquidity risk continued

	Bank					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2012						
Current, savings and other deposit accounts	**553,445**	**157,362**	**20,079**	**188**	**–**	**731,074**
Deposits from banks	**3,289**	**10,686**	**3**	**–**	**–**	**13,978**
Financial liabilities designated at fair value	**–**	**–**	**–**	**–**	**–**	**–**
Trading liabilities	**27,776**	**–**	**–**	**–**	**–**	**27,776**
Derivative financial instruments	**2,807**	**87**	**149**	**446**	**50**	**3,539**
Certificates of deposit and other debt securities in issue	**–**	**34**	**7,404**	**3,952**	**–**	**11,390**
Amounts due to subsidiaries	**5,441**	**9,840**	**–**	**–**	**–**	**15,281**
Other financial liabilities	**7,327**	**5,461**	**1,289**	**40**	**19**	**14,136**
Subordinated liabilities	**–**	**128**	**234**	**1,250**	**12,968**	**14,580**
	600,085	**183,598**	**29,158**	**5,876**	**13,037**	**831,754**
Commitments	**228,488**	**35,243**	**143**	**5**	**–**	**263,879**
Financial guarantee contracts	**10,415**	**64**	**–**	**–**	**–**	**10,479**
	238,903	**35,307**	**143**	**5**	**–**	**274,358**
At 31 December 2011						
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 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
	543,473	173,330	25,486	8,215	10,595	761,099
Commitments	216,941	29,772	79	1	–	246,793
Financial guarantee contracts	4,831	51	1	–	–	4,883
	221,772	29,823	80	1	–	251,676

(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.

62. Financial risk management continued

(c) Market risk continued

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.

Apart from the standard 1-day VAR mentioned above, the Group has introduced stressed VAR since the start of 2012 according to the Basel 2.5 requirement. Stressed VAR is the measure of VAR using a specific, continuous one-year period of stress for the trading portfolio, assuming a 10-day holding period with a 99 per cent level of confidence.

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.

The Group's VAR, both trading and non-trading, and stressed VAR for trading. The total positions of all interest rate risk and foreign exchange risk positions and on individual risk portfolios during 2012 and 2011 are shown in the table below.

	At 31 December 2012	Minimum during the year	Maximum during the year	Average for the year
Total VAR	**23**	**23**	**92**	**46**
Total trading VAR	**4**	**4**	**23**	**10**
VAR for foreign exchange risk (trading)	**4**	**2**	**9**	**5**
VAR for interest rate risk:				
– trading	**4**	**4**	**23**	**9**
– non-trading	**25**	**19**	**39**	**27**
Stressed VAR*				
Total trading VAR	**30**	**18**	**104**	**45**
VAR for foreign exchange risk (trading)	**12**	**5**	**33**	**16**
VAR for interest rate risk:				
– trading	**27**	**13**	**106**	**42**

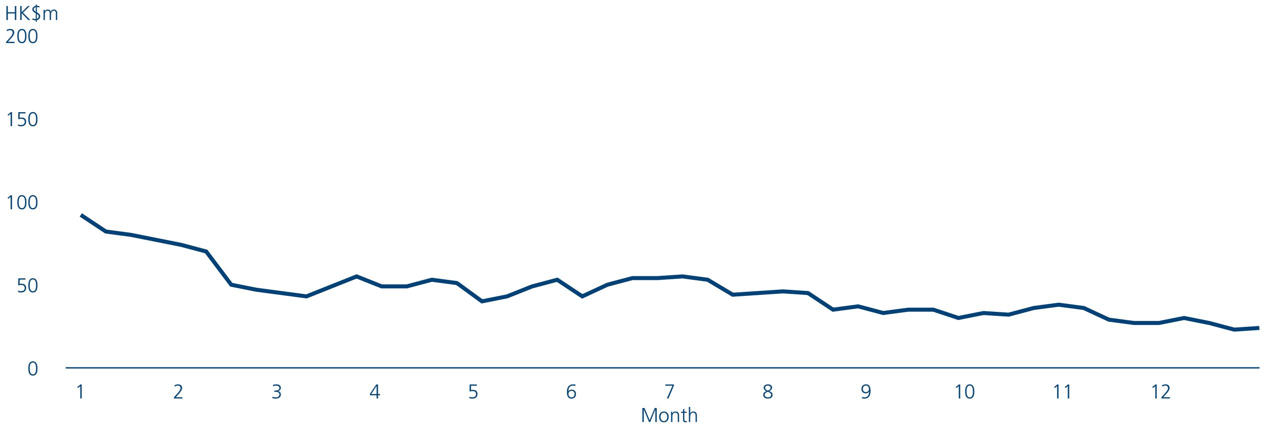
* Stressed VAR reporting is effective since 2012.

62. Financial risk management continued

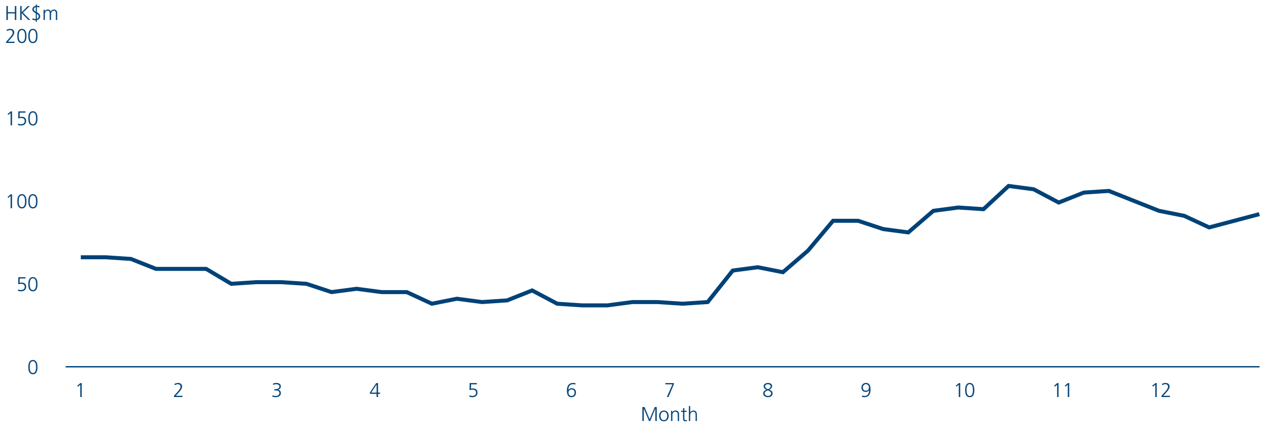
(c) Market risk continued

	At 31 December 2011	Minimum during the year	Maximum during the year	Average 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

Total Value at Risk for 2012



Total Value at Risk for 2011



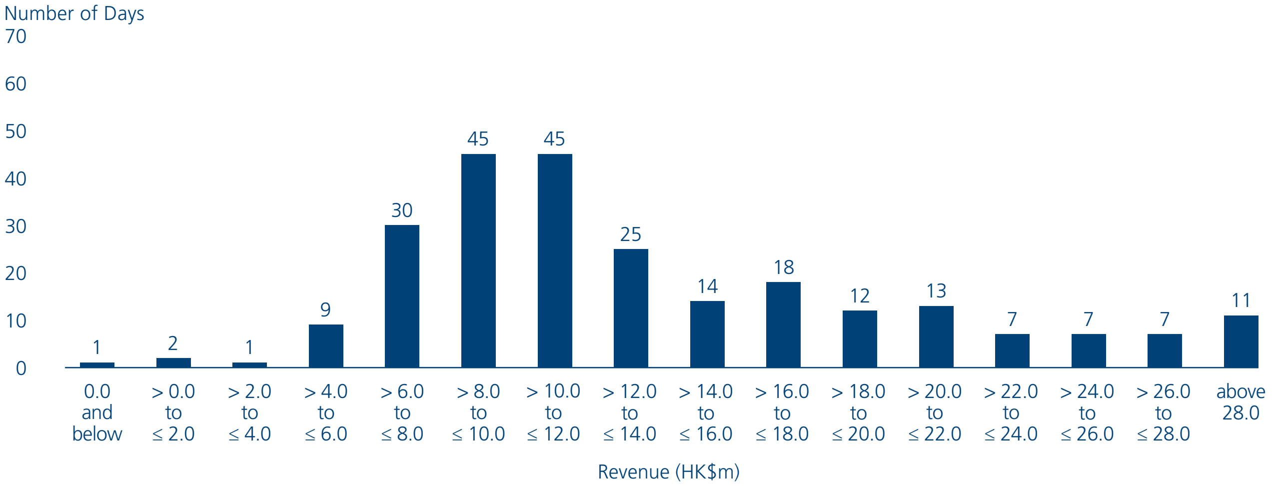
62. Financial risk management continued

(c) Market risk continued

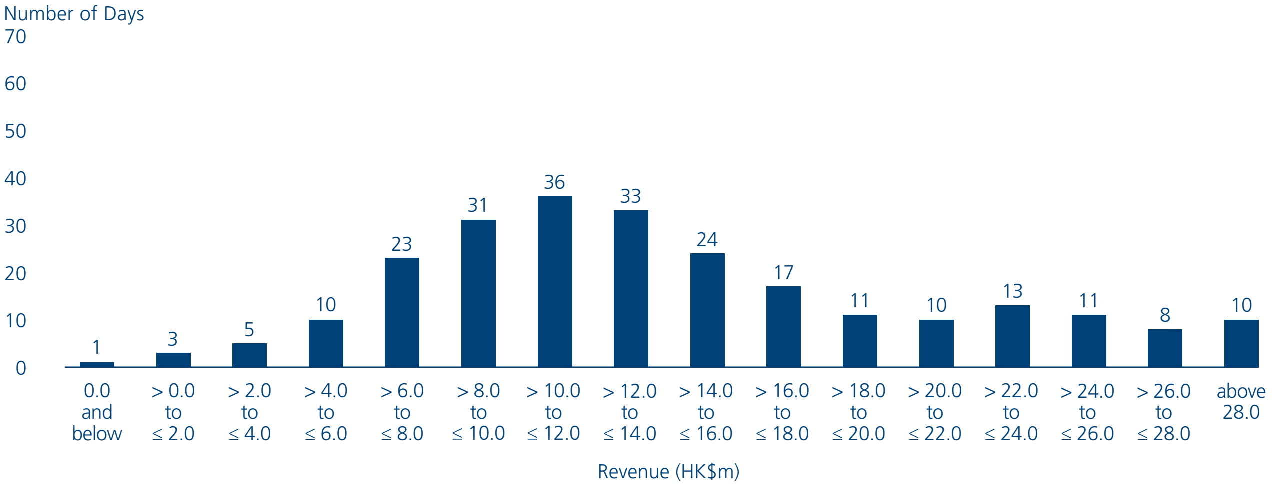
The average daily revenue earned from market risk-related treasury activities in 2012, including non-trading book net interest income and funding related to trading positions, was HK$14 million (2011: HK$14 million). The standard deviation of these daily revenues was HK$8 million, compared with HK$7 million for 2011.

An analysis of the frequency distribution of daily revenue shows that out of 247 trading days in 2012, losses were recorded on 1 day (2011: 1 day) and the maximum daily loss was HK$3 million (2011: HK$6 million). The most frequent result was a daily revenue of between HK$6 million and HK$18 million, with 177 occurrences (2011: 164 occurrences). The highest daily revenue was HK$69 million (2011: HK$41 million).

Daily Distribution of Market Risk Revenues for 2012



Daily Distribution of Market Risk Revenues for 2011



62. Financial risk management continued

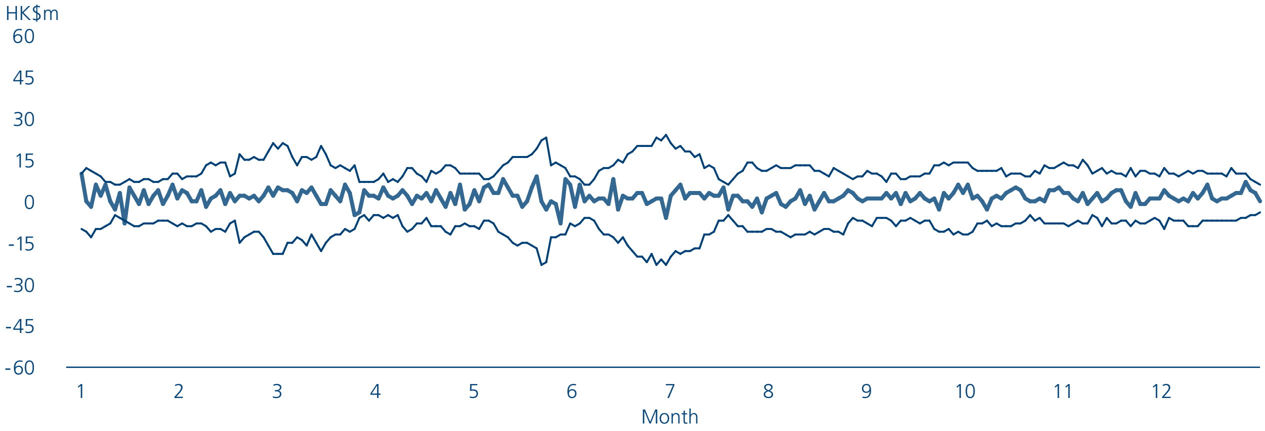
(c) Market risk continued

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.

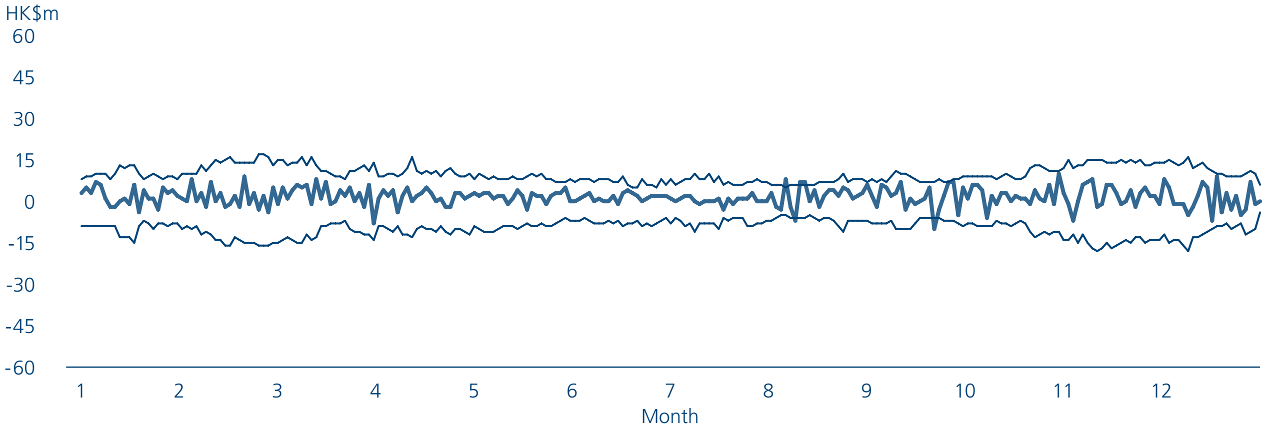
A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2012 and 2011 are shown in the table below.

A Comparison of Trading VAR with Actual Trading Profit and Loss for 2012



Trading VAR
Actual trading profit and loss

A Comparison of Trading VAR with Actual Trading Profit and Loss for 2011



Trading VAR
Actual trading profit and loss

62. 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 monitors 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 2013 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 2013.

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 ending 31 December 2013 by HK$1,882 million for 100 basis points case and by HK$1,378 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$1,726 million for 100 basis points case and by HK$1,447 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and take into account the change in pricing of retail products relative to change in market interest rates.

62. Financial risk management continued

(c) Market risk continued

Projected Net Interest Income

The sensitivity of projected net interest income is described as follows:

	100bp parallel increase	100bp parallel decrease	25bp increase at the beginning of each quarter	25bp decrease at the beginning of each quarter
Change in 2013 projected net interest income				
– HKD	**1,491**	**(1,190)**	**1,027**	**(1,050)**
– US$	**274**	**(310)**	**224**	**(252)**
– other	**117**	**(226)**	**127**	**(145)**
Total	**1,882**	**(1,726)**	**1,378**	**(1,447)**
Change in 2012 projected net interest income				
– 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)

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.

62. 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 December 2012	**Maximum impact**	**Minimum impact**
+ 100 basis points parallel move in all-in yield curves	**(988)**	**(1,027)**	**(863)**
As a percentage of shareholders' funds at 31 December 2012 (%)	**(1.1)**	**(1.1)**	**(0.9)**
– 100 basis points parallel move in all-in yield curves	**381**	**412**	**226**
As a percentage of shareholders' funds at 31 December 2012 (%)	**0.4**	**0.4**	**0.2**

	At 31 December 2011	Maximum impact	Minimum 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

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, are managed by ALCO. The details of net structural and non-structural foreign currency positions of the Group are set out in supplementary note 15.

Equities exposure

The Group's equities exposures in 2012 and 2011 are mainly 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.

62. Financial risk management continued

(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, taking into account where appropriate local market conditions and regulatory requirements apply.

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, incorporated with certain degree of randomness, 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 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 reviews and approves the investment policy including asset allocation, investment guidelines and limits on a periodic basis, while Asset and Liability Management Committee provides oversight of the asset/liability management process.

The Group establishes the investment policy for each major insurance product category according to specific product requirements and local regulatory requirement. The investment policy defines the asset allocations and restrictions with an aim to achieve the target investment return in the long term. 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.

62. 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 linked contracts[1]	Life non-linked contracts[2]	Non-life insurance[3]	Other assets[4]	Total[5]
2012					
Financial assets:					
– financial assets designated at fair value	**224**	**8,119**	**–**	**–**	**8,343**
– derivatives	**–**	**171**	**–**	**–**	**171**
– financial investments	**–**	**64,297**	**–**	**3,350**	**67,647**
– other financial assets	**11**	**7,878**	**49**	**2,105**	**10,043**
Total financial assets	**235**	**80,465**	**49**	**5,455**	**86,204**
Reinsurance assets	**–**	**414**	**–**	**16**	**430**
Present value of in-force long-term insurance contracts	**–**	**–**	**–**	**6,003**	**6,003**
Other assets	**–**	**889**	**–**	**2,333**	**3,222**
Total assets	**235**	**81,768**	**49**	**13,807**	**95,859**
Liabilities under investment contracts designated at fair value	**141**	**323**	**–**	**–**	**464**
Liabilities under insurance contracts	**91**	**81,579**	**–**	**–**	**81,670**
Deferred tax	**–**	**–**	**–**	**991**	**991**
Other liabilities	**–**	**–**	**–**	**627**	**627**
Total liabilities	**232**	**81,902**	**–**	**1,618**	**83,752**
Shareholders' equity	**–**	**–**	**–**	**12,107**	**12,107**
Total liabilities and shareholders' equity	**232**	**81,902**	**–**	**13,725**	**95,859**
2011					
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

1 Comprise life linked insurance contracts and linked investment contracts
2 Comprise life non-linked insurance contracts and non-linked investment contracts
3 Comprise non-life insurance contracts
4 Comprise shareholder assets
5 Total assets of life insurance subsidiaries at 31 December 2012 amounted to HK$95,810 million (31 December 2011: HK$82,718 million). Total assets of non-life insurance subsidiaries at 31 December 2012 amounted to HK$49 million (31 December 2011: HK$1,664 million).

62. 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. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum-at-risk so that it falls within specified insurance risk appetite. The Group also utilises reinsurance to manage the risk arising from guaranteeing minimum investment performance under a non-linked traditional non-participating insurance product. In addtion, the Group uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes. However, the Group remains liable to its policyholders with respect to ceded insurance if any reinsurer fails to meet the obligations it assumes.

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 and maturity benefit are usually provided. Most of the Group's non-linked products include a discretionary participating feature which allows policyholders to participate in the profits of the life fund. These plans offer a discretionary annual bonus in the form of dividend payable to the policyholders on each policy anniversary date.

In particular, a major block of non-linked products provides policyholders with an option to receive guaranteed and discretionary bonus in form of monthly bonus during a predefined period before maturity.

The principles for the distribution of profits among the policyholders are:

(i) to recognise the financial condition of the Group's insurance subsidiaries;

(ii) to take into consideration the reasonable expectation of policyholders and to provide a smooth and stable return over the long term; and

(iii) to balance the interests between the shareholders and policyholders.

Investment risks are managed through matching assets and liabilities. Investment strategy is set which is intended to provide sufficient investment return to satisfy policyholders' reasonable expectations. Mortality risks are managed through reinsurance and proper underwriting.

The Group has contractual discretion on the dividend declared. In practice the Group considers policyholders' reasonable expectations when setting dividend levels. It is the Group's intention to maintain a smooth and stable dividend scale which is set based on the long-term expected investment return. Annual review is performed to confirm whether the current dividend scale is supportable taking into account the actual and expected experiences on investments return, policy persistency, claims and expenses.

62. Financial risk management continued

(d) Insurance risk continued

(ii) Long-term insurance contracts – linked products

The Group writes linked long-term insurance policies, which typically provide policyholders with life insurance protection and a choice of 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 will be deducted from the funds accumulated.

Although the policyholders bear the market risk on linked products, the Group assumes reputational risk for any undue market risk taken by the policyholders. Consequently, it is in the Group's interest to ensure that the policyholders' exposure to market risk is consistent with any market risk information that the Group has communicated to the policyholders.

Claims and expenses experiences are reviewed regularly to ensure current charges are sufficient to cover the costs.

(iii) Long-term investment contracts – non-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. The accumulated fund balance will be payable to scheme members upon retirement or termination of employment. The Group provides an investment return guarantees on these funds. The guaranteed 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. The accumulated fund balance will be payable to scheme members upon retirement or termination of employment. Although scheme members bear the market risk on the funds, the Group assumes reputational risk for any undue market risk taken by the scheme members. Consequently, it is in the Group interest to ensure that the scheme members' exposure to market risk is consistent with any market risk information that the Company has communicated to the scheme members.

(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, pricing guidelines, 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.

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 acquired immunodeficiency syndrome ("AIDS"), severe acute respiratory syndrome ("SARS") or a human form of avian flu) or widespread changes in lifestyle, 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.

62. Financial risk management continued

(d) Insurance risk continued

To determine the concentration of insurance risks and the reinsurance coverage required, 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 an appropriate 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 49. By contrast for analysis of non-life insurance risk, written premiums represent an appropriate measure of risk exposure as shown in the following table.

Analysis of non-life insurance risk – net written insurance premiums

	2012	2011
Accident and health	**46**	101
Fire and other damage	**71**	126
Motor	**11**	25
Liability	**35**	54
Marine, aviation and transport	**10**	22
Other (non-life)	**2**	21
	175	349

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.

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:

62. Financial risk management continued

(d) Insurance risk continued

Financial assets held by insurance operations

	Group				
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2012					
Financial assets designated at fair value:					
– debt securities	**–**	**4,047**	**–**	**–**	**4,047**
– equity securities	**224**	**4,072**	**–**	**–**	**4,296**
	224	**8,119**	**–**	**–**	**8,343**
Financial investments					
Held-to-maturity:					
– debt securities	**–**	**64,297**	**–**	**3,334**	**67,631**
	–	**64,297**	**–**	**3,334**	**67,631**
Available-for-sale:					
– debt securities	**–**	**–**	**–**	**–**	**–**
– equity securities	**–**	**–**	**–**	**16**	**16**
	–	**–**	**–**	**16**	**16**
Derivatives	**–**	**171**	**–**	**–**	**171**
Other financial assets	**11**	**7,878**	**49**	**2,105**	**10,043**
	235	**80,465**	**49**	**5,455**	**86,204**

	Group				
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2011					
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

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 0.3% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2012 (2011: 0.4%). The table also shows that approximately 83.1% of financial assets was invested in debt securities at 31 December 2012 (2011: 84.6%) and 5.0% (2011: 5.4%) invested in equity securities.

62. Financial risk management continued

(d) Insurance risk continued

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 because there is a chance that the yields earned on its debt securities holding are lower than the investment returns implied by the guarantees payable to policyholders. The held-to-maturity debt securities account 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 2012 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the aggregated profit after taxation for the year and shareholders' equity at that date:

	2012		2011	
	Impact on profit after taxation for the year	**Impact on shareholders' equity**	Impact on profit after taxation for the year	Impact on shareholders' equity
+ 100 basis points shift in yield curves	**377**	**377**	517	508
– 100 basis points shift in yield curves	**(475)**	**(475)**	(335)	(326)

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 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 any resultant changes in policyholder behaviour.

62. Financial risk management continued

(d) Insurance risk continued

Equity price risk

The portfolio of marketable securities, (including collective investment schemes) backing non-linked insurance contracts, which the insurance subsidiaries of the Group carry 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 tactic asset allocation or hedging strategy and sharing the risk with policyholders through the discretionary participation feature. The Group's objective is to earn competitive 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.

The following table illustrates the impact on the aggregated profit after taxation for the year and shareholders' equity of a reasonably possible 10 per cent variance in equity prices:

	2012		2011	
	Impact on profit after taxation for the year	**Impact on shareholders' equity**	Impact on profit after taxation for the year	Impact on shareholders' equity
10 per cent increase in equity prices	**120**	**120**	277	277
10 per cent decrease in equity prices	**(84)**	**(84)**	(396)	(396)

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. The impact is estimated taking into account the sharing of risk through the discretionary participation feature (2011: without sharing of risk).

Foreign currency risk

The assets and liabilities are mainly denominated in United States dollar ("USD") and Hong Kong dollar ("HKD"). 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 foreign exchange forward contracts to manage its foreign currency risk. Most of the foreign exchange forward contracts have maturities of less than one year after the balance sheet date.

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 relative competitive 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.

62. Financial risk management continued

(d) Insurance risk continued

Treasury bills, other eligible bills and debt securities in insurance operations

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2012							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,905	142	–	–	–	–	4,047
	3,905	142	–	–	–	–	4,047
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	57,545	6,752	–	–	–	–	64,297
	57,545	6,752	–	–	–	–	64,297
Supporting shareholders funds							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–	–
	–	–	–	–	–	–	–
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	3,264	70	–	–	–	–	3,334
	3,264	70	–	–	–	–	3,334
Total							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,905	142	–	–	–	–	4,047
	3,905	142	–	–	–	–	4,047
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	60,809	6,822	–	–	–	–	67,631
	60,809	6,822	–	–	–	–	67,631

62. Financial risk management continued

(d) Insurance risk continued

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2011							
Supporting liabilities under non-linked insurance and investment contracts							
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	52,082	4,632	–	–	–	–	56,714
	52,082	4,632	–	–	–	–	56,714
Supporting shareholders funds							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–	–
	–	–	–	–	–	–	–
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	3,632	184	–	–	–	–	3,816
	3,632	184	–	–	–	–	3,816
Total							
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

62. 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						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2012							
Linked insurance contracts	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Non-linked insurance contracts	**414**	**–**	**–**	**–**	**–**	**–**	**414**
Total	**414**	**–**	**–**	**–**	**–**	**–**	**414**
Reinsurance Debtors	**4**	**–**	**–**	**12**	**–**	**–**	**16**
2011							
Linked insurance contracts	–	–	–	–	–	–	–
Non-linked insurance contracts	110	45	–	–	–	–	155
Total	110	45	–	–	–	–	155
Reinsurance Debtors	7	1	–	6	–	–	14

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
2012					
Non-life insurance	**–**	**–**	**–**	**–**	**–**
Life insurance (non-linked)	**15,414**	**34,173**	**68,544**	**46,688**	**164,819**
Life insurance (linked)	**12**	**49**	**132**	**853**	**1,046**
	15,426	**34,222**	**68,676**	**47,541**	**165,865**
2011					
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

62. 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
2012				
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	**140**	**323**	**–**	**463**
	141	**323**	**–**	**464**
2011				
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
	120	314	–	434

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 2012 was HK$6,003 million (31 December 2011: HK$5,188 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 date of reasonably possible changes in the main economic and business assumptions:

	2012	2011
+ 100 basis points shift in risk-free rate	**474**	619
– 100 basis points shift in risk-free rate	**(593)**	(401)

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 the consequential changes in policyholder behaviour.

62. 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 2012 results		Impact on 2011 results	
	Profit for the year	**Net assets**	Profit for the year	Net assets
20 per cent increase in claims costs	**–**	**–**	(9)	(9)
20 per cent decrease in claims costs	**–**	**–**	9	9
10 per cent increase in mortality and/or morbidity rates	**(86)**	**(86)**	(65)	(65)
10 per cent decrease in mortality and/or morbidity rates	**86**	**86**	64	64
50 per cent increase in lapse rates	**91**	**91**	259	259
50 per cent decrease in lapse rates	**(59)**	**(59)**	(243)	(243)
10 per cent increase in expense rates	**(84)**	**(84)**	(76)	(76)
10 per cent decrease in expense rates	**84**	**84**	76	76

Process used to determine assumptions for long-term insurance contracts

The process used to determine the assumptions is intended to result in stable and prudent estimates of future outcome. This is achieved by adopting relatively conservative assumptions which can withstand a reasonable range of fluctuation of actual experience. Annual review of the relevant experience is performed to assess the adequacy of margin between the assumptions adopted and the most likely estimate of future outcome. The assumptions that are considered include the probability of claims and investment returns.

For non-linked life business, the policy reserve is generally calculated on a modified net premium basis. The net premium is the level of premium payable over the premium payment period whose discounted value at the outset of the policy would be sufficient to exactly cover the discounted value of the original guaranteed benefits at maturity or at death if earlier. The net premium is then modified to allow for deferral of acquisition costs. The policy reserve is then calculated by subtracting the present value of future modified net premiums from the present value of the benefits guaranteed at maturity or death up to the balance sheet date. Negative provisions would not be allowed. The modified net premium basis makes no allowance for voluntary discontinuance by policyholders as this would generally result in a reduced level of policy reserve.

For linked life business, the policy reserve is generally determined as the total account balance of all in-force policies with an additional provision for the unexpired insurance risk.

62. Financial risk management continued

(d) Insurance risk continued

Assumptions

The principal assumptions underlying the calculation of the long-term insurance business provision are:

(i) Mortality

A base mortality table which is most appropriate for each type of contract is selected. A loading is generally added as a provision for adverse deviation. An annual investigation is performed to ascertain the appropriateness with the Group's insurance subsidiary's actual experience.

(ii) Morbidity

The morbidity incidence rates, which mainly cover major illness and disability, are generally derived from the reinsurance costs which also form the pricing basis. A loading is generally added as a provision for adverse deviation. An annual investigation is performed to ascertain the appropriateness with the Group's insurance subsidiary's actual experience.

(iii) Discount rates

Rate of interest

	2012	2011
Policies denominated in HKD	**3%**	3%
Policies denominated in USD	**4%**	4%

Under the modified net premium method, the long-term business provision is sensitive to the interest rate used when discounting.

Sensitivity to changes in variables

The Group's insurance company re-runs its valuation models on various bases. An analysis of sensitivity around various scenarios provides an insight to the key risks which the Group's insurance company is exposed to. The table presented below demonstrates the sensitivity of insured liability estimates to particular movements in assumptions used in the estimation process. Certain variables can be expected to impact on life assurance liabilities more than others, and consequently a greater degree of sensitivity to these variables may be expected.

Impact on reported profit to changes in key variable

	Change in variable %	**Change in liabilities**	
		2012	2011
Base run		**74,939**	65,713
Discount rate	**+1**	**(1,588)**	(1,972)
Discount rate	**–1**	**5,060**	4,927
Mortality/Morbidity	**+10**	**50**	47
Mortality/Morbidity	**–10**	**(44)**	(42)

The analysis above has been prepared for a change in variable with all other assumptions remaining constant and ignores changes in values of the related assets.

62. Financial risk management continued

(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.

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.

62. Financial risk management continued

(f) Capital management continued

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.

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 ("IRB") 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 approach is intended to cover unexpected losses and is derived from a formulae 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 IRB 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 percentage of gross revenues, whereas under the standardised approach it is one of three different percentages of gross revenues allocated to each of eight defined business lines. Finally, the advanced measurement approach uses the 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.

62. Financial risk management continued

(f) Capital management continued

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.

In December 2010, the Basel Committee on Banking Supervision ("BCBS") issued two documents: A global regulatory framework for more resilient banks and banking systems and International framework for liquidity risk measurement, standards and monitoring, which together are commonly referred to as "Basel III". In June 2011, the BCBS issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.

The Basel III rules set out the minimum common equity tier 1 ("CET1") requirement of 4.5% and additional capital conservation buffer requirement of 2.5%, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a maximum level of 2.5% effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers. In addition to the criteria detailed in the Basel III proposals, the BCBS issued further minimum requirements in January 2011 to ensure that all classes of capital instruments are able to absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of instruments issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

The Banking (Capital) (Amendment) Rules 2012 came into effect on 1 January 2013 to implement the first phase of Basel III capital standards in Hong Kong ("Basel III Capital Rules"). The changes in minimum capital ratio requirements are phased in from 1 January 2013 to 1 January 2019, while the capital treatment for counterparty credit risk is effective from 1 January 2013.

The Group has estimated the pro-forma impact of the Basel III Capital Rules on the Group's capital position at 31 December 2012. The capital requirements that came into effect on 1 January 2013 are estimated to result in capital ratios that are above the minimum requirements. The initial impact of the Basel III changes at 1 January 2013 would be to increase the CET1 ratio by 1.3% to 13.5% and total capital adequacy ratio by 2.6% to 16.6% approximately on a proforma basis.

The pro-forma capital position would be higher than the 31 December 2012 position under the existing rules, mainly because of the following reasons:

- introduction of concessionary thresholds for deduction of capital investments in non-consolidated financial institutions;
- the timing of the recognition of dividends; and
- the removal of the cap on unrealised gains on own-use and investment properties.

Following the implementation, capital ratios for the half-year ending 30 June 2013 will be calculated in accordance with the Basel III Capital Rules.

63 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. 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.

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.

63. Fair value of financial instruments continued

(a) Determination of fair value continued

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 the valuation of OTC derivative contracts to reflect within fair value the possibility that the counterparty may default and the Group may not receive the full market value of the transactions.

– 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.

– Structured notes

  The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph below on derivatives.

  Trading liabilities valued using a valuation technique with significant unobservable inputs principally comprised equity-linked structured notes, which are issued by the Group and provide the counterparty with a return that is linked to the performance of certain equity securities, and other portfolios. The notes are classified as level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices, between equity prices and interest rates and between interest rates and foreign exchange rates.

– Derivatives

  OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon "no-arbitrage" principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some 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, such as foreign exchange rates, interest rates and equity prices.

63. 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					
	quoted market price Level 1	using observable inputs Level 2	with significant non-observable inputs Level 3	Third party total	Amounts with HSBC entities*	Total
2012						
Assets						
Trading assets	**30,930**	**3,469**	**–**	**34,399**	**–**	**34,399**
Financial assets designated at fair value	**2,545**	**1,874**	**478**	**4,897**	**3,446**	**8,343**
Derivative financial instruments	**325**	**4,278**	**161**	**4,764**	**415**	**5,179**
Available-for-sale financial investments	**112,245**	**73,308**	**224**	**185,777**	**–**	**185,777**
Liabilities						
Trading liabilities	**21,492**	**38,226**	**135**	**59,853**	**–**	**59,853**
Financial liabilities designated at fair value	**–**	**464**	**–**	**464**	**–**	**464**
Derivative financial instruments	**63**	**3,398**	**–**	**3,461**	**657**	**4,118**
2011						
Assets						
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
Liabilities						
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

* 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.

63. Fair value of financial instruments *continued*

(a) Determination of fair value *continued*

	Bank					
	Valuation techniques					
	quoted market price Level 1	using observable inputs Level 2	with significant non-observable inputs Level 3	Third party total	Amounts with HSBC entities*	Total
2012						
Assets						
Trading assets	**30,930**	**705**	**–**	**31,635**	**–**	**31,635**
Financial assets designated at fair value	**–**	**–**	**–**	**–**	**–**	**–**
Derivative financial instruments	**320**	**3,891**	**–**	**4,211**	**423**	**4,634**
Available-for-sale financial investments	**112,179**	**33,135**	**100**	**145,414**	**–**	**145,414**
Liabilities						
Trading liabilities	**21,492**	**6,167**	**117**	**27,776**	**–**	**27,776**
Financial liabilities designated at fair value	**–**	**–**	**–**	**–**	**–**	**–**
Derivative financial instruments	**57**	**2,745**	**–**	**2,802**	**715**	**3,517**
2011						
Assets						
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
Liabilities						
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

* 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.

63. 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-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2012	150	–	634	71	523	–	–
Total gains or losses recognised in profit and loss	–	–	22	90	6	–	–
Total gains or losses recognised in other comprehensive income	74	–	–	–	–	–	–
Purchases	–	–	158	–	–	–	–
Issues/deposit taking	–	–	–	–	415	–	–
Sales	–	–	(205)	–	–	–	–
Settlements	–	–	(86)	–	(653)	–	–
Transfers out	–	–	(45)	–	(156)	–	–
Transfers in	–	–	–	–	–	–	–
Exchange adjustments	–	–	–	–	–	–	–
At 31 December 2012	224	–	478	161	135	–	–
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date	14	–	20	90	–	–	–

63. Fair value of financial instruments continued

(a) Determination of fair value continued

	Group						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2011	283	–	510	106	553	–	–
Total gains or losses recognised in profit and loss	–	–	(1)	(154)	(5)	–	–
Total gains or losses recognised 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 in profit or loss relating to those assets and liabilities held at the balance sheet date	13	–	2	(154)	5	–	–

63. Fair value of financial instruments continued

(a) Determination of fair value continued

	Bank						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2012	**44**	–	–	–	**421**	–	–
Total gains or losses recognised in profit and loss	–	–	–	–	–	–	–
Total gains or losses recognised in other comprehensive income	**56**	–	–	–	–	–	–
Purchases	–	–	–	–	–	–	–
Issues/deposit taking	–	–	–	–	**338**	–	–
Sales	–	–	–	–	–	–	–
Settlements	–	–	–	–	**(642)**	–	–
Transfers out	–	–	–	–	–	–	–
Transfers in	–	–	–	–	–	–	–
Exchange adjustments	–	–	–	–	–	–	–
At 31 December 2012	**100**	–	–	–	**117**	–	–
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date	**7**	–	–	–	–	–	–

63. Fair value of financial instruments continued

(a) Determination of fair value continued

	Bank						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2011	36	–	–	–	284	–	–
Total gains or losses recognised in profit and loss	8	–	–	–	–	–	–
Total gains or losses recognised in other comprehensive income	–	–	–	–	–	–	–
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 in profit or loss relating to those assets and liabilities held at the balance sheet date	6	–	–	–	–	–	–

For financial assets designated at fair value, the transfers out of Level 3 were due to change in valuation observability of certain debt securities during the year.

For held-for-trading liabilities, transfers 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.

63. 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
2012				
Derivatives/trading assets/trading liabilities	**3**	**(3)**	**–**	**–**
Financial assets/liabilities designated at fair value	**48**	**(48)**	**–**	**–**
Available-for-sale financial investments	**–**	**–**	**22**	**(22)**
2011				
Derivatives/trading assets/trading liabilities	8	(8)	–	–
Financial assets/liabilities designated at fair value	63	(63)	–	–
Available-for-sale financial investments	–	–	15	(15)

	Bank			
	Reflected in income statement		Reflected in other comprehensive income	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
2012				
Derivatives/trading assets/trading liabilities	**–**	**–**	**–**	**–**
Financial assets/liabilities designated at fair value	**–**	**–**	**–**	**–**
Available-for-sale financial investments	**–**	**–**	**10**	**(10)**
2011				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Available-for-sale financial investments	–	–	4	(4)

63. 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.

	Group		Bank	
	2012	2011	**2012**	2011
Recorded in the income statement:				
Derivatives/trading assets/trading liabilities	**96**	(159)	**–**	–
Financial assets/liabilities designated at fair value	**22**	(1)	**–**	–

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 balance sheet date of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

(i) Loans and advances to customers

Performing loans are grouped, as far as possible, into homogenous pools segregated by maturity and interest rates and the contractual cash flows are generally discounted using the Group's estimate of the discount rate that market participants would use in valuing instruments with similar maturity, re-pricing and credit risk characteristics.

The fair value of loans and 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 balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

63. 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).

63. 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			
	2012		2011	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks	**140,382**	**140,535**	107,742	107,707
Loans and advances to customers	**536,162**	**532,884**	480,574	468,563
Held-to-maturity debt securities	**67,631**	**72,716**	59,911	63,396
Financial Liabilities				
Current, savings and other deposit accounts	**769,147**	**769,223**	699,857	699,939
Deposits from banks	**19,845**	**19,845**	14,004	14,004
Certificates of deposit and other debt securities in issue	**11,291**	**11,317**	9,284	9,294
Subordinated liabilities	**11,821**	**14,107**	11,846	13,424

	Bank			
	2012		2011	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks	**74,846**	**74,846**	47,724	47,724
Loans and advances to customers	**476,734**	**473,451**	425,629	413,629
Financial Liabilities				
Current, savings and other deposit accounts	**730,533**	**730,609**	661,012	661,093
Deposits from banks	**13,952**	**13,952**	11,989	11,989
Certificates of deposit and other debt securities in issue	**11,291**	**11,317**	9,284	9,294
Subordinated liabilities	**11,821**	**14,107**	11,846	13,424

64. Comparative figures

As a result of the adoption of the amendment to HKAS 12 "Income Taxes", 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 2012.

65. 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.

66. Events after the balance sheet date

Non-adjusting post balance sheet event

On 7 January 2013, Industrial Bank Co., Ltd. ("Industrial Bank"), completed a private placement of additional share capital to a number of third parties, thereby diluting the Group's equity holding from 12.8% to 10.9%. As a result of this and other factors, the Group considers it is no longer in a position to exercise significant influence over Industrial Bank and ceased to account for the investment as an associate from that date, giving rise to an accounting gain of approximately HK$9.5 billion. This represented the difference between the fair value of the financial investment in Industrial Bank (RMB23.2 billion), based on the last trading date preceding the placement completion date, and its carrying value in the Group's consolidated financial statements, the reclassification of the related cumulative foreign exchange and other reserves and the related tax effect.

Financial implication of change in accounting treatment for Industrial Bank

The following table compares the Group's reported performance in 2012 and 2011 with the performance if the Group's investment in Industrial Bank was not equity accounted for in both 2012 and 2011.

Financial implication

	Group	
	2012	2011
Attributable Profit (as reported)	**19,426**	16,885
Excluding:		
Share of profits from Industrial Bank and related taxation	**(4,793)**	(3,309)
Including:		
Dividend income from Industrial Bank	**628**	422
Attributable Profit (adjusted)	**15,261**	13,998
Earnings per share (as reported)	**HK$10.16**	HK$8.83
Earnings per share (adjusted)	**HK$7.98**	HK$7.32

Capital Adequacy Impact

The change in accounting treatment for Industrial Bank will not create any significant impact on the Group's overall capital base given the Group's interest in Industrial Bank is required to be deducted from the capital base under the existing capital regime. As the Group will recognise an accounting gain of about HK$9.5 billion in 2013, this will in part have a positive impact on the Group's core capital under Basel II and CET1 capital under the Basel III regime.

67. Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 4 March 2013.