1 Basis Of Preparation

(a) The consolidated financial statements comprise the statements of Hang Seng Bank Limited ("the Bank") and all its subsidiaries made up to 31 December. The consolidated financial statements include the attributable share of the results and reserves of associates, based on the financial statements made up to dates not earlier than three months prior to 31 December. All significant intra-group transactions have been eliminated on consolidation. The Bank and its subsidiaries and associates are collectively referred to 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. These financial statements also comply with the module on "Financial Disclosure by Locally Incorporated Authorised Institutions" under the Supervisory Policy Manual and the supplemental guidance issued by the Hong Kong Monetary Authority. 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 3.

The HKICPA has issued certain new and revised HKFRSs that are first effective or available for early adoption for the current accounting period of the Group and the Bank. Note 4 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 3(g));

– investment property (see note 3(r));

– other leasehold land and buildings, for which the fair values cannot be allocated reliably between the land and buildings elements at the inception of the lease and the entire lease is therefore classified as a finance lease (see note 3(s));

– buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold interest in the land at the inception of the lease (see note 3(s)); and

– liabilities for share-based payment arrangements (see note 3(y)).

(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. In this regard, management believes that the critical accounting policies where judgement is necessarily applied are those which relate to goodwill impairment, loan impairment, valuation of financial instruments, and estimated employee retirement benefit costs of defined benefit schemes. 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 estimates with a significant risk of material adjustment in next year are discussed in note 5.

2 Nature Of Business

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

3 Principal Accounting Policies

(a) Interest income and expense

Interest income and expense for all interest-bearing 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 asset or financial liability 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 not future credit losses. The calculation includes all amounts paid or received by the Group that are an integral part of the effective interest rate, 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

The Group earns fee income from a diverse range of services it provides to its customers. Fee income is accounted for as follows:

- if the income is earned on the execution of a significant act, it is recognised as revenue when the significant act has been completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- if the income is earned as services are provided, it is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- if the income is an integral part of the effective interest rate of a financial instrument, it is recognised as an adjustment to the effective interest rate (for example, loan commitment fees) and reported in "Interest income" (see note 3(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 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 3(h) and (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 foreign exchange reserve in accordance with the accounting policy set out in note 3(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/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

Segmental information is presented in respect of business and geographical segments. Business by customer group information, which is more relevant to the Group in making operating and financial decisions, is chosen as the primary reporting format.

3 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 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

The Group will recognise losses for impaired loans promptly where 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

At each balance sheet date, the Group assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on individually assessed loans, the following factors are considered:

- 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 relevant foreign currency if loans are not in local currency; and
- where available, the secondary market price for the debt.

Impairment allowances of an individually assessed loan are measured as the difference between the carrying value and the present value of estimated future cash flows discounted at the original effective interest rate of the individual loan. Any loss is charged in the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account.

(ii) Collectively assessed loans

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

- in respect of losses which have been incurred but have not yet been identified as loans subject to individual assessment for impairment (see section (i)); and
- for homogeneous groups of loans that are not considered individually significant.

3 Principal Accounting Policies (continued)

(f) Loan impairment (continued)

(ii) Collectively assessed loans (continued)

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of loss has been identified individually, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment allowance. This allowance covers loans that are impaired at the balance sheet date but which will not be individually identified as such until some time in the future. 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 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 of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

(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". 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.

(g) Financial instruments

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

(i) Trading assets and trading liabilities

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

3 Principal Accounting Policies (continued)

(g) Financial instruments (continued)

(ii) Financial instruments designated at fair value

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

- eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases. Under this criterion, the main classes of financial instruments designated by the Group are :

Long-term debt issues – The interest payable on certain fixed rate long-term debt securities in issue and subordinated liabilities has been matched with the interest on "receive fixed/pay variable" interest rate swaps as part of a documented interest rate risk management strategy.

Fixed rate bonds and related derivatives for economic hedge – The interest receivable on certain fixed rate bonds has been matched with the interest on "receive variable/pay fixed" interest rate swaps as part of a documented interest rate risk management strategy.

An accounting mismatch would arise if the long-term debt issues and fixed rate bonds were accounted for at amortised cost because the related derivatives are measured at fair value with changes in the fair value taken through the income statement. By designating the long-term debt issues and fixed rate bonds at fair value, their movement in the fair value will be recorded in the income statement.

- 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 class 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". This includes the amount of change, during the period and cumulatively, in the fair value of designated financial liabilities and loans and receivables that is attributable to changes in their credit risk, i.e. the amount of change in fair value that is not attributable to changes in market interest rates. 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 and held-to-maturity investments

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 3(g)(ii)) or classified as held-to-maturity.

Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value. Changes in fair value are recognised in equity until the securities are either sold or impaired. On the sale of available-for-sale securities, cumulative gains or losses previously recognised in equity are recognised through the income statement within "Profit and loss on disposal of fixed assets and financial investments".

3 Principal Accounting Policies (continued)

(g) Financial instruments (continued)

(iii) Available-for-sale financial assets and held-to-maturity investments (continued)

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.

(h) Derivative financial instruments

Derivative financial instruments ("derivatives") are initially recognised at fair value and carried as assets when the fair value is positive and as liabilities when the fair value is negative.

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

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract, the terms of the embedded derivatives are the same as those of a stand-alone derivative, and the combined contract is not designated at fair value. These embedded derivatives are measured at fair value with changes in the fair value recognised in "Trading income".

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

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 hedges"). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value or cash flow hedges provided certain criteria are met.

It is the Group's policy to document, at the inception of a hedging relationship, the relationship between the hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking the hedge. Such policies also require documentation of the assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items attributable to the hedged risks.

(i) Fair value hedge

Changes in the fair value of derivatives that are designated and qualified as fair value hedging instruments are recorded in the income statement within "Trading income", together with changes in the fair value of the asset or 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.

3 Principal Accounting Policies (continued)

(i) Hedge accounting (continued)

(ii) Cash flow hedges

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

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

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity 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 reported in equity is immediately transferred 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.

For fair value hedge relationships, the Group utilises the cumulative dollar offset method 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.

All gains and losses from changes in the fair value of any derivatives held for trading and those that do not qualify for hedge accounting are recognised immediately in the income statement and reported in "Trading income". For derivative contracts which are used with financial instruments designated at fair value, the 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.

3 Principal Accounting Policies (continued)

(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) Determination of fair value

The fair value of financial instruments is based on their quoted market prices at the balance sheet date, or date close to balance sheet date, without any deduction for estimated future selling costs. Financial assets are priced at current bid prices, while financial liabilities are priced at current asking prices unless the position is immaterial or the bid and offer spread is small. In such case, mid rate will be applied for both long and short positions.

If a quoted market price is not available on a recognised stock exchange or from a broker/dealer for non-exchange-traded financial instruments, the fair value of the instrument is estimated using valuation techniques, including use of recent arm's-length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow techniques, option pricing models or any other valuation technique that provides a reliable estimate of prices obtained in actual market transactions.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates, and the discount rate used is a market rate at the balance sheet date applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the balance sheet date. Fair values for unquoted equity investments are estimated, if possible, using applicable price/earnings ratios for similar listed companies adjusted to reflect the specific circumstances of the issuer.

Investments in other unlisted open-ended investment funds are recorded at the net asset value per share as reported by the managers of such funds.

(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 investment 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 for the year, together with any impairment loss on goodwill relating to the investment in associate recognised for the year.

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, investment in associate is stated at cost less impairment allowances.

3 Principal Accounting Policies (continued)

(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 "Investments in associates". Goodwill is stated at cost less any accumulated impairment losses, which are charged to the income statement. Goodwill is allocated to cash-generating units and is tested for impairment annually by comparing the present value of the expected future cash flows from a business with the carrying value of its net assets, including attributable goodwill.

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 assurance business, acquired software licences and capitalised development costs of computer software programmes. The value of in-force long-term assurance business is stated at a valuation determined annually in consultation with independent actuaries using the methodology as described in note 3(ac). Computer software acquired is stated at cost less amortisation and impairment allowances. Amortisation of computer software is charged to the income statement over its useful life. Costs incurred in the development phase of a project to produce application software for internal use are capitalised and amortised over the software's estimated useful life, usually five years. A periodic review is performed on intangible assets to confirm that there has been no impairment.

(r) Investment property

Investment properties are land and/or buildings which are owned and/or held under a leasehold interest to earn rental income and/or for capital appreciation. These include land held for a currently undetermined future use.

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.

(s) Premises, plant and equipment

(i) The following properties 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:

- land held under operating leases and buildings thereon, where the fair value of the leasehold interest in the land and buildings cannot be measured separately at the inception of the lease and the building is not clearly held under an operating lease; and
- buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold interest in the land at the inception of the lease.

  Revaluations are performed by professionally qualified valuers with sufficient regularity to ensure that the carrying amount of these assets does not differ materially from that which would be determined using 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 property, and are thereafter taken to "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 property, and are thereafter to the income statement.

  Depreciation is calculated to write-off the valuation of the property 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.

3 Principal Accounting Policies (continued)

(s) Premises, plant and equipment (continued)

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

Leasehold interest in the land held for own use is accounted for as being held under an operating lease where the fair value of the interest in any buildings situated on the leasehold land could be measured separately from the fair value of the leasehold interest in land at the time the lease was first entered into by the Group. The interest in leasehold land is stated at cost in the balance sheet and is amortised to the income statement on a straight-line basis over the remaining lease term.

(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 3(r) & 3(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 3(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 3(s). Impairment allowances are accounted for in accordance with the accounting policy as set out in note 3(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 3(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 3(f) and 3(q) respectively.

3 Principal Accounting Policies (continued)

(v) Impairment of assets (continued)

(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

When there is objective evidence that an available-for-sale financial asset is impaired, the cumulative loss that had been recognised directly in equity is removed from equity and is recognised in the income statement. The amount of the cumulative loss that is recognised in the income statement is the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that asset previously recognised in income statement.

For unquoted available-for-sale equity securities that are carried at cost, the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

Impairment losses in respect of available-for-sale debt securities are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised. Reversals of impairment losses in such circumstances are recognised in the income statement.

Impairment losses recognised in the income statement in respect of available-for-sale equity securities are not reversed through the income statement. Any subsequent increase in the fair value of such assets is recognised directly in equity.

(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.

3 Principal Accounting Policies (continued)

(v) Impairment of assets (continued)

(iii) Other assets (continued)

Reversals of impairment losses

In respect of assets other than goodwill, an impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount. An impairment loss in respect of goodwill is not reversed.

A reversal of impairment losses is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the year in which the reversals are recognised.

(w) Income tax

Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised directly in equity, in which case they are recognised in equity. 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 Recognised Income and Expense 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.

3 Principal Accounting Policies (continued)

(x) Employee benefits (continued)

Where the calculation of the Group's net obligation results in a negative amount, the asset recognised is limited to the present value of any future refunds from the scheme or reductions in future contributions to the scheme less past service cost.

The retirement benefit costs of defined contribution schemes and mandatory provident fund schemes are the contributions made in accordance with the relative scheme rules and are charged to the income statement of the year.

(y) Equity compensation plans

The Group grants shares and options on shares on HSBC Holdings plc to certain employees under various vesting conditions.

For the grant of shares as discretionary bonuses, the Group has the obligation to acquire HSBC Holdings plc shares to deliver to the employees upon vesting and is expensed over the vesting period which, in this case, is the period from the date the bonus is announced until the award vests. The Group's liability is measured at fair value at each reporting date. The changes in fair value are recognised as an expense in each period.

For share options granted to employees of the group directly by HSBC Holdings plc, the compensation expense to be spread over the vesting period is determined by reference to the fair value of the options on grant date, and the impact of any non-market vesting conditions such as option lapses. The expense is recognised over the vesting period. As no charge has been made by HSBC Holdings plc for the grants of options, the corresponding amount is credited to "Other reserves" under shareholders' equity.

(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 accounted for in a separate foreign exchange reserve in equity. 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 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 instrument.

Financial guarantee liabilities are initially recognised at their fair value, and the initial fair value is amortised over the life of the financial guarantee. The guarantee liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment (when a payment under the guarantee has become probable). Financial guarantees are included within other liabilities.

(ac) Insurance contracts

Through its insurance subsidiaries, the Group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

3 Principal Accounting Policies (continued)

(ac) Insurance contracts (continued)

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 classification as set out in notes 3(d) to 3(i).

Insurance contracts are accounted for as follows:

Net earned insurance premiums

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.

Premiums for life assurance are accounted for when receivable, except in unit-linked business where premiums are accounted for when liabilities are recognised.

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 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.

Gross insurance claims for life assurance reflect the total cost of claims arising during the year, including policyholder cash dividend payment upon policy anniversary. 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 relevant fund or funds or index.

Reinsurance recoveries are accounted for in the same period as the related 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.

Value of long-term insurance business

A value is placed on insurance contracts that are classified as long-term assurance business, and are in force at the balance sheet date.

The value of the in-force long-term assurance business 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 and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. Movements in the value of in-force long-term assurance business are included in other operating income on a pre-tax basis. The value of in-force long-term insurance business is reported under "Intangible assets" in the balance sheet.

(ad) Investment contracts

Customer liabilities under unit-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".

3 Principal Accounting Policies (continued)

(ad) Investment contracts (continued)

Premiums 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.

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are capitalised and amortised over the period the investment management services are provided.

(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) 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 subject to common control or common significant influence. 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.

4 Changes In Accounting Policies

The Group has made the following changes in accounting policies in accordance with existing HKFRSs and on adoption of new HKFRSs issued by the HKICPA which became effective or available for early adoption for the current accounting period.

Change in presentation – Hong Kong Accounting Standard 1 "Presentation of Financial Statements"

With effect from 2006 reporting, interest income and expense from trading financial assets and liabilities and financial instruments designated at fair value are reported under "Net interest income" instead of "Net trading income" and "Net income from financial instruments designated at fair value" respectively as in the previous year. The change has been made principally to match the interest expense arising from trading liabilities with the interest income from non-trading assets. This also facilitates the comparison of the Group's net interest income and net interest margin with peer banks in Hong Kong.

Comparative figures have been reclassified to conform with the current year's presentation as follows:

Figures in HK$m	2005 (as previously reported)	Effect of change*	2005 (as restated)
Interest income	19,029	684	19,713
Interest expense	(7,961)	(956)	(8,917)
Net interest income	11,068	(272)	10,796
Trading income	579	306	885
Net income/(expense) from financial instruments designated at fair value	2	(34)	(32)

* Increase/(decrease) in the profit for the year.

4 Changes In Accounting Policies (continued)

For HSBC Group reporting, interest income and interest expense arising from financial assets and financial liabilities held for trading are reported as "Net trading income" and arising from financial instruments designated at fair value through profit and loss as "Net income from financial instruments designated at fair value" (other than for debt securities in issue and subordinated liabilities, together with the derivatives managed in conjunction with them).

Amendments to Hong Kong Accounting Standard 39 ("HKAS 39") and Hong Kong Financial Reporting Standard 4 "Financial Instruments: Recognition and Measurement and Insurance Contracts – Financial Guarantee Contracts"

In prior years, financial guarantee contracts were accounted for under HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets" as contingent liabilities and were disclosed as off-balance sheet items.

With effect from 1 January 2006 and in accordance with the above amendments, financial guarantee contracts issued are recognised as financial liabilities and reported under "Other liabilities". Details of the accounting policy on "Financial guarantees" is set out in note 3(ab) above.

Financial liabilities recorded under "Other liabilities" at 31 December 2006 amounted to HK$4 million. No restatement of comparative figures was made as the amounts were immaterial.

Hong Kong Financial Reporting Standard 7 ("HKFRS 7") "Financial Instruments: Disclosures"

The Group has adopted HKFRS 7 prior to its required application date of 1 January 2007. The adoption of HKFRS 7 impacted the type and amount of disclosures made in the financial statements, but had no impact on the reported profits or financial position of the Group. In accordance with the transitional requirements of HKFRS 7, the Group has provided full comparative information.

5 Accounting Estimates And Judgements

Key sources of estimation uncertainty and critical judgements in applying the Group's accounting policies which have significant effect on the financial statements are set out below.

(a) Key sources of estimation uncertainty

Impairment allowances on loans and advances

The Group periodically reviews its loan portfolios to assess whether impairment allowances exist. In determining whether impairment allowances should be recorded in the income statement, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

(b) Critical accounting judgements in applying the Group's accounting policies

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

For available-for-sale financial assets, a significant or prolonged decline in fair value below cost is considered to be objective evidence of impairment. Judgement is required when determining whether a decline in fair value has been significant or prolonged. In making this judgement, the historical data on market volatility as well as the price of the specific investment are taken into account. The Group also takes into account other factors, such as industry and sector performance and financial information regarding the issuer/investee.

(ii) Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity investments if the Group has the intention and ability to hold them until maturity. In evaluating whether the requirements to classify a financial asset as held-to-maturity are met, management make 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.

5 Accounting Estimates And Judgements (continued)

(b) Critical accounting judgements in applying the Group's accounting policies (continued)

(iii) Income taxes

Determining income tax provisions involves judgement on the future tax treatment of certain transactions. The Group carefully evaluates tax implications of transactions and tax provisions are set up accordingly. The tax treatment of such transactions is reconsidered periodically to take into account all changes in tax legislations.

6. Possible Impact Of Amendments, New Standards And Interpretations Issued But Not Yet Effective For The Year Ended 31 December 2006

The HKICPA has issued an amendment to HKAS 1 "Presentation of financial statements: capital disclosures" and the Hong Kong Monetary Authority has recommended additional disclosures which are not yet effective for the accounting year ended 31 December 2006. The Group has not adopted these changes in the financial statements.

7 Interest Income/Interest Expense

(a) Interest income

	2006	2005 restated
Interest income arising from:		
– financial assets that are not at fair value through profit and loss	**28,639**	19,029
– trading assets	**529**	623
– financial assets designated at fair value	**94**	61
	29,262	19,713
of which:		
– interest income from listed investments	**326**	246
– interest income from unlisted investments	**9,851**	6,772
– interest income from impaired financial assets	**26**	20

(b) Interest expense

	2006	2005 restated
Interest expense arising from:		
– financial liabilities that are not at fair value through profit and loss	**14,950**	7,961
– trading liabilities	**2,568**	929
– financial liabilities designated at fair value	**50**	27
	17,568	8,917
of which:		
– interest expense from debt securities in issue maturing after five years	**62**	126
– interest expense from customer accounts maturing after five years	**31**	17
– interest expense from subordinated liabilities	**332**	58

With effect from 2006 (and as restated for 2005), interest income and interest expense for all interest-bearing financial instruments are reported in "Interest income" and "Interest expense" respectively in the income statement. The change from the HSBC Group presentation described below has been made principally to match the interest expense arising from trading liabilities with the interest income from non-trading assets. This facilitates the comparison of the Group's net interest income and net interest margin with peer banks in Hong Kong.

7 Interest Income/Interest Expense (continued)

(b) Interest expense (continued)

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

8 Net Fee Income

	2006	2005 restated
– stockbroking and related services	805	493
– retail investment products and funds under management	891	916
– insurance	108	116
– account services	274	225
– private banking	336	174
– remittances	161	141
– cards	860	705
– credit facilities	111	117
– trade services	380	375
– other	148	132
Fee income	4,074	3,394
Fee expense	(577)	(438)
	3,497	2,956
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	1,320	1,162
– Fee income	1,615	1,421
– Fee expense	(295)	(259)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	540	388
– Fee income	641	466
– Fee expense	(101)	(78)

9 Trading Income

	2006	2005 restated
Trading income:		
– foreign exchange	1,178	785
– securities, derivatives and other trading activities	152	100
	1,330	885

10 Net Income/(Expense) From Financial Instruments Designated At Fair Value

	2006	2005 restated
Net income/(expense) on assets designated at fair value which back insurance and investment contracts	910	(25)
Net change in fair value of other financial instruments designated at fair value	(11)	(7)
	899	(32)
of which dividend income from:		
– listed investments	33	22
– unlisted investments	–	3
	33	25

11 Dividend Income

	2006	2005
Dividend income:		
– listed investments	37	48
– unlisted investments	10	12
	47	60

12 Net Earned Insurance Premiums

2006	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Gross written premiums	373	7,549	4	7,926
Movement in unearned premiums	26	–	–	26
Gross earned premiums	399	7,549	4	7,952
Gross written premiums ceded to reinsurers	(78)	(19)	–	(97)
Reinsurers' share of movement in unearned premiums	(9)	–	–	(9)
Reinsurers' share of gross earned premiums	(87)	(19)	–	(106)
Net earned insurance premiums	312	7,530	4	7,846

2005 (restated)	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Gross written premiums	392	7,492	5	7,889
Movement in unearned premiums	19	–	–	19
Gross earned premiums	411	7,492	5	7,908
Gross written premiums ceded to reinsurers	(103)	(14)	–	(117)
Reinsurers' share of movement in unearned premiums	(8)	–	–	(8)
Reinsurers' share of gross earned premiums	(111)	(14)	–	(125)
Net earned insurance premiums	300	7,478	5	7,783

13 Other Operating Income

	2006	2005
Rental income from investment properties	186	207
Movement in present value of in-force long-term insurance business	363	316
Other	296	275
	845	798

14 Net Insurance Claims Incurred And Movement In Policyholders' Liabilities

2006	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Claims, benefits and surrenders paid	105	990	24	1,119
Movement in provisions	(16)	6,990	1	6,975
Gross claims incurred and movement in policyholders' liabilities	89	7,980	25	8,094
Reinsurers' share of claims, benefits and surrenders paid	(14)	(7)	–	(21)
Reinsurers' share of movement in provisions	6	(2)	–	4
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(8)	(9)	–	(17)
Net insurance claims incurred and movement in policyholders' liabilities	81	7,971	25	8,077

2005	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Claims, benefits and surrenders paid	107	569	17	693
Movement in provisions	(9)	6,357	(6)	6,342
Gross claims incurred and movement in policyholders' liabilities	98	6,926	11	7,035
Reinsurers' share of claims, benefits and surrenders paid	(11)	(8)	–	(19)
Reinsurers' share of movement in provisions	(2)	–	–	(2)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(13)	(8)	–	(21)
Net insurance claims incurred and movement in policyholders' liabilities	85	6,918	11	7,014

15 Loan Impairment Charges And Other Credit Risk Provisions

	Group		Bank	
	2006	2005	**2006**	2005
Loan impairment (charges)/releases (note 33(b)):				
– individually assessed	**(107)**	(309)	**(85)**	(433)
– collectively assessed	**(145)**	(309)	**(222)**	(282)
	(252)	(618)	**(307)**	(715)
of which:				
– new and additional	**(423)**	(1,070)	**(461)**	(1,022)
– releases	**106**	351	**103**	229
– recoveries	**65**	101	**51**	78
	(252)	(618)	**(307)**	(715)
Other provision	**(12)**	–	**–**	–
	(264)	(618)	**(307)**	(715)

16 Operating Expenses

	2006	2005
Employee compensation and benefits:		
– salaries and other costs	**2,470**	2,074
– retirement benefit costs		
– defined benefit scheme (note 58(a))	**82**	107
– defined contribution scheme (note 58(b))	**42**	30
– share-based payments (note 59)	**100**	70
	2,694	2,281
General and administrative expenses:		
– rental expenses	**267**	207
– other premises and equipment	**829**	751
– other operating expenses	**1,118**	1,018
	2,214	1,976
Depreciation of business premises and equipment (note 38(a))	**323**	280
Amortisation of intangible assets (note 40)	**10**	9
	5,241	4,546
Cost efficiency ratio	**29.0%**	28.0%
Staff numbers* by region		
Hong Kong	**7,748**	7,425
Mainland	**661**	377
Others	**55**	43
Total	**8,464**	7,845

* Full-time equivalent

17 The Emoluments Of The Five Highest Paid Individuals

(i) The aggregate emoluments

	2006	2005
Salaries, allowances and benefits in kind	19	14
Retirement scheme contributions	2	2
Discretionary bonuses	6	6
Share-based payments	2	2
	29	24

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

HK$	2006 Number of Individuals	2005 Number of Individuals
3,500,001 – 4,000,000	1	1
4,000,001 – 4,500,000	–	2
4,500,001 – 5,000,000	2	–
5,500,001 – 6,000,000	1	2
10,500,001 – 11,000,000	1	–
	5	5

The emoluments of the five highest paid individuals set out above include the emoluments of three (2005: three) Executive Directors. Their respective directors' emoluments are included in note 18.

18 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[3] '000	Discretionary bonuses '000	Share-based payments[4] '000	Total 2006 '000	Total 2005 '000
Executive Directors							
Mr Raymond C F Or	150[1]	5,940	794	3,641	–	10,525	3,464
Mr Vincent H C Cheng (Ceased to be Vice-Chairman and Chief Executive on 25 May 05)	–	–	–	–	–	–	5,968
Mr W K Mok (Retired on 1 Jan 06)	–	–	–	–	–	–	5,762
Mr Joseph C Y Poon	150	3,380	329	1,696	–	5,555	3,605
Mr Patrick K W Chan	150	3,061	314	502	929	4,956	273
Non-Executive Directors							
Mr M R P Smith	230[1]	–	–	–	–	230	139
Mr D G Eldon (Retired on 21 Apr 05)	–	–	–	–	–	–	61
Mr S J Glass (Resigned on 24 Mar 06)	38[1]	–	–	–	–	38	125
Mr Edgar David Ancona (Appointed on 4 Apr 06)	50[1]	–	–	–	–	50	–
Mr John C C Chan [2]	210	–	–	–	–	210	163
Dr Y T Cheng [2]	150	–	–	–	–	150	125
Dr Marvin K T Cheung [2]	230	–	–	–	–	230	195
Mr Jenkin Hui [2]	190	–	–	–	–	190	151
Mr Peter T C Lee [2]	190	–	–	–	–	190	151
Dr Eric K C Li [2]	270	–	–	–	–	270	225
Dr Vincent H S Lo	150	–	–	–	–	150	125
Dr David W K Sin [2]	150	–	–	–	–	150	125
Mr Richard Y S Tang [2]	230	–	–	–	–	230	195
Mr Peter T S Wong	150[1]	–	–	–	–	150	76
Past Directors	–	–	2,101	–	–	2,101	2,077
	2,688	12,381	3,538	5,839	929	25,375	23,005
2005	2,315	12,101	3,216	4,336	1,037		

Notes:

(1) Fees receivable as a Director of Hang Seng Bank Limited were surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy.

(2) Independent Non-Executive Director.

(3) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.101 million in 2006. The Bank made contributions during 2006 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.

(4) These represent the estimated fair value of share option granted to certain directors under the HSBC Group share option plan and the fair value of restricted share and performance share under the HSBC Group share plan, which is measured according to the Group's accounting policies for share-

based payment as set out in note 3(y). The details of these benefits in kind are also set out in note 59.

19 Auditors' Remuneration

	Group		Bank	
	2006	2005	2006	2005
Statutory audit services	11	11	9	8
Non-statutory audit services and others	3	7	2	7
	14	18	11	15

20 Profit On Disposal Of Fixed Assets And Financial Investments

	2006	2005
Profit on disposal of available-for-sale securities:		
– realisation of amounts previously recognised in reserves at 1 January	137	611
– net gains/(losses) arising in the year	201	(153)
	338	458
Profit less loss on disposal of fixed assets	505	19
	843	477

21 Net Surplus On Property Revaluation

	2006	2005
Surplus of revaluation on investment properties (note 37(a))	304	1,160
Reversal of revaluation deficit on premises (note 38(a))	17	153
	321	1,313

22 Tax Expense

(a) Taxation in the consolidated income statement represents:

	2006	2005
Current tax-provision for Hong Kong profits tax		
Tax for the year	2,188	1,501
Current tax-taxation outside Hong Kong		
Tax for the year	36	12
Deferred tax		
Origination and reversal of temporary differences (note 48(b))	(175)	282
Total tax expense	2,049	1,795

The current tax provision is based on the estimated assessable profit for 2006, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 17.5 per cent (the same rate as in 2005). 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.

22 Tax Expense (continued)

(b) Reconciliation between taxation charge and accounting profit at applicable tax rates :

	2006	2005
Profit before tax	**14,395**	13,358
Notional tax on profit before tax, calculated at Hong Kong tax rate of 17.5% (2005: 17.5%)	**2,519**	2,338
Tax effect of:		
– different tax rates in other countries/areas	**(182)**	(291)
– non-taxable income and non-deductible expenses	**(162)**	(160)
– share of results of associates	**(114)**	(88)
– others	**(12)**	(4)
Actual charge for taxation	**2,049**	1,795

23 Profit Attributable To Shareholders

Of the profit attributable to shareholders, HK$10,806 million (2005: HK$10,080 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:

	2006	2005
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	**10,035**	9,423
Dividends declared during the year by subsidiaries from retained profits	**771**	657
The Bank's profit for the year (note 51)	**10,806**	10,080

24 Earnings Per Share

The calculation of earnings per share for 2006 is based on earnings of HK$12,038 million (HK$11,342 million in 2005) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2005).

25 Dividends Per Share

(a) Dividends attributable to the year

	2006		2005	
	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	**1.90**	**3,633**	1.90	3,633
	5.20	**9,942**	5.20	9,942

(b) Dividends attributable to the previous year, approved and paid during the year:

	2006	2005
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK$1.90 per share (2005: HK$1.90 per share)	**3,633**	3,633

26 Segmental Analysis

Segmental information is presented in respect of business and geographical segments. Business by customer group information, which is more relevant to the Group in making operating and financial decisions, is chosen as the primary reporting format.

For the purpose of segmental analysis, the allocation of revenue reflects the benefits of capital and other funding resources allocated to the customer groups or geographical segments by way of internal capital allocation and funds transfer pricing mechanisms. Cost allocation is based on the direct costs incurred by the respective customer groups and apportionment of management overheads. Rental charges at market rate for usage of premises are reflected as inter-segment income for the "Other" customer group and inter-segment expenses for the respective customer groups.

(a) By customer group

The Group's business comprises five customer groups. Personal Financial Services provides banking (including deposits, credit cards, mortgages and other retail lending) and wealth management services (including private banking, investment and insurance) to personal customers. Commercial Banking manages middle market and smaller corporate relationships and specialises in trade-related financial services. Corporate Banking handles relationships with large corporate and institutional customers. Treasury engages in balance sheet management and proprietary trading. Treasury also manages the funding and liquidity positions of the Group and other market risk positions arising from banking activities. "Other" mainly represents management of shareholders' funds and investments in premises, investment properties and equity shares.

26 Segmental Analysis (continued)

(a) By customer group (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Inter-segment elimination	Total
2006							
Net interest income	7,428	2,036	623	481	1,126	–	11,694
Net fee income/(expense)	2,576	809	86	(24)	50	–	3,497
Trading income	517	150	7	628	28	–	1,330
Net income/(expense) from financial instruments designated at fair value	910	–	–	(11)	–	–	899
Dividend income	8	5	–	–	34	–	47
Net earned insurance premiums	7,671	174	1	–	–	–	7,846
Other operating income	542	26	–	(4)	281	–	845
Inter-segment income	–	–	–	–	378	(378)	–
Total operating income	19,652	3,200	717	1,070	1,897	(378)	26,158
Net insurance claims incurred and movement in policyholders' liabilities	(8,014)	(63)	–	–	–	–	(8,077)
Net operating income before loan impairment (charges)/releases and other credit risk provisions	11,638	3,137	717	1,070	1,897	(378)	18,081
Loan impairment (charges)/releases and other credit risk provisions	(165)	(101)	14	–	(12)	–	(264)
Net operating income	11,473	3,036	731	1,070	1,885	(378)	17,817
Total operating expenses*	(3,472)	(1,098)	(168)	(175)	(328)	–	(5,241)
Inter-segment expenses	(326)	(38)	(6)	(8)	–	378	–
Operating profit	7,675	1,900	557	887	1,557	–	12,576
Profit on disposal of fixed assets and financial investments	26	–	–	–	817	–	843
Net surplus on property revaluation	–	–	–	–	321	–	321
Share of profits from associates	29	362	–	164	100	–	655
Profit before tax	7,730	2,262	557	1,051	2,795	–	14,395
Share of profit before tax**	52.9%	16.4%	3.8%	7.6%	19.3%	–	100.0%
Operating profit excluding inter-segment transactions	8,001	1,938	563	895	1,179	–	12,576
Operating profit excluding loan impairment (charges)/releases and other credit risk provisions	7,840	2,001	543	887	1,569	–	12,840
* Depreciation/amortisation included in operating expenses	(106)	(11)	(4)	(2)	(210)	–	(333)
** Share of profits from associates is adjusted to pre-tax basis for the purpose of calculating the Customer groups' share of profit before tax							
Total assets	167,241	69,633	76,619	326,181	29,390	–	669,064
Total liabilities	429,667	82,340	41,959	38,609	27,791	–	620,366
Investments in associates	141	1,775	–	801	771	–	3,488
Capital expenditure incurred during the year	159	44	11	8	157	–	379

26 Segmental Analysis (continued)
(a) By customer group (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Inter-segment elimination	Total
2005 (restated)							
Net interest income	7,092	1,587	612	995	510	–	10,796
Net fee income/(expense)	2,136	713	79	(21)	49	–	2,956
Trading income	367	134	6	378	–	–	885
Net income/(expense) from financial instruments designated at fair value	(25)	–	–	(7)	–	–	(32)
Dividend income	5	5	–	–	50	–	60
Net earned insurance premiums	7,607	176	–	–	–	–	7,783
Other operating income	562	25	4	–	207	–	798
Inter-segment income	–	–	–	–	308	(308)	–
Total operating income	17,744	2,640	701	1,345	1,124	(308)	23,246
Net insurance claims incurred and movement in policyholders' liabilities	(6,964)	(50)	–	–	–	–	(7,014)
Net operating income before loan impairment (charges)/ releases and other credit risk provisions	10,780	2,590	701	1,345	1,124	(308)	16,232
Loan impairment (charges)/ releases and other credit risk provisions	232	(803)	(47)	–	–	–	(618)
Net operating income	11,012	1,787	654	1,345	1,124	(308)	15,614
Total operating expenses*	(3,086)	(903)	(142)	(157)	(258)	–	(4,546)
Inter-segment expenses	(258)	(40)	(5)	(5)	–	308	–
Operating profit	7,668	844	507	1,183	866	–	11,068
Profit on disposal of fixed assets and financial investments	–	–	–	(217)	694	–	477
Net surplus on property revaluation	–	–	–	–	1,313	–	1,313
Share of profits from associates	18	234	–	106	142	–	500
Profit before tax	7,686	1,078	507	1,072	3,015	–	13,358
Share of profit before tax**	56.8%	8.8%	3.7%	8.3%	22.4%	–	100.0%
Operating profit excluding inter-segment transactions	7,926	884	512	1,188	558	–	11,068
Operating profit excluding loan impairment (charges)/releases and other credit risk provisions	7,436	1,647	554	1,183	866	–	11,686
* Depreciation/amortisation included in operating expenses	(103)	(13)	(3)	(2)	(168)	–	(289)
** Share of profits from associates is adjusted to pre-tax basis for the purpose of calculating the Customer groups' share of profit before tax							
Total assets	152,086	54,319	77,514	266,645	30,256	–	580,820
Total liabilities	372,941	77,249	31,672	33,541	21,687	–	537,090
Investments in associates	116	1,454	–	657	702	–	2,929
Capital expenditure incurred during the year	107	20	7	2	95	–	231

26 Segmental Analysis (continued)

(b) By geographical region

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.

	2006	%	2005	%
Total operating income				
– Hong Kong	24,449	93	21,377	92
– Americas	1,295	5	1,644	7
– Mainland and other	414	2	225	1
	26,158	100	23,246	100
Profit before tax				
– Hong Kong	12,380	86	11,253	84
– Americas	1,262	9	1,614	12
– Mainland and other	753	5	491	4
	14,395	100	13,358	100
Capital expenditure incurred during the year				
– Hong Kong	335	88	206	89
– Americas	–	–	–	–
– Mainland and other	44	12	25	11
	379	100	231	100
Total assets				
– Hong Kong	573,067	86	497,406	86
– Americas	65,997	10	60,845	10
– Mainland and other	30,000	4	22,569	4
	669,064	100	580,820	100
Total liabilities				
– Hong Kong	603,636	97	520,260	97
– Americas	4,180	1	9,395	2
– Mainland and other	12,550	2	7,435	1
	620,366	100	537,090	100
Contingent liabilities and commitments				
– Hong Kong	165,541	95	137,536	97
– Americas	–	–	–	–
– Mainland and other	8,701	5	3,973	3
	174,242	100	141,509	100

27 Analysis Of Assets And Liabilities By Remaining Maturity

The maturity analysis is based on the remaining period at the balance sheet date to the contractual maturity date in accordance with the guideline issued by the Hong Kong Monetary Authority.

	Group							
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2006								
Assets								
Cash and balances with banks and other financial institutions	9,390	–	–	–	–	–	–	9,390
Placings with and advances to banks and other financial institutions	16,529	82,200	976	–	–	–	–	99,705
Trading assets	–	–	–	–	–	12,467	–	12,467
Financial assets designated at fair value	–	136	400	1,256	2,557	–	3,931	8,280
Derivative financial instruments	–	166	146	153	48	1,374	–	1,887
Advances to customers	17,087	34,868	39,736	87,768	99,894	–	–	279,353
Financial investments	–	22,703	51,385	134,981	16,601	–	2,040	227,710
Investments in associates	–	–	–	–	–	–	3,488	3,488
Investment properties	–	–	–	–	–	–	2,732	2,732
Premises, plant and equipment	–	–	–	–	–	–	6,516	6,516
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	580	580
Intangible assets	–	–	–	–	–	–	2,070	2,070
Other assets	6,304	5,694	1,500	262	10	–	1,116	14,886
	49,310	145,767	94,143	224,420	119,110	13,841	22,473	669,064
Liabilities								
Current, savings and other deposit accounts	290,463	182,885	8,497	976	–	–	–	482,821
Deposits from banks	2,797	14,032	1,121	–	–	–	–	17,950
Trading liabilities	–	–	–	–	–	60,093	–	60,093
Financial liabilities designated at fair value	81	–	–	996	–	–	485	1,562
Derivative financial instruments	–	7	101	98	11	1,314	–	1,531
Certificates of deposit and other debt securities in issue	–	74	866	6,655	–	–	–	7,595
Other liabilities	6,486	8,577	468	120	143	–	329	16,123
Liabilities to customers under insurance contracts	–	–	–	–	–	–	22,975	22,975
Deferred tax and current tax liabilities	–	481	747	–	–	–	1,488	2,716
Subordinated liabilities	–	–	–	7,000	–	–	–	7,000
	299,827	206,056	11,800	15,845	154	61,407	25,277	620,366

27 Analysis Of Assets And Liabilities By Remaining Maturity (continued)

	Group							
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2005								
Assets								
Cash and balances with banks and other financial institutions	9,201	–	–	–	–	–	–	9,201
Placings with and advances to banks and other financial institutions	11,824	52,661	4,597	204	–	–	–	69,286
Trading assets	–	–	–	–	–	12,600	–	12,600
Financial assets designated at fair value	–	52	113	1,601	2,262	–	1,999	6,027
Derivative financial instruments	–	106	105	218	25	1,261	–	1,715
Advances to customers	14,330	26,348	33,457	91,279	95,266	–	–	260,680
Financial investments	–	14,214	35,010	126,831	12,528	–	1,321	189,904
Investments in associates	–	–	–	–	–	–	2,929	2,929
Investment properties	–	–	–	–	–	–	4,273	4,273
Premises, plant and equipment	–	–	–	–	–	–	6,750	6,750
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	594	594
Intangible assets	–	–	–	–	–	–	1,636	1,636
Other assets	8,589	4,589	1,360	28	6	–	653	15,225
	43,944	97,970	74,642	220,161	110,087	13,861	20,155	580,820
Liabilities								
Current, savings and other deposit accounts	233,907	190,206	5,916	966	–	–	–	430,995
Deposits from banks	1,664	10,370	9	–	–	–	–	12,043
Trading liabilities	–	–	–	–	–	45,804	–	45,804
Financial liabilities designated at fair value	26	–	–	–	994	–	508	1,528
Derivative financial instruments	–	22	81	318	36	1,335	–	1,792
Certificates of deposit and other debt securities in issue	–	233	1,952	7,788	50	–	–	10,023
Other liabilities	6,706	6,661	442	48	99	–	182	14,138
Liabilities to customers under insurance contracts	–	–	–	–	–	–	15,335	15,335
Deferred tax and current tax liabilities	370	2	78	–	–	–	1,471	1,921
Subordinated liabilities	–	–	–	–	3,511	–	–	3,511
	242,673	207,494	8,478	9,120	4,690	47,139	17,496	537,090

27 Analysis Of Assets And Liabilities By Remaining Maturity (continued)

	Bank							
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2006								
Assets								
Cash and balances with banks and other financial institutions	9,360	–	–	–	–	–	–	9,360
Placings with and advances to banks and other financial institutions	14,810	65,049	820	–	–	–	–	80,679
Trading assets	–	–	–	–	–	10,778	–	10,778
Financial assets designated at fair value	–	91	299	1,048	150	–	7	1,595
Derivative financial instruments	–	154	122	95	48	1,368	–	1,787
Advances to customers	16,788	33,890	37,351	76,073	80,133	–	–	244,235
Amounts due from subsidiaries	59,231	33,370	–	–	–	–	–	92,601
Financial investments	–	16,703	43,447	98,166	4,028	–	78	162,422
Investments in subsidiaries	–	–	–	–	–	–	2,357	2,357
Investments in associates	–	–	–	–	–	–	1,634	1,634
Investment properties	–	–	–	–	–	–	1,557	1,557
Premises, plant and equipment	–	–	–	–	–	–	4,219	4,219
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	580	580
Intangible assets	–	–	–	–	–	–	143	143
Other assets	6,264	5,206	1,061	1	–	–	924	13,456
	106,453	154,463	83,100	175,383	84,359	12,146	11,499	627,403
Liabilities								
Current, savings and other deposit accounts	289,779	179,497	8,473	963	–	–	–	478,712
Deposits from banks	2,527	14,032	1,121	–	–	–	–	17,680
Trading liabilities	–	–	–	–	–	60,093	–	60,093
Financial liabilities designated at fair value	–	–	–	996	–	–	(9)	987
Derivative financial instruments	–	4	95	97	11	1,313	–	1,520
Certificates of deposit and other debt securities in issue	–	74	866	6,683	–	–	–	7,623
Amounts due to subsidiaries	664	1,056	–	–	–	–	–	1,720
Other liabilities	6,517	8,515	434	91	44	–	1,450	17,051
Deferred tax and current tax liabilities	–	347	843	–	–	–	808	1,998
Subordinated liabilities	–	–	–	7,000	–	–	–	7,000
	299,487	203,525	11,832	15,830	55	61,406	2,249	594,384

27 Analysis Of Assets And Liabilities By Remaining Maturity (continued)

	Bank							
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2005								
Assets								
Cash and balances with banks and other financial institutions	9,173	–	–	–	–	–	–	9,173
Placings with and advances to banks and other financial institutions	9,258	36,027	1,031	204	–	–	–	46,520
Trading assets	–	–	–	–	–	9,153	–	9,153
Financial assets designated at fair value	–	–	50	1,442	151	–	4	1,647
Derivative financial instruments	–	106	101	150	25	1,241	–	1,623
Advances to customers	14,031	25,367	29,649	77,191	68,872	–	–	215,110
Amounts due from subsidiaries	47,713	43,616	–	–	–	–	1,932	93,261
Financial investments	–	12,031	28,366	98,008	3,656	–	59	142,120
Investments in subsidiaries	–	–	–	–	–	–	2,104	2,104
Investments in associates	–	–	–	–	–	–	1,634	1,634
Investment properties	–	–	–	–	–	–	2,644	2,644
Premises, plant and equipment	–	–	–	–	–	–	4,798	4,798
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	594	594
Intangible assets	–	–	–	–	–	–	71	71
Other assets	8,282	3,951	1,067	8	–	–	528	13,836
	88,457	121,098	60,264	177,003	72,704	10,394	14,368	544,288
Liabilities								
Current, savings and other deposit accounts	232,765	181,890	5,897	966	–	–	–	421,518
Deposits from banks	1,664	10,370	9	–	–	–	–	12,043
Trading liabilities	–	–	–	–	–	45,804	–	45,804
Financial liabilities designated at fair value	–	–	–	–	994	–	(27)	967
Derivative financial instruments	–	22	80	317	36	1,316	–	1,771
Certificates of deposit and other debt securities in issue	–	233	1,952	7,825	50	–	–	10,060
Amounts due to subsidiaries	419	1,014	–	–	–	–	–	1,433
Other liabilities	6,702	6,626	436	20	–	–	1,328	15,112
Deferred tax and current tax liabilities	370	2	46	–	–	–	885	1,303
Subordinated liabilities	–	–	–	–	3,511	–	–	3,511
	241,920	200,157	8,420	9,128	4,591	47,120	2,186	513,522

28 Accounting Classifications

The table below sets out the Group's classification of financial assets and liabilities:

	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2006							
Cash and balances with banks and other financial institutions	–	–	–	–	–	9,390	9,390
Placings with and advances to banks and other financial institutions	–	–	–	–	99,705	–	99,705
Derivative financial instruments	1,374	–	513	–	–	–	1,887
Advances to customers	59	–	–	–	279,353	–	279,412
Investment securities	12,408	8,280	211,573	16,137	–	–	248,398
Acceptances and endorsements	–	–	–	–	–	2,855	2,855
Total financial assets	13,841	8,280	212,086	16,137	379,058	12,245	641,647
Non-financial assets							27,417
Total assets							669,064
Current, savings and other deposit accounts	35,066	–	–	–	–	482,821	517,887
Deposits from banks	–	–	–	–	–	17,950	17,950
Derivative financial instruments	1,314	–	217	–	–	–	1,531
Certificates of deposit and other debt securities in issue	14,821	–	–	–	–	7,595	22,416
Other financial liabilities	10,206	–	–	–	–	–	10,206
Subordinated liabilities	–	987	–	–	–	7,000	7,987
Liabilities to customers under investment contracts	–	575	–	–	–	–	575
Acceptances and endorsements	–	–	–	–	–	2,855	2,855
Total financial liabilities	61,407	1,562	217	–	–	518,221	581,407
Non-financial liabilities							38,959
Total liabilities							620,366

28 Accounting Classifications (continued)

	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2005							
Cash and balances with banks and other financial institutions	–	–	–	–	–	9,201	9,201
Placings with and advances to banks and other financial institutions	–	–	–	–	69,286	–	69,286
Derivative financial instruments	1,261	–	454	–	–	–	1,715
Advances to customers	–	–	–	–	260,680	–	260,680
Investment securities	12,600	6,027	179,173	10,731	–	–	208,531
Acceptances and endorsements	–	–	–	–	–	2,371	2,371
Total financial assets	13,861	6,027	179,627	10,731	329,966	11,572	551,784
Non-financial assets							29,036
Total assets							580,820
Current, savings and other deposit accounts	24,422	–	–	–	–	430,995	455,417
Deposits from banks	–	–	–	–	–	12,043	12,043
Derivative financial instruments	1,335	–	457	–	–	–	1,792
Certificates of deposit and other debt securities in issue	13,616	–	–	–	–	10,023	23,639
Other financial liabilities	7,766	–	–	–	–	–	7,766
Subordinated liabilities	–	967	–	–	–	3,511	4,478
Liabilities to customers under investment contracts	–	561	–	–	–	–	561
Acceptances and endorsements	–	–	–	–	–	2,371	2,371
Total financial liabilities	47,139	1,528	457	–	–	458,943	508,067
Non-financial liabilities							29,023
Total liabilities							537,090

29 Cash and balances with banks and other financial institutions

	Group		Bank	
	2006	2005	**2006**	2005
Cash in hand	**4,920**	4,772	**4,920**	4,772
Balances with central banks	**357**	303	**357**	303
Balances with banks and other financial institutions	**4,113**	4,126	**4,083**	4,098
	9,390	9,201	**9,360**	9,173

30 Placings With And Advances To Banks And Other Financial Institutions

	Group		Bank	
	2006	2005	2006	2005
Placings with and advances to banks and other financial institutions maturing within one month	75,722	54,338	59,880	38,054
Placings with and advances to banks and other financial institutions maturing after one month	23,983	14,948	20,799	8,466
	99,705	69,286	80,679	46,520

31 Trading Assets

	Group		Bank	
	2006	2005	2006	2005
Treasury bills	6,071	2,594	6,071	2,594
Certificates of deposit	212	538	212	453
Other debt securities	6,109	9,440	4,420	6,078
Debt securities	12,392	12,572	10,703	9,125
Equity shares	16	28	16	28
Total trading securities	12,408	12,600	10,719	9,153
Loans and advances to customers*	59	–	59	–
Total trading assets	12,467	12,600	10,778	9,153
Debt securities:				
– listed in Hong Kong	2,839	767	2,839	767
– listed outside Hong Kong	269	–	269	–
	3,108	767	3,108	767
– unlisted	9,284	11,805	7,595	8,358
	12,392	12,572	10,703	9,125
Equity shares:				
– listed in Hong Kong	16	17	16	17
– unlisted	–	11	–	11
	16	28	16	28
Total trading securities	12,408	12,600	10,719	9,153
Debt securities				
Issued by public bodies:				
– central governments and central banks	8,969	5,625	8,969	5,488
– other public sector entities	926	1,489	375	653
	9,895	7,114	9,344	6,141
Issued by other bodies:				
– banks and other financial institutions	1,555	2,836	600	1,172
– corporate entities	942	2,622	759	1,812
	2,497	5,458	1,359	2,984
	12,392	12,572	10,703	9,125
Equity shares				
Issued by corporate entities	16	28	16	28
Total trading securities	12,408	12,600	10,719	9,153

* These represent amounts receivable from counterparties on trading transactions not yet settled.

32 Financial Assets Designated At Fair Value

	Group		Bank	
	2006	2005	**2006**	2005
Certificates of deposit	**232**	194	**90**	88
Other debt securities	**4,587**	4,075	**1,505**	1,559
Debt securities	**4,819**	4,269	**1,595**	1,647
Equity shares	**3,461**	1,758	**–**	–
	8,280	6,027	**1,595**	1,647
Debt securities:				
– listed in Hong Kong	**359**	100	**350**	99
– listed outside Hong Kong	**31**	22	**–**	–
	390	122	**350**	99
– unlisted	**4,429**	4,147	**1,245**	1,548
	4,819	4,269	**1,595**	1,647
Equity shares:				
– listed in Hong Kong	**1,202**	732	**–**	–
– listed outside Hong Kong	**1,300**	979	**–**	–
	2,502	1,711	**–**	–
– unlisted	**959**	47	**–**	–
	3,461	1,758	**–**	–
	8,280	6,027	**1,595**	1,647
Debt securities				
Issued by public bodies:				
– central governments and central banks	**870**	865	**856**	854
– other public sector entities	**285**	295	**236**	241
	1,155	1,160	**1,092**	1,095
Issued by other bodies:				
– banks and other financial institutions	**3,535**	2,937	**411**	409
– corporate entities	**129**	172	**92**	143
	3,664	3,109	**503**	552
	4,819	4,269	**1,595**	1,647
Equity shares				
Issued by corporate entities	**3,461**	1,758	**–**	–
	8,280	6,027	**1,595**	1,647

33 Advances To Customers

(a) Advances to customers

	Group 2006	Group 2005	Bank 2006	Bank 2005
Gross advances to customers	**280,277**	261,714	**245,071**	215,982
Less:				
Loan impairment allowances:				
– individually assessed	**(406)**	(524)	**(332)**	(453)
– collectively assessed	**(518)**	(510)	**(504)**	(419)
	279,353	260,680	**244,235**	215,110
Included in advances to customers are:				
– trade bills	**3,907**	3,024	**3,907**	3,024
– loan impairment allowances	**(16)**	(14)	**(16)**	(14)
	3,891	3,010	**3,891**	3,010

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

	Group 2006 %	Group 2005 %	Bank 2006 %	Bank 2005 %
Loan impairment allowances:				
– individually assessed	**0.15**	0.20	**0.14**	0.21
– collectively assessed	**0.18**	0.19	**0.20**	0.19
Total loan impairment allowances	**0.33**	0.39	**0.34**	0.40

(b) Loan impairment allowances against advances to customers

	Group Individually assessed	Group Collectively assessed	Group Total
2006			
At 1 January	524	510	1,034
Amounts written off	(224)	(177)	(401)
Recoveries of advances written off in previous years	25	40	65
New impairment allowances charged to income statement (note 15)	238	185	423
Impairment allowances released to income statement (note 15)	(131)	(40)	(171)
Unwind of discount of loan impairment allowances recognised as "interest income"	(26)	–	(26)
At 31 December	406	518	924

33 Advances To Customers (continued)

(b) Loan impairment allowances against advances to customers (continued)

	Group Individually assessed	Group Collectively assessed	Group Total
2005			
At 1 January	692	319	1,011
Amounts written off	(510)	(166)	(676)
Recoveries of advances written off in previous years	53	48	101
New impairment allowances charged to income statement (note 15)	707	363	1,070
Impairment allowances released to income statement (note 15)	(398)	(54)	(452)
Unwind of discount of loan impairment allowances recognised as "interest income"	(20)	–	(20)
At 31 December	524	510	1,034

	Bank Individually assessed	Bank Collectively assessed	Bank Total
2006			
At 1 January	**453**	**419**	**872**
Amounts written off	**(206)**	**(176)**	**(382)**
Recoveries of advances written off in previous years	**12**	**39**	**51**
New impairment allowances charged to income statement (note 15)	**200**	**261**	**461**
Impairment allowances released to income statement (note 15)	**(115)**	**(39)**	**(154)**
Unwind of discount of loan impairment allowances recognised as "interest income"	**(12)**	**–**	**(12)**
At 31 December	**332**	**504**	**836**
2005			
At 1 January	484	256	740
Amounts written off	(486)	(166)	(652)
Recoveries of advances written off in previous years	31	47	78
New impairment allowances charged to income statement (note 15)	687	335	1,022
Impairment allowances released to income statement (note 15)	(254)	(53)	(307)
Unwind of discount of loan impairment allowances recognised as "interest income"	(9)	–	(9)
At 31 December	453	419	872

(c) Impaired advances and allowances

	Group		Bank	
	2006	2005	**2006**	2005
Gross impaired advances	**1,387**	1,433	**1,002**	1,043
Individually assessed allowances	**(406)**	(524)	**(332)**	(453)
Net impaired advances	**981**	909	**670**	590
Individually assessed allowances as a percentage of gross impaired advances	**29.3%**	36.6%	**33.1%**	43.4%
Gross impaired advances as a percentage of gross advances to customers	**0.5%**	0.5%	**0.4%**	0.5%

33 Advances To Customers (continued)

(d) Overdue advances

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

2006	Group	%	Bank	%
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– six months or less but over three months	504	0.2	260	0.1
– one year or less but over six months	263	0.1	195	0.1
– over one year	173	–	157	–
	940	0.3	612	0.2

2005	Group	%	Bank	%
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– six months or less but over three months	482	0.2	216	0.1
– one year or less but over six months	211	0.1	162	0.1
– over one year	169	–	163	0.1
	862	0.3	541	0.3

Advances with a specific repayment date are classified as overdue when the principal or interest is overdue and remains unpaid at year-end. Advances repayable by regular instalments are treated as overdue when an instalment payment is overdue and remains unpaid at year-end. Advances repayable on demand are classified as overdue either when a demand for repayment has been served on the borrower but repayment has not been made in accordance with the demand notice, or when the advances have remained continuously outside the approved limit advised to the borrower for more than the overdue period in question.

(e) Rescheduled advances

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

	Group	%	Bank	%
2006	**357**	**0.1**	**212**	**0.1**
2005	361	0.1	176	0.1

Rescheduled advances are those that have been rescheduled or renegotiated for reasons related to the borrower's financial difficulties. This will normally involve the granting of concessionary terms and resetting the overdue account to non-overdue status. A rescheduled advance will continue to be disclosed as such unless the debt has been performing in accordance with the rescheduled terms for a period of six to twelve months. Rescheduled advances that have been overdue for more than three months under the rescheduled terms are reported as overdue advances to customers.

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

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area which is different from that of the counterparty. At 31 December 2006, over 90 per cent of the Group's advances to customers, including related impaired advances and overdue advances, were classified under Hong Kong (a position unchanged from that at 31 December 2005).

33 Advances To Customers (continued)

(g) Gross advances to customers by industry sector

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

	Group		Bank	
	2006	2005 restated	2006	2005 restated
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	18,051	16,446	17,773	16,168
– property investment	48,096	45,964	46,252	43,656
– financial concerns	2,103	968	2,099	961
– stockbrokers	234	221	234	221
– wholesale and retail trade	6,360	5,562	6,353	5,546
– manufacturing	7,670	6,477	7,626	6,349
– transport and transport equipment	11,145	11,919	5,925	3,173
– other	22,787	22,912	22,410	21,802
	116,446	110,469	108,672	97,876
Individuals				
– advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	20,078	22,879	1,108	782
– advances for the purchase of other residential properties	83,616	81,318	75,597	71,055
– credit card advances	9,448	7,735	9,448	7,735
– other	8,813	7,563	8,775	7,478
	121,955	119,495	94,928	87,050
Total gross advances for use in Hong Kong	238,401	229,964	203,600	184,926
Trade finance	19,684	15,874	19,684	15,874
Gross advances for use outside Hong Kong	22,192	15,876	21,787	15,182
Gross advances to customers (note 33(a))	280,277	261,714	245,071	215,982

(h) Net investments in finance leases

Advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring 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	
	2006	2005	2006	2005
Finance leases	91	82	57	1
Hire purchase contracts	7,333	9,569	1,665	–
	7,424	9,651	1,722	1

33 Advances To Customers (continued)
(h) Net investments in finance leases (continued)

	Group		
	Present value of minimum lease payments receivable	Interest income relating to future periods	Total minimum lease payments receivable
2006			
Amounts receivable:			
– within one year	705	345	1,050
– after one year but within five years	1,775	1,082	2,857
– after five years	4,966	2,266	7,232
	7,446	3,693	11,139
Loans impairment allowances	(22)		
Net investments in finance leases and hire purchase contracts	7,424		
2005			
Amounts receivable:			
– within one year	808	451	1,259
– after one year but within five years	2,283	1,485	3,768
– after five years	6,591	2,624	9,215
	9,682	4,560	14,242
Loans impairment allowances	(31)		
Net investments in finance leases and hire purchase contracts	9,651		

	Bank		
	Present value of minimum lease payments receivable	Interest income relating to future periods	Total minimum lease payments receivable
2006			
Amounts receivable:			
– within one year	231	69	300
– after one year but within five years	561	166	727
– after five years	933	663	1,596
	1,725	898	2,623
Loans impairment allowances	(3)		
Net investments in finance leases and hire purchase contracts	1,722		
2005			
Amounts receivable:			
– after one year but within five years	1	–	1
	1	–	1
Loans impairment allowances	–		
Net investments in finance leases and hire purchase contracts	1		

34 Financial Investments

	Group 2006	Group 2005	Bank 2006	Bank 2005
Available-for-sale at fair value:				
– debt securities	**209,463**	177,813	**162,308**	142,067
– equity shares	**2,110**	1,360	**114**	53
Held-to-maturity debt securities at amortised cost	**16,137**	10,731	**–**	–
	227,710	189,904	**162,422**	142,120
Fair value of held-to-maturity debt securities	**16,551**	10,778	**–**	–
Treasury bills	**1,088**	4,816	**1,088**	4,816
Certificates of deposit	**25,020**	27,048	**17,440**	23,118
Other debt securities	**199,492**	156,680	**143,780**	114,133
Debt securities	**225,600**	188,544	**162,308**	142,067
Equity shares	**2,110**	1,360	**114**	53
	227,710	189,904	**162,422**	142,120
Debt securities:				
– listed in Hong Kong	**3,759**	3,008	**3,701**	2,967
– listed outside Hong Kong	**1,914**	1,947	**838**	836
	5,673	4,955	**4,539**	3,803
– unlisted	**219,927**	183,589	**157,769**	138,264
	225,600	188,544	**162,308**	142,067
Equity shares:				
– listed in Hong Kong	**1,702**	1,049	**7**	–
– listed outside Hong Kong	**150**	186	**99**	–
	1,852	1,235	**106**	–
– unlisted	**258**	125	**8**	53
	2,110	1,360	**114**	53
	227,710	189,904	**162,422**	142,120
Fair value of listed financial investments	**7,538**	6,209	**4,645**	3,803
Debt securities				
Issued by public bodies:				
– central governments and central banks	**8,321**	15,981	**7,530**	15,030
– other public sector entities	**7,044**	8,667	**6,354**	7,010
	15,365	24,648	**13,884**	22,040
Issued by other bodies:				
– banks and other financial institutions	**192,751**	149,557	**136,291**	109,405
– corporate entities	**17,484**	14,339	**12,133**	10,622
	210,235	163,896	**148,424**	120,027
	225,600	188,544	**162,308**	142,067
Equity shares				
Issued by corporate entities	**2,110**	1,360	**114**	53
	227,710	189,904	**162,422**	142,120

35 Investments In Subsidiaries

The principal subsidiaries of the Bank are:

Name of company	Place of incorporation	Principal activities	Issued equity capital
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	General insurance	HK$84,184,570
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
HSI Services 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

All the above companies are wholly-owned subsidiaries except for Hang Seng Life Limited in which the Bank holds 50 per cent of its shareholding and controls the composition of its board of directors. All subsidiaries are held directly by the Bank except for HSI Services Limited. The principal places of operation are the same as the places of incorporation.

36 Investments In Associates

	Group 2006	Group 2005	Bank 2006	Bank 2005
Unlisted investments, at cost	–	–	1,634	1,634
Share of net assets	3,158	2,611	–	–
Goodwill	330	318	–	–
	3,488	2,929	1,634	1,634

The principal associates are:

Name of company	Place of incorporation and operation	Principal activity	Group's interest in equity capital	Issued equity capital
Barrowgate Limited	Hong Kong SAR	Property investment	24.64%	HK$10,000
Industrial Bank Co., Ltd.	People's Republic of China	Banking	15.98%	RMB3,999,000,000

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. is owned directly by the Bank.

In accordance with HKAS 28, 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, and is treated on an investment basis, with the holding recognised at cost and dividends accounted for as declared.

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

The summarised financial information of the associates with the aggregated amount in which the Group's interests have been accounted for:

	2006	2005
Assets	94,108	70,537
Liabilities	(90,950)	(67,926)
Revenue	2,067	1,632
Expenses	(1,412)	(1,132)
Profit for the year	655	500
Contingent liabilities	16,332	14,783

37 Investment Properties

The Group's investment properties are stated at fair value as valued by independent professional valuer on at least an annual basis. The most recent valuation was performed by DTZ Debenham Tie Leung Limited, at 30 September 2006, who confirmed that there had been no material change in valuation at 31 December 2006. The valuation was 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	
	2006	2005	**2006**	2005
At 1 January	**4,273**	3,383	**2,644**	2,046
Disposals	**(1,539)**	(116)	**(1,169)**	(95)
Surplus on revaluation credited to income statement (note 21)	**304**	1,160	**127**	802
Transfer to assets held for sale	**(355)**	–	**(83)**	–
Transfer from/(to) premises (note 38(a))	**49**	(154)	**38**	(109)
At 31 December	**2,732**	4,273	**1,557**	2,644
Leaseholds				
Held in Hong Kong				
– long leases (over 50 years unexpired)	**1,079**	2,442	**469**	1,536
– medium leases (10 to 50 years unexpired)	**1,652**	1,830	**1,087**	1,107
Held outside Hong Kong				
– medium leases (10 to 50 years unexpired)	**1**	1	**1**	1
	2,732	4,273	**1,557**	2,644

(b) 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.

The direct operating expenses arising from investment properties were HK$29 million in 2006. (2005: HK$27 million). Of this amount, HK$26 million (2005: HK$25 million) was the direct operating expenses from investment properties that generated rental income.

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

	Group		Bank	
	2006	2005	**2006**	2005
Less than one year	**111**	175	**58**	119
Five years or less but over one year	**52**	77	**22**	57
	163	252	**80**	176

38 Premises, Plant And Equipment

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 September 2006, who confirmed that there had been no material change in valuation at 31 December 2006. 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
2006			
Cost or valuation:			
At 1 January	6,348	2,694	9,042
Exchange adjustments	3	4	7
Additions	–	269	269
Disposals	(683)	(73)	(756)
Elimination of accumulated depreciation on revalued premises	(143)	–	(143)
Surplus on revaluation:			
– credited to premises revaluation reserve	629	–	629
– credited to income statement (note 21)	17	–	17
Transfer to assets held for sale	(100)	–	(100)
Transfer to investment property (note 37(a))	(49)	–	(49)
At 31 December	6,022	2,894	8,916
Accumulated depreciation:			
At 1 January	–	(2,292)	(2,292)
Exchange adjustments	–	(2)	(2)
Charge for the year (note 16)	(145)	(178)	(323)
Written off on disposal	2	72	74
Elimination of accumulated depreciation on revalued premises	143	–	143
At 31 December	–	(2,400)	(2,400)
Net book value at 31 December	6,022	494	6,516

38 Premises, Plant And Equipment (continued)

(a) Movement of premises, plant and equipment (continued)

	Group		
	Premises	Plant and equipment	Total
2005			
Cost or valuation:			
At 1 January	5,162	2,638	7,800
Exchange adjustments	2	2	4
Additions	–	167	167
Disposals	(49)	(113)	(162)
Elimination of accumulated depreciation on revalued premises	(120)	–	(120)
Surplus on revaluation:			
– credited to premises revaluation reserve	1,046	–	1,046
– credited to income statement (note 21)	153	–	153
Transfer from investment property (note 37(a))	154	–	154
At 31 December	6,348	2,694	9,042
Accumulated depreciation:			
At 1 January	–	(2,242)	(2,242)
Charge for the year (note 16)	(120)	(160)	(280)
Written off on disposal	–	110	110
Elimination of accumulated depreciation on revalued premises	120	–	120
At 31 December	–	(2,292)	(2,292)
Net book value at 31 December	6,348	402	6,750

38 Premises, Plant And Equipment (continued)

(a) Movement of premises, plant and equipment (continued)

	Bank Premises	Plant and equipment	Total
2006			
Cost or valuation:			
At 1 January	4,398	2,670	7,068
Exchange adjustments	3	4	7
Additions	–	267	267
Disposals	(683)	(72)	(755)
Elimination of accumulated depreciation on revalued premises	(98)	–	(98)
Surplus on revaluation:			
– credited to premises revaluation reserve	208	–	208
– credited to income statement	12	–	12
Transfer to assets held for sale	(74)	–	(74)
Transfer to investment property (note 37(a))	(38)	–	(38)
At 31 December	3,728	2,869	6,597
Accumulated depreciation:			
At 1 January	–	(2,270)	(2,270)
Exchange adjustments	–	(2)	(2)
Charge for the year	(100)	(177)	(277)
Written off on disposal	2	71	73
Elimination of accumulated depreciation on revalued premises	98	–	98
At 31 December	–	(2,378)	(2,378)
Net book value at 31 December	3,728	491	4,219

38 Premises, Plant And Equipment (continued)

(a) Movement of premises, plant and equipment (continued)

	Bank		
	Premises	Plant and equipment	Total
2005			
Cost or valuation:			
At 1 January	3,620	2,615	6,235
Exchange adjustments	2	2	4
Additions	–	166	166
Disposals	(49)	(113)	(162)
Elimination of accumulated depreciation on revalued premises	(83)	–	(83)
Surplus on revaluation:			
– credited to premises revaluation reserve	788	–	788
– credited to income statement	11	–	11
Transfer from investment property (note 37(a))	109	–	109
At 31 December	4,398	2,670	7,068
Accumulated depreciation:			
At 1 January	–	(2,222)	(2,222)
Charge for the year	(83)	(158)	(241)
Written off on disposal	–	110	110
Elimination of accumulated depreciation on revalued premises	83	–	83
At 31 December	–	(2,270)	(2,270)
Net book value at 31 December	4,398	400	4,798

(b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2006	2005	**2006**	2005
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,284**	1,984	**653**	1,339
– medium leases (10 to 50 years unexpired)	**4,663**	4,293	**3,000**	2,988
Held outside Hong Kong:				
– long leases (over 50 years unexpired)	**4**	3	**4**	3
– medium leases (10 to 50 years unexpired)	**71**	68	**71**	68
	6,022	6,348	**3,728**	4,398

(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	
	2006	2005	**2006**	2005
Cost less accumulated depreciation at 31 December	**2,019**	2,181	**955**	1,098

39 Interest In Leasehold Land Held For Own Use Under Operating Lease

The Group's interest in leasehold land held for own use is accounted for as operating lease. The lease is a medium term lease with 10 to 50 years unexpired and the net book value is as follows:

	Group		Bank	
	2006	2005	**2006**	2005
At 1 January	**594**	609	**594**	609
Amortisation of prepaid operating lease payment	**(14)**	(15)	**(14)**	(15)
At 31 December	**580**	594	**580**	594

40 Intangible Assets

	Group		Bank	
	2006	2005	**2006**	2005
Present value of in-force long-term insurance business	**1,927**	1,565	**–**	–
Internally developed software	**129**	56	**129**	56
Acquired software	**14**	15	**14**	15
	2,070	1,636	**143**	71

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

	Group	
	2006	2005
At 1 January	**1,565**	1,249
Addition from current year new business	**516**	521
Movement from in-force business	**(163)**	(150)
Other movement	**9**	(55)
At 31 December	**1,927**	1,565

The key assumptions used in the computation of present value of in-force long-term insurance business ("PVIF") are as follows:

	2006	2005
Risk free rate	**3.73%**	4.19%
Risk discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Average lapse rate:		
– 1st year	**5.0%**	5.0%
– 2nd year onwards	**2.0%**	2.0%

40 Intangible Assets (continued)

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

The following table shows the sensitivity of PVIF valuation to change in individual assumptions at balance sheet dates:

	2006	2005
+100 basis points shift in risk-free rate	495	304
-100 basis points shift in risk-free rate	(537)	(338)
+100 basis points shift in risk discount rate	(81)	(60)
-100 basis points shift in risk discount rate	89	66
+100 basis points shift in expenses inflation	(8)	(7)
-100 basis points shift in expenses inflation	8	6
+100 basis points shift in lapse rate	371	202
-100 basis points shift in lapse rate	(393)	(211)

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

	Group		Bank	
	2006	2005	2006	2005
Cost:				
At 1 January	164	103	164	103
Additions	110	64	110	64
Disposals	(30)	(3)	(30)	(3)
At 31 December	244	164	244	164
Accumulated amortisation:				
At 1 January	(93)	(86)	(93)	(86)
Charge for the year (note 16)	(10)	(9)	(10)	(9)
Written off on disposals	2	2	2	2
At 31 December	(101)	(93)	(101)	(93)
Net book value at 31 December	143	71	143	71

41 Other Assets

	Group		Bank	
	2006	2005	2006	2005
Items in the course of collection from other banks	6,036	8,068	6,036	8,068
Prepayments and accrued income	3,520	3,016	2,823	2,383
Deferred tax assets (note 48)	1	9	–	–
Assets held for sale*	256	216	165	110
Acceptances and endorsements	2,855	2,371	2,855	2,371
Other accounts	2,218	1,545	1,577	904
	14,886	15,225	13,456	13,836

* The accumulated income recognised directly in equity relating to assets held for sale for 2006 was HK$57 million (2005: nil).

42 Current, Savings And Other Deposit Accounts

	Group 2006	Group 2005	Bank 2006	Bank 2005
Current, savings and other deposit accounts:				
– as stated in balance sheet	**482,821**	430,995	**478,712**	421,518
– structured deposits reported as trading liabilities (note 43)	**35,066**	24,422	**35,066**	24,422
	517,887	455,417	**513,778**	445,940
By type:				
– demand and current accounts	**29,594**	27,248	**29,594**	27,248
– savings accounts	**223,255**	188,839	**223,255**	188,839
– time and other deposits	**265,038**	239,330	**260,929**	229,853
	517,887	455,417	**513,778**	445,940

43 Trading Liabilities

	Group 2006	Group 2005	Bank 2006	Bank 2005
Structured certificates of deposit and other debt securities in issue (note 45)	**14,821**	13,616	**14,821**	13,616
Structured deposits (note 42)	**35,066**	24,422	**35,066**	24,422
Short positions in securities and other	**10,206**	7,766	**10,206**	7,766
	60,093	45,804	**60,093**	45,804

44 Financial Liabilities Designated At Fair Value

	Group 2006	Group 2005	Bank 2006	Bank 2005
4.125% callable fixed rate subordinated notes	**987**	967	**987**	967
Liabilities to customers under investment contracts	**575**	561	**–**	–
	1,562	1,528	**987**	967

At 31 December 2006, the difference between the carrying amount and the contractual amount of subordinated notes payable at maturity amounted to HK$13 million (2005: HK$33 million) and the accumulated amount of the change in fair value attributable to change in credit risk was HK$0.4 million (same as 2005).

45 Certificates Of Deposit And Other Debt Securities In Issue

	Group 2006	Group 2005	Bank 2006	Bank 2005
Certificates of deposit and other debt securities in issue:				
– as stated in balance sheet	7,595	10,023	7,623	10,060
– structured certificates of deposit and other debt securities in issue reported as trading liabilities (note 43)	14,821	13,616	14,821	13,616
	22,416	23,639	22,444	23,676
By type:				
– certificates of deposit in issue	18,075	22,525	18,103	22,562
– other debt securities in issue	4,341	1,114	4,341	1,114
	22,416	23,639	22,444	23,676

46 Other Liabilities

	Group 2006	Group 2005	Bank 2006	Bank 2005
Items in the course of transmission to other banks	6,469	6,517	6,469	6,517
Accruals	2,641	1,653	2,520	1,572
Acceptances and endorsements	2,855	2,371	2,855	2,371
Other	4,158	3,597	5,207	4,652
	16,123	14,138	17,051	15,112

47 Liabilities To Customers Under Insurance Contracts

	Group 2006 Gross	Group 2006 Reinsurance	Group 2006 Net	Group 2005 Gross	Group 2005 Reinsurance	Group 2005 Net
Non-life insurance						
Unearned premiums	177	(39)	138	174	(47)	127
Notified claims	147	(22)	125	156	(23)	133
Claims incurred but not reported	43	(11)	32	58	(17)	41
Other	39	(1)	38	34	(77)	(43)
	406	(73)	333	422	(164)	258
Policyholders' liabilities						
Life (non-linked)	22,382	(2)	22,380	14,727	(1)	14,726
Life (linked)	187	–	187	186	–	186
	22,569	(2)	22,567	14,913	(1)	14,912
	22,975	(75)	22,900	15,335	(165)	15,170

47 Liabilities To Customers Under Insurance Contracts (continued)

The movement of liabilities under insurance contracts was as follows:

(a) Non-life insurance

	Gross	Group Reinsurance	Net
2006			
Unearned premiums			
At 1 January	174	(47)	127
Gross written premiums	373	(78)	295
Gross earned premiums	(399)	87	(312)
Exchange and other movements	29	(1)	28
At 31 December	177	(39)	138
Notified and incurred but not reported claims			
At 1 January			
– notified claims	156	(23)	133
– claims incurred but not reported	58	(17)	41
	214	(40)	174
Claims paid	(104)	14	(90)
Claims incurred	90	(7)	83
Exchange and other movements	(10)	–	(10)
	(24)	7	(17)
At 31 December			
– notified claims	147	(22)	125
– claims incurred but not reported	43	(11)	32
	190	(33)	157
Other	39	(1)	38
	406	(73)	333

47 Liabilities To Customers Under Insurance Contracts (continued)

(a) Non-life insurance (continued)

	Gross	Group Reinsurance	Net
2005			
Unearned premiums			
At 1 January	199	(55)	144
Gross written premiums	392	(103)	289
Gross earned premiums	(411)	111	(300)
Exchange and other movements	(6)	–	(6)
At 31 December	174	(47)	127
Notified and incurred but not reported claims			
At 1 January			
– notified claims	162	(21)	141
– claims incurred but not reported	62	(19)	43
	224	(40)	184
Claims paid	(107)	(11)	(118)
Claims incurred	98	9	107
Exchange and other movements	(1)	2	1
	(10)	–	(10)
At 31 December			
– notified claims	156	(23)	133
– claims incurred but not reported	58	(17)	41
	214	(40)	174
Other	34	(77)	(43)
	422	(164)	258

47 Liabilities To Customers Under Insurance Contracts (continued)

(b) Policyholders' liabilities

	Gross	Group Reinsurance	Net
2006			
Life (non-linked)			
At 1 January	14,727	(1)	14,726
Benefits paid	(354)	–	(354)
Claims incurred and movement in policyholders' liabilities	7,980	–	7,980
Exchange and other movements	29	(1)	28
At 31 December	22,382	(2)	22,380
Life (linked)			
At 1 January	186	–	186
Benefits paid	(24)	–	(24)
Claims incurred and movement in policyholders' liabilities	25	–	25
At 31 December	187	–	187
	22,569	(2)	22,567
2005			
Life (non-linked)			
At 1 January	8,005	(1)	8,004
Benefits paid	(205)	8	(197)
Claims incurred and movement in policyholders' liabilities	6,926	(8)	6,918
Exchange and other movements	1	–	1
At 31 December	14,727	(1)	14,726
Life (linked)			
At 1 January	192	–	192
Benefits paid	(17)	–	(17)
Claims incurred and movement in policyholders' liabilities	11	–	11
At 31 December	186	–	186
	14,913	(1)	14,912

48 Deferred Tax And Current Tax Liabilities

(a) Deferred tax and current tax assets and liabilities are represented in the balance sheet:

	Group		Bank	
	2006	2005	**2006**	2005
Included in "Other assets":				
Current taxation recoverable	**15**	14	**–**	–
Deferred taxation (note 41)	**1**	9	**–**	–
	16	23	**–**	–
Included in "Deferred tax and current tax liabilities":				
Provision for Hong Kong profits tax	**1,211**	441	**1,175**	412
Provision for taxation outside Hong Kong	**17**	8	**15**	6
Deferred taxation	**1,488**	1,472	**808**	885
	2,716	1,921	**1,998**	1,303

(b) Deferred tax assets and liabilities recognised

The major components of deferred tax (assets)/liabilities recognised in the balance sheets 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 hedges	Other	Total
2006							
At 1 January	**48**	**1,386**	**(83)**	**(130)**	**(93)**	**335**	**1,463**
Charged/(credited) to income statement (note 22(a))	**26**	**(279)**	**(1)**	**–**	**–**	**79**	**(175)**
Charged/(credited) to reserves	**–**	**5**	**–**	**96**	**54**	**44**	**199**
At 31 December	**74**	**1,112**	**(84)**	**(34)**	**(39)**	**458**	**1,487**
2005							
At 1 January	21	1,002	(50)	113	2	222	1,310
Charged/(credited) to income statement (note 22(a))	27	209	(33)	–	–	79	282
Charged/(credited) to reserves	–	175	–	(243)	(95)	34	(129)
At 31 December	48	1,386	(83)	(130)	(93)	335	1,463

48 Deferred Tax And Current Tax Liabilities (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 hedges	Other	Total
2006							
At 1 January	**48**	**1,069**	**(67)**	**(135)**	**(93)**	**63**	**885**
Charged/(credited) to income statement	**26**	**(219)**	**(15)**	**–**	**–**	**14**	**(194)**
Charged/(credited) to reserves	**–**	**(71)**	**–**	**88**	**54**	**46**	**117**
At 31 December	**74**	**779**	**(82)**	**(47)**	**(39)**	**123**	**808**
2005							
At 1 January	34	821	(39)	97	2	13	928
Charged/(credited) to income statement	14	118	(28)	–	–	17	121
Charged/(credited) to reserves	–	130	–	(232)	(95)	33	(164)
At 31 December	48	1,069	(67)	(135)	(93)	63	885

(c) Deferred tax assets not recognised

At balance sheet date, the Group has not recognised deferred tax assets in respect of tax losses of subsidiaries amounted to HK$34 million (2005: HK$34 million) which are considered unlikely to be utilised. There is no expiry provisions for tax losses.

(d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised in 2006 (2005: Nil).

49 Subordinated Liabilities

Nominal value	Description	Group 2006	Group 2005	Bank 2006	Bank 2005
Amount owed to third parties					
HK$1,500 million	Callable floating rate subordinated notes due June 2015 [1]	**1,496**	1,495	**1,496**	1,495
HK$1,000 million	4.125% callable fixed rate subordinated notes due June 2015 [2]	**987**	967	**987**	967
US$450 million	Callable floating rate subordinated notes due July 2016 [3]	**3,483**	–	**3,483**	–
Amount owed to HSBC Group undertakings					
US$260 million	Callable floating rate subordinated loan debt due December 2015 [4]	**2,021**	2,016	**2,021**	2,016
		7,987	4,478	**7,987**	4,478
Representing:					
– measured at amortised cost		**7,000**	3,511	**7,000**	3,511
– designated at fair value (note 44)		**987**	967	**987**	967
		7,987	4,478	**7,987**	4,478

The above subordinated notes and loan each carries a one-time call option exercisable by the Group on a day falling five years plus one day after the relevant date of issue/drawdown.

(1) Interest rate at three-month HIBOR plus 0.35 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month HIBOR plus 0.85 per cent, payable quarterly.

(2) Interest rate at 4.125 per cent per annum, payable semi-annually, to the call option date. Thereafter, it will be reset to three-month HIBOR plus 0.825 per cent, payable quarterly.

(3) Interest rate at three-month US dollar LIBOR plus 0.30 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.80 per cent, payable quarterly.

(4) Interest rate at three-month US dollar LIBOR plus 0.31 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.81 per cent, payable quarterly.

50 Share Capital

Authorised:

The authorised share capital of the Bank is HK$11,000 million (2005: HK$11,000 million) divided into 2,200 million shares (2005: 2,200 million shares) of HK$5 each.

	2006	2005
Issued and fully paid:		
1,911,842,736 shares (2005: 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 (2005: Nil).

51 Reserves

	Group	Bank	Associates
2006			
Retained profits	29,044	17,281	1,719
Premises revaluation reserve	3,491	2,486	–
Cash flow hedges reserve	(220)	(192)	–
Available-for-sale investments reserve	923	(165)	10
Capital redemption reserve	99	99	–
Other reserves	452	318	125
Total reserves	33,789	19,827	1,854
Retained profits			
At 1 January	26,052	15,562	1,097
Exchange and other adjustments	1	–	–
Profit attributable to shareholders	12,038	10,806	655
Dividends	(9,942)	(9,942)	(33)
Transfer from premises revaluation reserve:			
– depreciation on revaluation surplus	77	61	–
– realisation of revaluation surplus on disposal of premises	600	576	–
Actuarial gains on defined benefit plans	218	218	–
At 31 December	29,044	17,281	1,719
Premises revaluation reserve, net of tax			
At 1 January	3,543	2,844	–
Unrealised surplus on revaluation	519	171	–
Transfer to retained profits:			
– depreciation on revaluation surplus	(77)	(61)	–
– realisation of revaluation surplus on disposal of premises	(494)	(468)	–
At 31 December	3,491	2,486	–
Cash flow hedges reserve, net of tax			
At 1 January	(483)	(446)	–
Amounts recognised in equity during the year	(179)	(162)	–
Amounts removed from equity and included in the income statement for the year	442	416	–
At 31 December	(220)	(192)	–
Available-for-sale investments reserve, net of tax			
At 1 January	(17)	(635)	167
Amounts recognised in equity during the year	1,232	510	(157)
Transfer to income statement:			
– on impairment	12	–	–
– change in fair value of hedged items	21	24	–
– on disposal	(325)	(64)	–
At 31 December	923	(165)	10
Capital redemption reserve			
At 1 January and 31 December	99	99	–
Other reserves			
At 1 January	185	150	31
Foreign exchange reserve	183	84	94
Share options granted by ultimate holding company to the Group's employees	84	84	–
At 31 December	452	318	125
Total reserves at 31 December	33,789	19,827	1,854

51 Reserves (continued)

	Group	Bank	Associates
2005 (restated)			
Retained profits	26,052	15,562	1,097
Premises revaluation reserve	3,543	2,844	–
Cash flow hedges reserve	(483)	(446)	–
Available-for-sale investments reserve	(17)	(635)	167
Capital redemption reserve	99	99	–
Other reserves	185	150	31
Total reserves	29,379	17,574	1,295
Retained profits			
At 1 January	24,389	15,169	672
Exchange and other adjustments	(2)	–	–
Profit attributable to shareholders	11,342	10,080	500
Dividends	(9,942)	(9,942)	(75)
Transfer from premises revaluation reserve:			
– depreciation on revaluation surplus	58	48	–
– realisation of revaluation surplus on disposal of premises	49	49	–
Actuarial gains on defined benefit plans	158	158	–
At 31 December	26,052	15,562	1,097
Premises revaluation reserve, net of tax			
At 1 January	2,778	2,281	–
Unrealised surplus on revaluation	863	651	–
Transfer to retained profits:			
– depreciation on revaluation surplus	(58)	(48)	–
– realisation of revaluation surplus on disposal of premises	(40)	(40)	–
At 31 December	3,543	2,844	–
Cash flow hedges reserve, net of tax			
At 1 January	9	9	–
Amounts recognised in equity during the year	(524)	(496)	–
Amounts removed from equity and included in the income statement for the year	32	41	–
At 31 December	(483)	(446)	–
Available-for-sale investments reserve, net of tax			
At 1 January	1,458	456	–
Amounts recognised in equity during the year	(1,237)	(1,509)	167
Transfer to income statement:			
– change in fair value of hedged items	249	245	–
– on disposal	(487)	173	–
At 31 December	(17)	(635)	167
Capital redemption reserve			
At 1 January and 31 December	99	99	–
Other reserves			
At 1 January	69	66	–
Foreign exchange reserve	50	20	31
Share options granted by ultimate holding company to the Group's employees	64	64	–
Others	2	–	–
At 31 December	185	150	31
Total reserves at 31 December	29,379	17,574	1,295

51 Reserves (continued)

"Premises revaluation reserve", "Cash flow hedges reserve", "Available-for-sale investments reserve", "Capital redemption reserve" and "Other reserves" do not represent realised profits and are not available for distribution.

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 retained profits which can be distributed to shareholders.

In accordance with the HKMA guideline "Impact of the New Hong Kong Accounting Standards on Authorised Institutions' Capital Base and Regulatory Reporting", the Group has earmarked a "regulatory reserve" from retained profits of HK$518 million (2005: HK$510 million). This regulatory reserve is included as tier 2 capital together with the collective impairment allowances for the calculation of the Group's capital adequacy ratios as disclosed in note 52.

52 Capital Adequacy Ratios

The Group's capital adequacy ratios adjusted for market risk at 31 December, calculated in accordance with the guideline "Maintenance of Adequate Capital Against Market Risk" issued by the Hong Kong Monetary Authority, are as follows:

	2006	2005
Adjusted total capital ratio	**13.6%**	12.8%
Adjusted tier 1 capital ratio	**10.7%**	10.4%

The Group's capital adequacy ratios at 31 December, calculated in accordance with the Third Schedule of the Hong Kong Banking Ordinance, are as follows:

	2006	2005
Total capital ratio	**13.6%**	12.8%
Tier 1 capital ratio	**10.7%**	10.4%

53 Reconciliation Of Cash Flow Statement

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

	2006	2005 restated
Operating profit	12,576	11,068
Net interest income	(11,694)	(10,796)
Dividend income	(47)	(60)
Loan impairment charges and other credit risk provisions	264	618
Depreciation	323	280
Amortisation of intangible assets	10	9
Amortisation of available-for-sale investments	(532)	12
Amortisation of held-to-maturity debt securities	2	–
Advances written off net of recoveries	(336)	(575)
Interest received	22,232	14,262
Interest paid	(16,693)	(8,399)
Operating profit before changes in working capital	6,105	6,419
Change in treasury bills and certificates of deposit with original maturity more than three months	5,077	8,113
Change in placings with and advances to banks maturing after one month	(9,035)	2,534
Change in trading assets	4,252	3,983
Change in financial assets designated at fair value	(56)	1,060
Change in derivative financial instruments	(433)	(395)
Change in advances to customers	(18,589)	(8,857)
Change in other assets	(6,427)	(11,929)
Change in financial liabilities designated at fair value	20	–
Change in current, savings and other deposit accounts	51,826	(9,189)
Change in deposits from banks	5,637	110
Change in trading liabilities	14,289	29,263
Change in certificates of deposit and other debt securities in issue	(2,428)	(2,589)
Change in other liabilities	8,458	9,423
Elimination of exchange differences and other non-cash items	(3,707)	315
Cash generated from operating activities	54,989	28,261
Taxation paid	(1,448)	(1,421)
Net cash inflow from operating activities	53,541	26,840

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

	2006	2005
Cash and balances with banks and other financial institutions	9,390	9,201
Placings with and advances to banks and other financial institutions maturing within one month	74,072	53,294
Treasury bills	5,158	3,018
Certificates of deposit	1,655	–
	90,275	65,513

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$3,718 million at 31 December 2006 (2005: HK$2,911 million).

54 Contingent Liabilities, Commitments And Derivatives

	Group		
	Contract amount	Credit equivalent amount	Risk-weighted amount
2006			
Contingent liabilities:			
Guarantees	4,150	3,877	3,679
Commitments:			
Documentary credits and short-term trade-related transactions	8,717	1,745	1,738
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	142,463	–	–
– one year and over	18,719	9,360	8,696
Other	193	193	193
	170,092	11,298	10,627
Exchange rate contracts:			
Spot and forward foreign exchange	267,822	2,715	591
Other exchange rate contracts	64,377	499	110
	332,199	3,214	701
Interest rate contracts:			
Interest rate swaps	162,969	1,376	295
Other interest rate contracts	2,350	2	–
	165,319	1,378	295
Other derivative contracts	5,668	382	90
2005			
Contingent liabilities:			
Guarantees	4,133	3,907	3,131
Commitments:			
Documentary credits and short-term trade-related transactions	7,402	1,480	1,480
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	109,369	–	–
– one year and over	20,385	10,193	9,158
Other	220	220	220
	137,376	11,893	10,858
Exchange rate contracts:			
Spot and forward foreign exchange	188,088	1,426	333
Other exchange rate contracts	15,176	193	48
	203,264	1,619	381
Interest rate contracts:			
Interest rate swaps	161,083	1,472	308
Other interest rate contracts	4,255	20	4
	165,338	1,492	312
Other derivative contracts	1,194	86	17

54 Contingent Liabilities, Commitments And Derivatives (continued)

	Bank		
	Contract amount	Credit equivalent amount	Risk-weighted amount
2006			
Contingent liabilities:			
Guarantees	**4,554**	**4,281**	**4,083**
Commitments:			
Documentary credits and short-term trade-related transactions	**8,717**	**1,745**	**1,738**
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	**141,902**	**–**	**–**
– one year and over	**18,539**	**9,270**	**8,606**
Other	**50**	**50**	**50**
	169,208	**11,065**	**10,394**
Exchange rate contracts:			
Spot and forward foreign exchange	**270,972**	**2,747**	**607**
Other exchange rate contracts	**64,377**	**499**	**110**
	335,349	**3,246**	**717**
Interest rate contracts:			
Interest rate swaps	**155,225**	**1,260**	**272**
Other interest rate contracts	**2,350**	**2**	**–**
	157,575	**1,262**	**272**
Other derivative contracts	**5,668**	**382**	**90**
2005			
Contingent liabilities:			
Guarantees	4,533	4,308	3,531
Commitments:			
Documentary credits and short-term trade-related transactions	7,402	1,480	1,480
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	109,089	–	–
– one year and over	20,205	10,103	9,068
Other	44	44	44
	136,740	11,627	10,592
Exchange rate contracts:			
Spot and forward foreign exchange	191,433	1,459	349
Other exchange rate contracts	15,176	193	48
	206,609	1,652	397
Interest rate contracts:			
Interest rate swaps	151,982	1,343	282
Other interest rate contracts	4,255	20	4
	156,237	1,363	286
Other derivative contracts	1,194	86	17

54 Contingent Liabilities, Commitments And Derivatives (continued)

The tables above give the nominal contract, credit equivalent and risk-weighted amounts of off-balance sheet transactions. The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Third Schedule of the Hong Kong Banking Ordinance ("the Third Schedule") on capital adequacy and depend on the status of the counterparty and the maturity characteristics. The risk weights used range from 0 per cent to 100 per cent for contingent liabilities and commitments, and from 0 per cent to 50 per cent for exchange rate, interest rate and other derivative contracts.

In accordance with the Third Schedule, contingent liabilities and commitments are credit-related instruments that include acceptances and endorsements, letters of credit, guarantees and commitments to extend credit. The risk involved is essentially the same as the credit risk involved in extending loan facilities to customers. These transactions are, therefore, subject to the same credit origination, portfolio maintenance and collateral requirements as for customers applying for loans. As the facilities may expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

In accordance with HKAS 39, acceptances and endorsements are recognised on the balance sheet in "Other assets" and "Other liabilities". These acceptances and endorsements are included in the capital adequacy calculation as contingencies in accordance with the Third Schedule.

Derivative financial instruments arise from futures, forward, swap and option transactions undertaken in the foreign exchange, interest rate and equity markets. The contract amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date and do not represent amounts at risk. The credit equivalent amount of these instruments is measured as the sum of positive marked-to-market values and the potential future credit exposure in accordance with the Third Schedule.

Derivative financial instruments are held for trading or designated as either fair value hedge or cash flow hedges. The following table shows the nominal contract amounts and marked-to-market value of assets and liabilities by each class of derivatives.

	Group			
	2006		2005	
	Trading	Hedging	Trading	Hedging
Contract amounts:				
Interest rate contracts	105,001	60,318	102,233	63,105
Exchange rate contracts	332,199	–	203,264	–
Other derivative contracts	5,668	–	1,194	–
	442,868	60,318	306,691	63,105
Derivative assets:				
Interest rate contracts	435	513	481	454
Exchange rate contracts	866	–	776	–
Other derivative contracts	73	–	4	–
	1,374	513	1,261	454
Derivative liabilities:				
Interest rate contracts	573	217	998	457
Exchange rate contracts	722	–	310	–
Other derivative contracts	19	–	27	–
	1,314	217	1,335	457

54 Contingent Liabilities, Commitments And Derivatives (continued)

	Bank			
	2006		2005	
	Trading	Hedging	Trading	Hedging
Contract amounts:				
Interest rate contracts	103,302	54,273	98,774	57,463
Exchange rate contracts	335,349	–	206,609	–
Other derivative contracts	5,668	–	1,194	–
	444,319	54,273	306,577	57,463
Derivative assets:				
Interest rate contracts	429	419	462	381
Exchange rate contracts	866	–	776	–
Other derivative contracts	73	–	4	–
	1,368	419	1,242	381
Derivative liabilities:				
Interest rate contracts	563	216	978	456
Exchange rate contracts	722	–	310	–
Other derivative contracts	19	–	27	–
	1,304	216	1,315	456

The above derivative assets and liabilities, being the positive or negative marked-to-market value of the respective derivative contracts, represent gross replacement costs, as none of these contracts are subject to any bilateral netting arrangements.

55 Assets Pledged As Security For Liabilities

At 31 December 2006, liabilities of the Group and the Bank amounting to HK$10,651 million (2005: HK$7,858 million) were secured by the deposit of assets, including assets subject to sale and repurchase arrangements. The amounts of assets pledged by the Group and the Bank to secure these liabilities was HK$11,412 million (2005: HK$7,997 million) and mainly comprised items included in "Trading assets" and "Financial investments".

56 Capital Commitments

	Group		Bank	
	2006	2005	2006	2005
Expenditure authorised and contracted for	141	113	141	111

57 Lease Commitments

The Group leases certain properties and equipment under operating leases. The leases typically run for an initial period of one to five years and may include an option to renew the lease when all terms are renegotiated. None of these leases includes contingent rentals.

The total future minimum lease payments payable under non-cancellable operating leases are as follows:

	Group		Bank	
	2006	2005	**2006**	2005
Within one year	**329**	191	**328**	191
Between one and five years	**635**	409	**634**	409
Over five years	**45**	–	**45**	–
	1,009	600	**1,007**	600

58 Employee Retirement Benefits

(a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 60% 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 was 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 Group makes contributions to these schemes in accordance with the recommendation of qualified actuary based on annual actuarial valuations. The latest annual actuarial valuations at 31 December 2006 was performed by E Chiu, fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Ltd, 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 sheets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2006			
Present value of funded obligations (note 58(a)(iii))	**(3,727)**	**(175)**	**(3)**
Fair value of scheme assets (note 58(a)(iv))	**4,454**	**242**	**32**
Net assets recognised in the balance sheet (note 58(a)(v))	**727**	**67**	**29**
Obligations covered by scheme assets (%)	**120**	**138**	**1,067**
2005			
Present value of funded obligations (note 58(a)(iii))	(3,571)	(167)	(4)
Fair value of scheme assets (note 58(a)(iv))	3,947	221	31
Net assets recognised in the balance sheet (note 58(a)(v))	376	54	27
Obligations covered by scheme assets (%)	111	132	775

58 Employee Retirement Benefits (continued)

(a) Defined benefit schemes (continued)

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

	Group and Bank HSBDBS	HSBPS	HSBNTBS
2006			
Equity	**2,312**	**36**	**–**
Bonds	**1,880**	**169**	**–**
Certificates of deposit issued by the Bank	**4**	**–**	**–**
Ordinary shares issued by ultimate holding company	**66**	**–**	**–**
Other	**192**	**37**	**32**
	4,454	**242**	**32**
2005			
Equity	1,639	32	–
Bonds	1,776	157	–
Ordinary shares issued by ultimate holding company	168	–	–
Other	364	32	31
	3,947	221	31

(iii) Change in the present value of scheme obligations

	Group and Bank HSBDBS	HSBPS	HSBNTBS
2006			
At 1 January	**3,571**	**167**	**4**
Current service cost	**172**	**–**	**–**
Interest cost	**150**	**7**	**–**
Actuarial losses	**132**	**16**	**1**
Benefits paid	**(298)**	**(15)**	**(2)**
At 31 December	**3,727**	**175**	**3**
2005			
At 1 January	3,663	182	4
Current service cost	187	1	–
Interest cost	148	7	–
Actuarial (gains)/losses	(118)	(6)	1
Benefits paid	(309)	(17)	(1)
At 31 December	3,571	167	4

58 Employee Retirement Benefits (continued)

(a) Defined benefit schemes (continued)

(iv) Change in the fair value of scheme assets

	Group and Bank HSBDBS	HSBPS	HSBNTBS
2006			
At 1 January	**3,947**	**221**	**31**
Contributions by the Bank	**175**	**9**	**–**
Expected return on scheme assets	**238**	**8**	**1**
Experience gains	**392**	**19**	**2**
Benefits paid	**(298)**	**(15)**	**(2)**
At 31 December	**4,454**	**242**	**32**
2005			
At 1 January	3,737	220	32
Contributions by the Bank	225	8	–
Expected return on scheme assets	227	9	–
Experience gains	67	1	–
Benefits paid	(309)	(17)	(1)
At 31 December	3,947	221	31

(v) Movements in the net assets recognised in the balance sheets are as follows:

	Group and Bank HSBDBS	HSBPS	HSBNTBS
2006			
At 1 January	**376**	**54**	**27**
Contributions by the Bank	**175**	**9**	**–**
Net (expense)/income recognised in the income statement (note 58(a)(vi))	**(84)**	**1**	**1**
Net actuarial gains	**260**	**3**	**1**
At 31 December	**727**	**67**	**29**
Experience losses on scheme liabilities	**(33)**	**(2)**	**(1)**
Experience gains on scheme assets	**392**	**19**	**2**
Losses from change in actuarial assumptions	**(99)**	**(14)**	**–**
Net actuarial gains	**260**	**3**	**1**
2005			
At 1 January	74	38	28
Contributions by the Bank	225	8	–
Net (expense)/income recognised in the income statement (note 58(a)(vi))	(108)	1	–
Net actuarial gains/(losses)	185	7	(1)
At 31 December	376	54	27
Experience gains/(losses) on scheme liabilities	17	3	(1)
Experience gains on scheme assets	67	1	–
Gains from change in actuarial assumptions	101	3	–
Net actuarial gains/(losses)	185	7	(1)

58 Employee Retirement Benefits (continued)

(a) Defined benefit schemes (continued)

(vi) Amounts recognised in the income statement are as follows:

		Group	
	HSBDBS	HSBPS	HSBNTBS
2006			
Current service cost	**(172)**	**–**	**–**
Interest cost	**(150)**	**(7)**	**–**
Expected return on scheme assets	**238**	**8**	**1**
Net (expense)/income for the year (note 16)	**(84)**	**1**	**1**
Actual return on scheme assets	**630**	**27**	**3**
2005			
Current service cost	(187)	(1)	–
Interest cost	(148)	(7)	–
Expected return on scheme assets	227	9	–
Net (expense)/income for the year (note 16)	(108)	1	–
Actual return on scheme assets	294	10	–

(vii) The principal actuarial assumptions used as at 31 December (expressed as weighted averages) are as follows:

		Group and Bank	
	HSBDBS %	HSBPS %	HSBNTBS %
2006			
Discount rate	**3.8**	**3.8**	**3.8**
Expected rate of return on scheme assets	**7.5**	**4.0**	**2.0**
Expected rate of salary increases	**3.0**	**3.0**	**3.0**
Expected rate of pension increases	**–**	**1.5**	**–**
2005			
Discount rate	4.2	4.2	4.2
Expected rate of return on scheme assets	6.0	4.0	2.0
Expected rate of salary increases	3.0	3.0	3.0
Expected rate of pension increases	–	1.5	–

(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.

58 Employee Retirement Benefits (continued)

(b) Defined contribution schemes (continued)

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:

	2006	2005
Amounts charged to the income statement (note 16)	42	30

59 Share-Based Payments

The Group participated in various share compensation plans operated by the HSBC Group for acquiring of HSBC Holdings plc shares. They are the Savings-Related Share Option Plan, Executive/Group Share Option Plan and Restricted Share Plan/ Performance Share Awards/Achievement Share Awards. Analysis of the movement in the number of share options and exercise price of these plans is set out below.

(a) Savings-Related Share Option Plan

The Savings-Related Share Option Plan invites eligible employees to enter into savings contracts to save Hong Kong dollar equivalent of up to £250 per month, with the option to use the savings to acquire shares. The options are exercisable within six months following between the first and fifth anniversaries of the commencement of the savings contract depending on conditions set at grant. The exercise price is at a 20 per cent discount to the market value at the date of grant.

(i) Movements in the number of share options held by employees are as follows:

	2006		2005	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
At 1 January	6.10	5,566	5.93	5,671
Granted in the year	7.49	1,701	6.68	1,551
Exercised in the year	5.42	(1,865)	6.07	(1,301)
Lapsed in the year	6.10	(377)	5.93	(355)
At 31 December	6.78	5,025	6.10	5,566
Amounts charged to the income statement (note 16)		53		44
Options vested at 31 December		8		–

(ii) Details of share options granted during the year:

	2006		2005
Exercise period	Exercise price £	Number ('000)	Number ('000)
1 Aug 2007 to 31 Jan 2008	7.49	411	–
1 Aug 2008 to 31 Jan 2009	6.68	–	1,234
1 Aug 2009 to 31 Jan 2010	7.49	1,072	–
1 Aug 2010 to 31 Jan 2011	6.68	–	317
1 Aug 2011 to 31 Jan 2012	7.49	218	–
		1,701	1,551

59 Share-Based Payments (continued)

(a) Savings-Related Share Option Plan (continued)

(iii) Details of share options exercised during the year:

Exercise period	Exercise price £	2006 Number ('000)	2005 Number ('000)
1 Aug 2004 to 31 Jan 2005	5.40	–	8
1 Aug 2004 to 31 Jan 2005	6.75	–	4
1 Aug 2005 to 31 Jan 2006	6.03	–	1,108
1 Aug 2005 to 31 Jan 2006	6.32	–	181
1 Aug 2006 to 31 Jan 2007	6.75	94	–
1 Aug 2006 to 31 Jan 2007	5.35	1,768	–
1 Aug 2006 to 31 Jan 2007	6.47	3	–
		1,865	1,301

The weighted average share price at the date of exercise for share options exercised during the year was £9.54 (2005: £9.10).

(iv) Terms of share options at balance sheet date

Exercise period	Exercise price £	2006 Number ('000)	2005 Number ('000)
1 Aug 2006 to 31 Jan 2007	6.75	–	95
1 Aug 2006 to 31 Jan 2007	5.35	8	1,795
1 Aug 2007 to 31 Jan 2008	6.32	31	32
1 Aug 2007 to 31 Jan 2008	6.47	1,303	1,401
1 Aug 2008 to 31 Jan 2009	5.35	316	334
1 Aug 2008 to 31 Jan 2009	6.68	1,055	1,176
1 Aug 2009 to 31 Jan 2010	6.47	409	431
1 Aug 2010 to 31 Jan 2011	6.68	285	302
1 Aug 2007 to 31 Jan 2008	7.49	374	–
1 Aug 2009 to 31 Jan 2010	7.49	1,038	–
1 Aug 2011 to 31 Jan 2012	7.49	206	–
		5,025	5,566

(b) Executive/Group Share Option Plan

Executive Share Option Plan (for options granted in 1999 and 2000) and Group Share Option Plan (for options granted in 2001 to 2004) were issued by the HSBC Holdings plc and awarded to high performing employees of the Group on a discretionary basis. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. Exercise of the options, is also subject to the attainment of a corporate performance condition. The Group Share Option Plan has been closed since 2004.

59 Share-Based Payments (continued)

(b) Executive/Group Share Option Plan (continued)

(i) Movements in the number of share options held by employees are as follows:

	2006 Weighted average exercise price £	2006 Number ('000)	2005 Weighted average exercise price £	2005 Number ('000)
At 1 January	7.80	5,031	7.76	5,935
Exercised in the year	7.63	(1,450)	7.45	(617)
Lapsed in the year	7.80	(116)	7.76	(287)
At 31 December	7.86	3,465	7.80	5,031
Amounts charged to the income statement (note 16)		31		20
Options vested at 31 December		2,378		2,803

(ii) Details of share options exercised during the year:

Exercise period	Exercise price £	2006 Number ('000)	2005 Number ('000)
1 Apr 1999 to 31 Mar 2006	3.33	–	9
24 Mar 2000 to 23 Apr 2007	5.02	7	–
16 Mar 2001 to 15 Mar 2008	6.28	–	8
29 Mar 2002 to 28 Mar 2009	6.38	195	213
3 Apr 2003 to 2 Apr 2010	7.46	197	131
23 Apr 2004 to 22 Apr 2011	8.71	325	105
7 May 2005 to 6 May 2012	8.41	315	151
2 May 2006 to 1 May 2013	6.91	410	–
30 Apr 2007 to 29 Apr 2017	8.28	1	–
		1,450	617

The weighted average share price at the date of exercise for share options exercised during the year was £9.59 (2005: £8.89).

(iii) Terms of share options at balance sheet date

Exercise period	Exercise price £	2006 Number ('000)	2005 Number ('000)
24 Mar 2000 to 23 Apr 2007	5.02	–	8
29 Mar 2002 to 28 Mar 2009	6.38	349	544
3 Apr 2003 to 2 Apr 2010	7.46	318	516
23 Apr 2004 to 22 Apr 2011	8.71	567	896
7 May 2005 to 6 May 2012	8.41	524	839
2 May 2006 to 1 May 2013	6.91	620	1,047
30 Apr 2007 to 29 Apr 2017	8.28	1,087	1,181
		3,465	5,031

59 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. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2006 are as follows:

	1-year Savings-Related Share Option Plan	3-year Savings-Related Share Option Plan	5-year Savings-Related Share Option Plan
Risk-free interest rate (%)	4.7	4.8	4.7
Expected life (years)	1	3	5
Expected volatility (%)	17	17	17

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.

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

Restricted shares, which operated from 1996 to 2004, were granted with vesting criteria subject to attaining the HSBC Group targets. Since 2005, performance share awards are made to the Group's most senior executives taking into account individual performance in the year. The share awards are divided into two criteria for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return measure and the other half of the award is subject to an Earnings Per Share target. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if the minimum criteria are failed to meet.

Achievement shares were launched in 2005 and are awarded to eligible employees after taking into account of the employee's performance in the year. Shares are awarded without corporate performance conditions and are released to employees after three years provided the employees have remained employed by the Group for this period. The fair value of the shares awarded is charged to the income statement as share compensation cost over the period from issue date to release date.

	2006 Number ('000)	2005 Number ('000)
At 1 January	350	459
Additions during the year	88	141
Released in the year	(47)	(48)
Lapsed in the year	(89)	(202)
At 31 December	302	350
Amounts charged to the income statement (note 16)	16	6

The closing price of the HSBC Holdings plc share at 31 December 2006 was £9.31 (2005: £9.33).

The weighted average remaining vesting period as at 31 December 2006 was 1.76 years (2005: 2.10 years).

60 Material Related-Party Transactions

(a) Immediate holding company and fellow subsidiary companies

In 2006, the Group entered into transactions with its immediate holding company and fellow subsidiary companies in the ordinary course of its interbank activities including the acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were priced at the relevant market rates at the time of the transactions.

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. The premiums, commissions and other fees on these transactions are determined on an arm's length basis.

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	
	2006	2005	2006	2005	2006	2005
Interest income	131	159	67	8	7	3
Interest expense	(466)	(208)	(34)	(38)	(10)	(1)
Other operating income/(expense)	52	44	(4)	(3)	–	–
Operating expenses	(580)	(633)	(282)	(127)	(11)	(10)
Amounts due from:						
Cash and balances with banks and other financial institutions	133	46	1,532	672	8	1
Placings with and advances to banks and other financial institutions	730	2,785	3,843	710	146	78
Trading assets	–	50	–	–	–	–
Derivative financial instruments	151	101	43	44	–	–
Financial assets designated at fair value	2,842	2,299	–	–	–	–
Advances to customers	–	–	–	–	233	233
Financial investments	1,023	1,135	–	–	–	–
Other assets	64	27	15	2	3	–
	4,943	6,443	5,433	1,428	390	312
Amounts due to:						
Current, savings and other deposit accounts	92	41	107	126	21	14
Deposits from banks	5,422	4,972	302	164	563	–
Derivative financial instruments	238	411	95	77	–	–
Subordinated liabilities	2,022	2,016	–	–	–	–
Other liabilities	348	286	125	75	–	–
	8,122	7,726	629	442	584	14
Derivative contracts:						
Contract amount	39,443	35,364	14,078	12,308	–	–
Credit equivalent amount	615	355	107	106	–	–
Risk-weighted amount	123	71	21	21	–	–

60 Material Related-Party Transactions (continued)

(a) Immediate holding company and fellow subsidiary companies (continued)

	Bank							
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Subsidiaries		Associates	
	2006	2005	2006	2005	2006	2005	2006	2005
Amounts due from:								
Cash and balances with banks and other financial institutions	114	30	1,532	671	–	–	8	1
Placings with and advances to banks and other financial institutions	–	1,909	3,843	710	–	–	146	78
Trading assets	–	50	–	–	–	–	–	–
Derivative financial instruments	151	101	39	24	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–	–	–
Advances to customers	–	–	–	–	–	–	–	–
Amounts due from subsidiaries	–	–	–	–	92,601	93,261	–	–
Financial investments	220	325	–	–	–	–	–	–
Other assets	49	13	6	1	–	–	3	–
	534	2,428	5,420	1,406	92,601	93,261	157	79
Amounts due to:								
Current, savings and other deposit accounts	92	41	107	126	–	–	21	14
Deposits from banks	5,422	4,972	302	164	–	–	563	–
Derivative financial instruments	238	411	85	58	–	–	–	–
Subordinated liabilities	2,022	2,016	–	–	–	–	–	–
Amounts due to subsidiaries	–	–	–	–	1,720	1,433	–	–
Other liabilities	321	269	123	74	–	–	–	–
	8,095	7,709	617	422	1,720	1,433	584	14
Derivative contracts:								
Contract amount	39,443	35,364	12,379	8,848	–	–	–	–
Credit equivalent amount	615	355	101	73	–	–	–	–
Risk-weighted amount	123	71	20	15	–	–	–	–

(b) Key management personnel remuneration

Remuneration for key management personnel, including amounts paid to the Bank's directors as disclosed in note 18 and highest paid employees as disclosed in note 17, is as follows:

	Group		Bank	
	2006	2005 restated	2006	2005 restated
Employee benefits	28	22	28	22
Post-employment benefits	4	4	4	4
Equity compensation benefits	2	2	2	2
	34	28	34	28

60 Material Related-Party Transactions (continued)

(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	
	2006	2005	**2006**	2005 restated
Interest received	**565**	440	**522**	387
Interest paid	**163**	90	**163**	90
Fees and exchange income received	**16**	18	**16**	18
Loans and advances	**14,123**	13,166	**13,673**	11,725
Deposits	**4,038**	3,830	**4,038**	3,830
Undrawn commitments	**6,435**	6,130	**6,435**	6,130
Maximum aggregate amount of loans and advances during the year	**20,153**	19,599	**18,713**	17,903

(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	
	2006	2005	**2006**	2005
Aggregate amount of relevant transactions outstanding at 31 December	**80**	61	**80**	61
Maximum aggregate amount of relevant transactions during the year	**150**	107	**150**	107

(e) Associates

The Group maintains a shareholders' loan to an associate. The balance at 31 December 2006 was HK$233 million (2005: HK$233 million).

The Bank has entered into Technical Support and Assistance Agreement with Industrial Bank Co., Ltd (IB) to provide technical support and assistance in relation to various banking operations and businesses of IB. The Bank has also assisted IB in managing and growing the credit card business, and provided support in the issuance of dual-logo credit cards.

(f) Ultimate holding company

The Group participates in various share option plans operated by HSBC Holdings plc whereby share options of HSBC Holdings plc are granted to employees of the Group. The fair value of these share options on grant date is recognised as an expense and spread over the vesting period, the corresponding amount is credited to "Other reserves". The balance of this reserve as at 31 December 2006 amounted to HK$214 million (2005: HK$130 million).

61 Financial Risk Management

This section presents information about the Group's management and control of risks, in particular, those associated with its use of financial instruments ("financial risks"). Major types of financial risks the Group exposed to include credit, liquidity and market risks.

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by the Executive Committee and Audit Committee.

(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, treasury and leasing 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 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 categorize 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.

Impairment loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loans impairment allowances are made promptly where necessary and 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

Currently, the Group's risk rating framework consisted of seven facility grades, taking into account the risk of default and the availability of security or other credit risk mitigation. A more sophisticated risk rating framework on counterparty credit risk based on default probability and loss estimates and comprising up to 22 categories, is being progressively implemented across the Group on parallel basis. The rating methodology of this framework is based upon a wide range of financial analytics. The new approach will allow a more granular analysis of risk and trends.

61 Financial Risk Management (continued)

(a) Credit risk (continued)

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;
- in the commercial real estate sector, charges over the properties being financed.

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 with the exception of asset backed securities and similar instruments, which are secured by pools of financial assets.

Settlement risk

Settlement risk arises where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily Settlement Limits are established to cover the settlement risk arising from the Group's trading transactions on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated when effected via Assured Payment Systems, or on a delivery versus payment basis.

The ISDA Master Agreement is the Group's preferred agreement for documenting derivative activities. It provides the contractual framework that a full range of over-the-counter ("OTC") products is conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement, if either party defaults or following other pre-agreed termination events.

Concentration of credit risk

Concentration of credit risk exists when changes in geographic, economic or industry factors similarly affect groups of counterparties whose aggregate credit exposure is material in relation to the Group's total exposures. The Group's portfolio of financial instrument is diversified along geographic, industry and product sectors. Analysis of geographical concentration of the Group's assets is disclosed in note 26 and credit risk concentration of respective financial assets is disclosed in notes 31 to 34.

61 Financial Risk Management (continued)

(a) Credit risk (continued)

The below analysis shows the exposures to credit risk in accordance with HKFRS 7 "Financial Instruments: Disclosures".

(i) Maximum exposure to credit risk before collateral held or other credit enhancements

	Group		Bank	
	2006	2005	**2006**	2005
Cash and balances with banks and other financial institutions	**9,390**	9,201	**9,360**	9,173
Placings with and advances to banks and other financial institutions	**99,705**	69,286	**80,679**	46,520
Trading assets	**12,467**	12,600	**10,778**	9,153
Financial assets designated at fair value	**8,280**	6,027	**1,595**	1,647
Derivative financial instruments	**1,887**	1,715	**1,787**	1,623
Advances to customers	**279,353**	260,680	**244,235**	215,110
Financial investments	**227,710**	189,904	**162,422**	142,120
Amounts due from subsidiaries	**–**	–	**92,601**	93,261
Other assets	**30,272**	31,407	**23,946**	25,681
Financial guarantees and other credit related contingent liabilities	**12,867**	11,535	**13,271**	11,935
Loan commitments and other credit related commitments	**197,586**	149,059	**196,702**	148,423
	879,517	741,414	**837,376**	704,646

(ii) Credit quality

Gross loans and advances

Distribution of gross loans and advances by credit quality

	Group		Bank	
	2006	2005	**2006**	2005
Gross loans and advances to customers (note 33(a)):				
– neither past due nor impaired	**277,256**	258,937	**242,642**	213,852
– past due but not impaired	**1,634**	1,344	**1,427**	1,087
– impaired (note 33(c))	**1,387**	1,433	**1,002**	1,043
	280,277	261,714	**245,071**	215,982
Gross loans and advances to banks:				
– neither past due nor impaired	**104,075**	73,715	**85,019**	50,921
– past due but not impaired	**100**	–	**100**	–
– impaired	**–**	–	**–**	–
	104,175	73,715	**85,119**	50,921

61 Financial Risk Management (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Distribution of gross loans and advances that are neither past due nor impaired

The credit quality of the portfolio of gross loans and advances that were neither past due nor impaired at the balance sheet dates indicated below can be assessed by reference to the Group's standard credit grading system. The following information is based on that system:

	Group		Bank	
	2006	2005	**2006**	2005
Gross loans and advances to customers				
Grades 1 to 3: Satisfactory risk	**272,579**	254,315	**238,328**	209,529
Grade 4: Watch list and special mention	**4,213**	4,229	**3,912**	4,011
Grade 5: Sub-standard but not impaired	**464**	393	**402**	312
	277,256	258,937	**242,642**	213,852
Gross loans and advances to banks				
Grades 1 to 3: Satisfactory risk	**104,045**	73,715	**84,989**	50,921
Grade 4: Watch list and special mention	**30**	–	**30**	–
	104,075	73,715	**85,019**	50,921

Grades 1 and 2 include corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to value ratios, and other retail accounts which are not impaired and are maintained within product guidelines.

Grade 3 represents satisfactory risk and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios than grades 1 and 2, all non-impaired credit card exposures, and other retail exposures which operate outside product guidelines without being impaired.

Grades 4 and 5 include corporate facilities that require various degrees of special attention and all retail exposures that are progressively between 30 and 90 days past due.

Gross loans and advances which were past due but not impaired

The analysis below shows the gross loans and advances to customers and banks that were past due but not impaired at the balance sheet dates indicated:

	Group		Bank	
	2006	2005	**2006**	2005
Three months or less	**1,427**	984	**1,425**	978
Six months or less but over three months	**218**	281	**56**	79
Over six months	**89**	79	**46**	30
	1,734	1,344	**1,527**	1,087

Other than gross loans and advances, no financial assets was past due but not impaired at the balance sheet dates of 2006 and 2005.

Renegotiated loans that would otherwise be past due or impaired

Renegotiated loans are those that have been restructured due to deterioration in the borrower's financial position and where the Group has made concessions that it would not otherwise consider. Once the loan is restructured it remains in this category independent of satisfactory performance after restructuring.

	Group		Bank	
	2006	2005	**2006**	2005
Renegotiated loans that would otherwise be past due or impaired	**660**	615	**392**	333

61 Financial Risk Management (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Debt securities

Financial investments by rating agency designation

The following table presents an analysis of financial securities, other than loans, by rating agency designation at the balance sheet dates, 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.

	Group		
	Treasury bills	Debt securities	Total
At 31 December 2006			
AAA	**40**	**21,091**	**21,131**
AA- to AA+	**6,807**	**101,260**	**108,067**
A- to A+	**312**	**101,932**	**102,244**
Lower than A-	**–**	**6,366**	**6,366**
Unrated	**–**	**5,003**	**5,003**
	7,159	**235,652**	**242,811**
of which issued by:			
– central governments and central banks	**7,159**	**11,001**	**18,160**
– other public sector entities	**–**	**8,255**	**8,255**
– banks and other financial institutions	**–**	**197,841**	**197,841**
– corporate entities	**–**	**18,555**	**18,555**
	7,159	**235,652**	**242,811**
of which classified as:			
– trading assets	**6,071**	**6,321**	**12,392**
– financial assets designated at fair value	**–**	**4,819**	**4,819**
– available-for-sale debt securities	**1,088**	**208,375**	**209,463**
– held-to-maturity debt securities	**–**	**16,137**	**16,137**
	7,159	**235,652**	**242,811**
At 31 December 2005			
AAA	37	26,204	26,241
AA– to AA+	–	83,855	83,855
A- to A+	7,373	78,873	86,246
Lower than A-	–	6,462	6,462
Unrated	–	2,581	2,581
	7,410	197,975	205,385
of which issued by:			
– central governments and central banks	7,410	15,061	22,471
– other public sector entities	–	10,451	10,451
– banks and other financial institutions	–	155,330	155,330
– corporate entities	–	17,133	17,133
	7,410	197,975	205,385
of which classified as:			
– trading assets	2,594	9,978	12,572
– financial assets designated at fair value	–	4,269	4,269
– available-for-sale debt securities	4,816	172,997	177,813
– held-to-maturity debt securities	–	10,731	10,731
	7,410	197,975	205,385

61 Financial Risk Management (continued)
(a) Credit risk (continued)
(ii) Credit quality (continued)
Debt securities (continued)

	Treasury bills	Bank Debt securities	Total
At 31 December 2006			
AAA	40	9,221	9,261
AA- to AA+	6,807	74,503	81,310
A- to A+	312	75,249	75,561
Lower than A-	–	6,206	6,206
Unrated	–	2,268	2,268
	7,159	167,447	174,606
of which issued by:			
– central governments and central banks	7,159	10,196	17,355
– other public sector entities	–	6,965	6,965
– banks and other financial institutions	–	137,302	137,302
– corporate entities	–	12,984	12,984
	7,159	167,447	174,606
of which classified as:			
– trading assets	6,071	4,632	10,703
– financial assets designated at fair value	–	1,595	1,595
– available-for-sale debt securities	1,088	161,220	162,308
	7,159	167,447	174,606
At 31 December 2005			
AAA	37	11,262	11,299
AA- to AA+	–	66,229	66,229
A- to A+	7,373	60,195	67,568
Lower than A-	–	6,294	6,294
Unrated	–	1,449	1,449
	7,410	145,429	152,839
of which issued by:			
– central governments and central banks	7,410	13,962	21,372
– other public sector entities	–	7,904	7,904
– banks and other financial institutions	–	110,986	110,986
– corporate entities	–	12,577	12,577
	7,410	145,429	152,839
of which classified as:			
– trading assets	2,594	6,531	9,125
– financial assets designated at fair value	–	1,647	1,647
– available-for-sale debt securities	4,816	137,251	142,067
	7,410	145,429	152,839

61 Financial Risk Management (continued)

(a) Credit risk (continued)

(iii) Collateral and other credit enhancements obtained

During the years indicated, the Group obtained assets by taking possession of collateral held as security, or calling other credit enhancement, as follows:

	Group		Bank	
Nature of assets	**2006**	2005	**2006**	2005
Residential properties	**156**	179	**72**	75
Commercial and industrial properties	**2**	2	**2**	–
Others	**17**	35	**17**	35
	175	216	**91**	110

(b) Liquidity risk

Liquidity management is essential to ensure the Group has the ability to meet its obligations as they fall due. It is the Group's policy to maintain a strong liquidity position by properly managing the liquidity structure of its assets, liabilities and commitments so that cash flows are appropriately balanced and all funding obligations are comfortably met.

The Group has established policies and procedures to monitor and control its liquidity position on a daily basis by adopting a cash flow management approach. The approach seeks to forecast committed cash inflows and outflows of the business and results in a daily net funding requirements which indicates the refinancing needs for any given day within the scope of the forecast conditions. Stress scenarios analysis for normal business conditions, an institution-specific crisis and a general market crisis are also conducted on a regular basis. The Group always maintains a stock of high quality liquid assets to ensure the availability of sufficient cash flow to meet its financial commitments, including customer deposits on maturity and undrawn facilities, over a specified future period. The liquidity management process is monitored by the Asset and Liability Management Committee ("ALCO") and is reported to the Executive Committee and the Board of Directors.

The average liquidity ratio for the year, calculated in accordance with the Fourth Schedule of the Hong Kong Banking Ordinance, is as follows:

	Group	
	2006	2005
The Bank and its major banking subsidiaries	**51.9%**	45.1%

61 Financial Risk Management (continued)

(b) Liquidity risk (continued)

The following table gives the cash-flow projection of the Group's financial liabilities including interest payable and undrawn commitments at balance sheet date based on the dates of their contractual payment obligations. Interest payable in respect of term financial liabilities are reported based on contractual interest payment date. Financial liabilities repayable on demand (such as savings and current deposits) including interest accrued up to balance sheet date are reported under the column "repayable on demand". Liabilities in trading portfolios are not included in this analysis as they are typically held for short periods of time.

	Group				
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years
At 31 December 2006					
Current, savings and other deposit accounts	291,042	183,800	8,638	1,067	–
Deposits from banks	2,799	14,094	1,155	–	–
Financial liabilities designated at fair value	81	10	31	1,103	494
Derivative financial instruments	–	391	1,169	1,307	299
Certificates of deposit and other debt securities in issue	–	195	1,047	7,099	–
Other financial liabilities	157	3,338	270	–	–
Subordinated liabilities	–	93	278	8,201	–
Loan commitments and other credit related commitments	1,823	32,716	22,086	110,429	20
	295,902	234,637	34,674	129,206	813
At 31 December 2005					
Current, savings and other deposit accounts	234,016	191,034	5,986	1,048	–
Deposits from banks	1,674	10,392	9	–	–
Financial liabilities designated at fair value	26	10	31	1,186	535
Derivative financial instruments	–	299	1,579	2,225	426
Certificates of deposit and other debt securities in issue	–	379	2,120	8,476	51
Other financial liabilities	120	2,676	208	–	–
Subordinated liabilities	–	39	118	4,179	–
Loan commitments and other credit related commitments	3,273	23,758	9,654	98,151	13
	239,109	228,587	19,705	115,265	1,025

61 Financial Risk Management (continued)

(b) Liquidity risk (continued)

	Bank				
	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years
At 31 December 2006					
Current, savings and other deposit accounts	**290,355**	**180,364**	**8,614**	**1,053**	**–**
Deposits from banks	**2,529**	**14,094**	**1,155**	**–**	**–**
Financial liabilities designated at fair value	**–**	**10**	**31**	**1,103**	**–**
Derivative financial instruments	**–**	**341**	**1,054**	**1,195**	**299**
Certificates of deposit and other debt securities in issue	**–**	**195**	**1,047**	**7,128**	**–**
Amounts due to subsidiaries	**665**	**1,059**	**–**	**–**	**–**
Other financial liabilities	**157**	**3,264**	**270**	**–**	**–**
Subordinated liabilities	**–**	**93**	**278**	**8,201**	**–**
Loan commitments and other credit related commitments	**1,680**	**32,155**	**22,086**	**110,249**	**20**
	295,386	**231,575**	**34,535**	**128,929**	**319**
At 31 December 2005					
Current, savings and other deposit accounts	232,875	182,660	5,966	1,048	–
Deposits from banks	1,674	10,392	9	–	–
Financial liabilities designated at fair value	–	10	31	1,186	–
Derivative financial instruments	–	276	1,446	2,016	426
Certificates of deposit and other debt securities in issue	–	379	2,128	8,505	51
Amounts due to subsidiaries	420	1,018	–	–	–
Other financial liabilities	120	2,076	208	–	–
Subordinated liabilities	–	39	118	4,179	–
Loan commitments and other credit related commitments	3,097	23,758	9,654	98,151	13
	238,186	220,608	19,560	115,085	490

61 Financial Risk Management (continued)

(c) Market risk management

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, proprietary position-taking and other marked-to-market positions so designated. 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 Board of Directors. Limits are set for each portfolio, product and risk type, with market liquidity being a principal factor in determining the level of limits set. The Group has dedicated standards, policies and procedures in place to control and monitor the market risk. An independent market risk control function is responsible for measuring market risk exposures, monitoring and reporting these exposures against the prescribed limits on a daily basis. The market risks which arise on each business are assessed and transferred to either Treasury for management, or to separate books managed under the supervision of ALCO.

Value at risk ("VAR")

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR. The Group has obtained approval from the HKMA to use its VAR model for calculation of market risk capital charge.

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. In line with the HSBC Group, the Group has changed its VAR calculation from a variance/co-variance ("VCV") basis to historical simulation ("HS") basis with effect from 3 May 2005. HS 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 one-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

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 one-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 one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

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

61 Financial Risk Management (continued)

(c) Market risk management (continued)

The Group's VAR, both trading and non-trading, for all interest rate risk and foreign exchange risk positions and on individual risk portfolios during 2006 and 2005 are shown in the table below. The VAR figures for 2005 are based on four months VCV and eight months' HS.

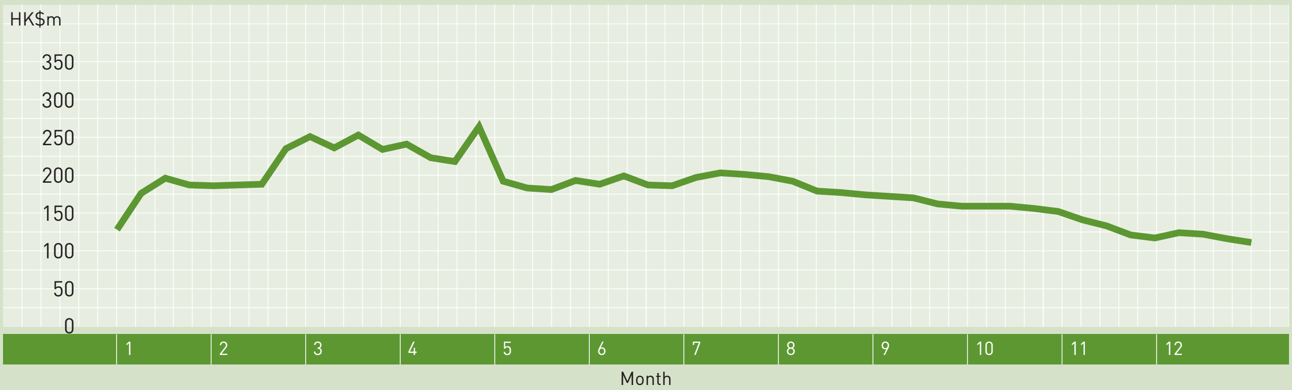
Value at risk

	At 31 December 2006	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	42	29	119	64
VAR for foreign exchange risk (trading)	2	1	16	5
VAR for interest rate risk				
– trading	4	3	16	8
– non-trading	45	35	123	68

	At 31 December 2005	Minimum during the year	Maximum during the year	Average for the year
VAR for all interest rate risk and foreign exchange risk	113	111	264	181
VAR for foreign exchange risk (trading)	3	–	6	2
VAR for interest rate risk				
– trading	3	1	21	4
– non-trading	118	117	260	180

Value at Risk for 2006

Value at Risk for 2005



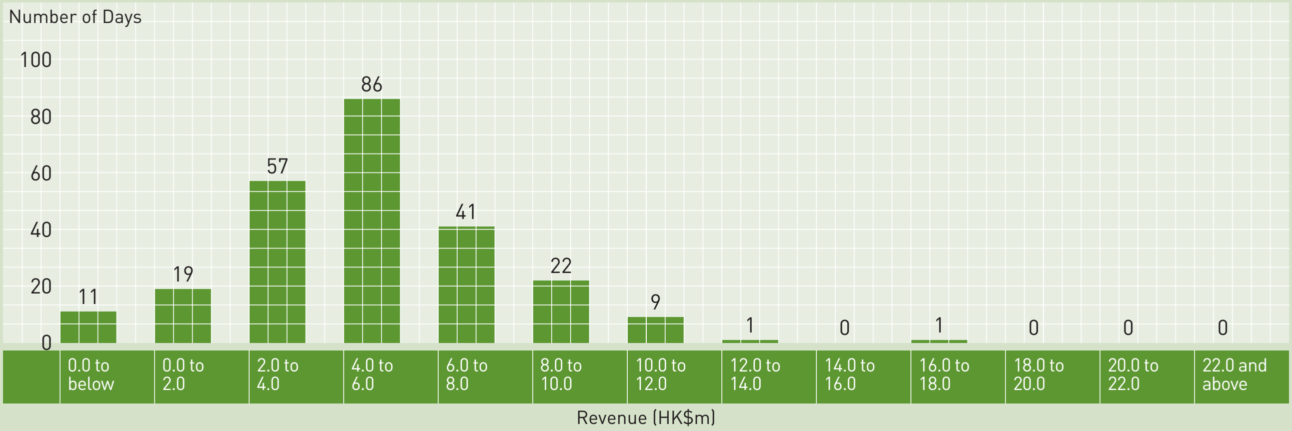
61 Financial Risk Management (continued)

(c) Market risk management (continued)

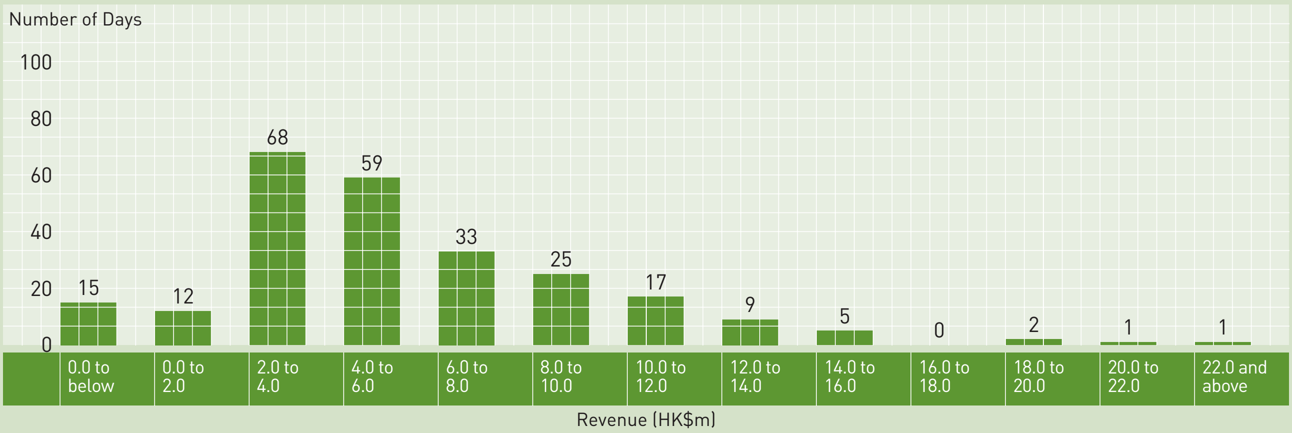
The average daily revenue earned from market risk-related treasury activities in 2006, including non-trading book net interest income and funding related to trading positions, was HK$5 million (same as 2005). The standard deviation of these daily revenues was HK$3 million, compared with HK$8 million for 2005.

An analysis of the frequency distribution of daily revenue shows that out of 247 trading days in 2006, losses were recorded on 11 days (2005: 15 days) and the maximum daily loss was HK$5 million (2005: HK$84 million). The most frequent result was a daily revenue of between HK$2 million and HK$6 million, with 143 occurrences (2005: 127 occurrences). The highest daily revenue was HK$17 million (2005: HK$23 million).

Daily Distribution of Market Risk Revenues for 2006



Daily Distribution of Market Risk Revenues for 2005



61 Financial Risk Management (continued)

(c) Market risk management (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 Board of Directors and under the monitoring of ALCO.

Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and present value of a basis point ("PVBP") limits, and a list of permissible instruments authorised by the Board of Directors, 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 arising from the differing repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts.

Analysis of these risks is complicated by having to make assumptions on optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions, should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios and structural interest rate risks are transferred to Treasury or to separate books managed under the supervision of the ALCO.

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

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 yield curves at the beginning of year from 1 January 2007 and 25 basis points parallel fall or rise in all yield curves at the beginning of each quarter during the 12 month period from 1 January 2007.

Assuming no management actions, such a series of incremental parallel rises in all yield curves would decrease planned net interest income for the year to 31 December 2007 by HK$154 million for 100 basis points case and by HK$206 million for 25 basis points case, while such a series of incremental parallel falls in all yield curves would increase planned net interest income by HK$334 million for 100 basis points case and by HK$309 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and takes into account the change in pricing of retail products relative to change in market interest rates.

61 Financial Risk Management (continued)

(c) Market risk management (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 2007 projected net interest income	**(154)**	**334**	**(206)**	**309**
Change in 2006 projected net interest income	(245)	314	(289)	315

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.

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 yield curves. The table below describes the sensitivity to these movements at the balance sheet date indicated below and the maximum and minimum month figures during the year then ended:

	At 31 December 2006	Maximum impact	Minimum impact
+100 basis points parallel move all in yield curves	**(1,223)**	**(1,573)**	**(1,223)**
As a percentage of shareholders' funds at 31 December 2006 (%)	**(2.6)**	**(3.4)**	**(2.6)**
–100 basis points parallel move all in yield curves	**1,223**	**1,573**	**1,223**
As a percentage of shareholders' funds at 31 December 2006 (%)	**2.6**	**3.4**	**2.6**

	At 31 December 2005	Maximum impact	Minimum impact
+100 basis points parallel move all in yield curves	(1,574)	(2,137)	(1,574)
As a percentage of shareholders' funds at 31 December 2005 (%)	(3.7)	(5.0)	(3.7)
–100 basis points parallel move all in yield curves	1,574	2,137	1,574
As a percentage of shareholders' funds at 31 December 2005 (%)	3.7	5.0	3.7

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.

61 Financial Risk Management (continued)

(c) Market risk management (continued)

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 Board of Directors. Structural foreign exchange positions arising from capital investments in associate, subsidiaries and branches outside Hong Kong, mainly in US dollar and renminbi as set out below, are managed by ALCO.

The table below summarises the net structural and non-structural foreign currency positions of the Group and the Bank.

	Group			
	USD	RMB	Other foreign currencies	Total foreign currencies
2006				
Non-structural position				
Spot assets	205,544	14,422	107,320	327,286
Spot liabilities	(189,232)	(12,670)	(90,897)	(292,799)
Forward purchases	128,102	353	15,294	143,749
Forward sales	(141,544)	(1,904)	(31,575)	(175,023)
Net options position	120	–	(130)	(10)
Net long non-structural position	2,990	201	12	3,203
% of total net non-structural position	93.3%	6.3%	0.4%	100.0%
Structural position	1,430	3,760	141	5,331
% of total net structural position	26.8%	70.5%	2.7%	100.0%
2005 (restated)				
Non-structural position				
Spot assets	193,149	5,955	98,115	297,219
Spot liabilities	(168,513)	(6,008)	(97,661)	(272,182)
Forward purchases	84,026	439	40,291	124,756
Forward sales	(104,960)	(300)	(40,772)	(146,032)
Net options position	(77)	–	75	(2)
Net long non-structural position	3,625	86	48	3,759
% of total net non-structural position	96.4%	2.3%	1.3%	100.0%
Structural position	1,035	2,439	107	3,581
% of total net structural position	28.9%	68.1%	3.0%	100.0%

61 Financial Risk Management (continued)
(c) Market risk management (continued)
Foreign exchange exposure (continued)

	Bank			
	USD	RMB	Other foreign currencies	Total foreign currencies
2006				
Non-structural position				
Spot assets	171,565	14,422	69,454	255,441
Spot liabilities	(155,253)	(12,670)	(53,031)	(220,954)
Forward purchases	128,102	353	15,294	143,749
Forward sales	(141,544)	(1,904)	(31,575)	(175,023)
Net options position	120	–	(130)	(10)
Net long non-structural position	2,990	201	12	3,203
% of total net non-structural position	93.3%	6.3%	0.4%	100.0%
Structural position	1,430	2,784	141	4,355
% of total net structural position	32.8%	63.9%	3.3%	100.0%
2005				
Non-structural position				
Spot assets	153,467	5,955	63,853	223,275
Spot liabilities	(128,831)	(6,008)	(63,399)	(198,238)
Forward purchases	84,026	439	40,291	124,756
Forward sales	(104,960)	(300)	(40,772)	(146,032)
Net options position	(77)	–	75	(2)
Net long non-structural position	3,625	86	48	3,759
% of total net non-structural position	96.4%	2.3%	1.3%	100.0%
Structural position	1,035	2,043	107	3,185
% of total net structural position	32.5%	64.1%	3.4%	100.0%

Equities exposure
The Group's equities exposure in 2006 is mainly in long-term equity investments which are reported as "Financial investments" set out in note 34. Equities held for trading purpose are included under "Trading assets" set out in note 31. These are subject to trading limit and risk management control procedures and other market risk regime.

(d) Insurance underwriting risk
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 ("Insurance Commissioner") and are required to observe the relevant compliance requirements stipulated by the Insurance Commissioner.

The Group manages its insurance risks through the application of sound underwriting, reinsurance, risk management and claims procedures as discussed below. There are well established claims procedures handled by professional department independent of underwriting. Reserves are prudently maintained for claims and policyholders' liabilities in accordance with the policies and procedures set out in note 3(ac) in page 106. Present value of in-force long-term insurance business (PVIF) is calculated using prudent actuarial assumptions set out in note 40(a) in page 144. The sensitivity of the PVIF valuation to changes in individual assumptions is also exhibited therein.

61 Financial Risk Management (continued)

(d) Insurance underwriting risk (continued)

Insurance risk (continued)

Insurance business is also exposed to financial risks if the proceeds from the financial assets are not sufficient to fund the obligations arising from insurance and investment contracts. The insurance business manages financial risk through asset and liability management, prudent investment guidelines and market risk management techniques of the Group.

Life Insurance business

Life insurance contracts include endowments, pensions and term assurance. The Group assesses and monitors the life insurance risk exposures for both individual types of risks insured and overall risks by using internal risk measurement models, sensitivity analysis, scenario analyses and stress testing.

Underwriting strategy

The Group's overall approach to life insurance risk is to maintain a good diversification to ensure a balanced portfolio and is based on a large portfolio of similar risks over a number of years to reduce the variability of the outcome.

The following gives an assessment of the life's main products and the ways in which it manages the associated risks:

Long-term insurance contracts – non-linked products

Long-term non-linked insurance contracts provide guaranteed death benefit with a fixed level of premium determined at the time of policy issue. For insurance products with a savings element, guaranteed surrender and maturity benefits are usually provided.

To manage the insurance risk arisen from such contracts, the Group has the complete contractual discretion on the bonuses declared and maintained a smooth dividend scale based on long-term rate of return. Annual review is performed to assess whether the current dividend scale is supportable taken into account the overall experience on investment, claims, operating expense and lapse. On the other hand, investment risks are managed through matching assets and liabilities. Investment strategies are set to ensure sufficient investment return to satisfy policyholders' reasonable expectations. Mortality risks are managed through reinsurance and proper underwriting.

Long-term insurance contracts – unit-linked products

Long-term unit-linked insurance contracts provide policyholders life insurance protection with direct investment in a variety of funds. Premiums received are deposited into the chosen fund after deduction of a premium fee. Other charges for the cost of insurance and administration will be deducted from the funds accumulated. For long-term unit-linked insurance contracts, the policyholders bear the market risk on the linked assets and liabilities. However, the Group assumes reputational risk for any undue market risk taken by policyholders. In this regards, the Group will ensure that the policyholders' exposure to market risk is consistent with that of the market. Claims and expenses are reviewed regularly to ensure current charges are sufficient to cover the costs.

Long-term investment contracts

The Group underwrites retirement fund business which is classified as investment contracts. Like the insurance contracts, investment contracts comprise of non-linked return guaranteed products and unit-linked products.

For non-linked return guaranteed products, the Group provides an investment return guarantee on these retirement funds. 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.

For unit-linked products, the Group manages the relative risk similar to long-term unit-linked insurance contracts.

Reinsurance strategy

The Group reinsures a portion of the risks it underwrites in order to control its exposures to losses and protect capital resources. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured. The Group also utilises a reinsurance agreement with non-affiliated reinsurers to control its exposure to losses resulting from catastrophe. To minimize the credit risk arisen from reinsurance, only a number of professional companies meeting credit rating standard are selected.

61 Financial risk management (continued)

(d) Insurance underwriting risk (continued)

Life Insurance business (continued)

Concentration of insurance risks

Concentration of risk may arise where a particular event or series of events could impact heavily on the Group's liabilities. Such concentrations may arise from a single contract or through a small number of related contracts, and relate to circumstances where significant liabilities could arise. The Group mitigates such risk through reinsurance. To determine the concentration of insurance risk and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the Group.

Non-life insurance business

Non-life insurance contracts include mainly fire property damage, accident property damage, marine cargo, motor, accident and health, employees' compensation/employers' liability and general liability.

Underwriting strategy

The Group manages the underwriting risk to ensure that the risks are well diversified in terms of type and amount of risk and industry. The Group focuses on underwriting business in Hong Kong and most of its business is solicited by the Bank which act as an insurance agent. An underwriting strategy is prepared and reviewed annually and it sets out the classes of business and the territories in which the business is to be written, the industry sectors and the target customers which the Group is prepared to underwrite.

Reinsurance strategy

To increase the underwriting capacity and to mitigate the Group's exposure, reinsurance arrangements were specially made for each class of business thereby limiting the Group's liabilities to an optimal level according to the underwriting results of the relevant covers. The reinsurance arrangements include excess of loss, catastrophe coverage, treaty and facultative reinsurance.

Concentration of insurance risks

Within the insurance process, concentrations of risks may arise where a particular event or a series of events could impact heavily the Group's liabilities. Such concentrations may arise from the occurrence of a catastrophe affecting a number of insurance contracts. Most of the insurance contracts are annually renewable and the Group has the right to refuse renewal or to change the terms and conditions of contracts at renewal.

For property damage business, there is the potential risk of concentration arising from the provision of insurance coverage to policyholders in the same location. Catastrophic losses are protected by reinsurance. For accident and health business, potential accumulations of personal accident risks are mitigated by the purchase of catastrophe reinsurance. For motor insurance business, reinsurance protection has been arranged where necessary to avoid excessive exposure to large losses, particularly those relating to personal injury claims. For marine cargo business, reinsurance is arranged with the Group's net exposure per risk per vessel at a particular automatic gross acceptance level. For employees' compensation/employers' liability, catastrophic losses are protected by reinsurance.

62 Use Of Derivatives

Derivatives are financial contracts whose value 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 procedures used for other credit transactions. Details of the nominal value, fair value and credit risk-weighted amounts of derivatives are set out in note 54. Market risk from derivative positions is controlled individually and in combination with on-balance sheet market risk positions within the Group's market risk limits regime as described in note 61(c).

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative instruments are classified as either held for trading or hedging.

62 Use Of Derivatives (continued)

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.

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

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 accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The table below is a summary of the fair value of outstanding derivatives that were held for hedging purposes at the balance sheet dates indicated.

	Group		Bank	
	Fair value hedges	Cash flow hedges	Fair value hedges	Cash flow hedges
At 31 December 2006				
Interest rate contracts:				
– derivative assets	**165**	**348**	**122**	**297**
– derivative liabilities	**64**	**153**	**63**	**153**
At 31 December 2005				
Interest rate contracts:				
– derivative assets	156	298	110	271
– derivative liabilities	142	315	141	315

(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. Gains or losses arising from fair value hedges for the years indicated were detailed as below:

	Group	
	2006	2005
Gains/(losses):		
– on hedging instruments	**25**	255
– on the hedged items attributable to the hedged risk	**(21)**	(249)
	4	6

62 Use Of Derivatives (continued)

(b) Cash flow hedges

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 hedges of forecast transactions.

The gains and losses on ineffective portions of cash flow hedges derivatives recognised in the income statement were as follows:

	Group	
	2006	2005
Gains/(losses) on ineffective portions of cash flow hedges	(3)	–

The schedules of forecast principal balances on which the expected interest cash flows associated with derivatives that are cash flow hedges were as follows:

	Group		
	Three months or less	Three months to one year	One year to five years
At 31 December 2006			
Cash inflows from assets	45,825	40,102	12,240
Cash outflows from liabilities	–	–	–
Net cash inflows	45,825	40,102	12,240
At 31 December 2005			
Cash inflows from assets	45,745	95,763	91,573
Cash outflows from liabilities	–	–	–
Net cash inflows	45,745	95,763	91,573

	Bank		
	Three months or less	Three months to one year	One year to five years
At 31 December 2006			
Cash inflows from assets	42,396	37,170	10,848
Cash outflows from liabilities	–	–	–
Net cash inflows	42,396	37,170	10,848
At 31 December 2005			
Cash inflows from assets	43,019	87,961	79,129
Cash outflows from liabilities	–	–	–
Net cash inflows	43,019	87,961	79,129

62 Use Of Derivatives (continued)

Hedge effectiveness testing

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

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

For fair value hedge relationships, the Group utilises the cumulative dollar offset method 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 year 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.

63 Fair Value Of Financial Instruments

(a) Determination of fair value

Fair value estimates are generally subjective in nature, and are made as of a specific point in time based on the characteristics of the financial instruments and relevant market information. Where available, the most suitable measure for fair value is the quoted market price. In the absence of organised secondary markets for most financial instruments, and in particular for loans, deposits and unlisted derivatives, direct market prices are not available, the fair value of such instruments is therefore calculated on the basis of well-established valuation techniques using current market parameters. In particular, the fair value is a theoretical value applicable at a given reporting date, and hence can only be used as an indicator of the value realisable in a future sale.

All valuation models are validated before they are used as a basis for financial reporting, by qualified personnel independent of the area that created the mode. Wherever possible, the Group compares valuations derived from models with quoted prices of similar financial instruments, and with actual values when realised, in order to further validate and calibrate the models. These techniques involve uncertainties and are significantly affected by the assumptions used and judgement made regarding risk characteristics of various financial instruments, discount rates, estimates of future cash flows, future expected loss experiences and other factors.

The methods and significant assumptions applied in determining the fair value of financial instruments are set out in note 3(n).

63 Fair Value of Financial Instruments (continued)

(b) Fair value

All financial instruments are stated at fair value or carried at amounts not materially different from their fair values as at 31 December 2006 and 2005 except as follows:

	Group			
	2006		2005	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	99,705	99,705	69,286	69,284
Advances to customers	279,353	281,856	260,680	260,139
Held-to-maturity debt securities	16,137	16,551	10,731	10,778
Financial Liabilities				
Current, savings and other deposit accounts	482,821	482,804	430,995	430,944
Deposits from banks	17,950	17,950	12,043	12,043
Certificates of deposit and other debt securities in issue	7,595	7,448	10,023	9,825
Subordinated liabilities	7,000	7,008	3,511	3,547

	Bank			
	2006		2005	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	80,679	80,679	46,520	46,518
Advances to customers	244,235	246,741	215,110	214,791
Financial Liabilities				
Current, savings and other deposit accounts	478,712	478,694	421,518	421,467
Deposits from banks	17,680	17,680	12,043	12,043
Certificates of deposit and other debt securities in issue	7,623	7,477	10,060	9,864
Subordinated liabilities	7,000	7,008	3,511	3,547

64 Cross-Border Claims

Cross-border claims include receivables, loans and advances, balances due from banks, holdings of certificates of deposit, bills, promissory notes, commercial paper and other negotiable debt instruments, as well as accrued interest and overdue interest on these assets. Claims are classified according to the location of the counterparties after taking into account the transfer of risk. For a claim guaranteed by a party situated in a country different from the counterparty, the risk will be transferred to the country of the guarantor. For a claim on the branch of a bank or other financial institution, the risk will be transferred to the country where its head office is situated. Claims on individual countries or areas, after risk transfer, amounting to 10 per cent or more of the aggregate cross-border claims are shown as follows:

	Banks and other financial institutions	Sovereign and public sector entities	Other	Total
At 31 December 2006				
Asia-Pacific excluding Hong Kong:				
– Australia	**33,724**	**–**	**1,355**	**35,079**
– Other	**49,686**	**1,247**	**9,677**	**60,610**
	83,410	**1,247**	**11,032**	**95,689**
The Americas:				
– United States	**25,998**	**1,451**	**9,114**	**36,563**
– Other	**18,800**	**3,482**	**6,837**	**29,119**
	44,798	**4,933**	**15,951**	**65,682**
Western Europe:				
– United Kingdom	**38,203**	**–**	**9,619**	**47,822**
– Other	**101,805**	**590**	**4,165**	**106,560**
	140,008	**590**	**13,784**	**154,382**
At 31 December 2005				
Asia-Pacific excluding Hong Kong:				
– Australia	23,961	144	712	24,817
– Other	38,140	1,447	6,882	46,469
	62,101	1,591	7,594	71,286
The Americas:				
– United States	13,163	1,709	6,575	21,447
– Other	16,248	4,727	5,814	26,789
	29,411	6,436	12,389	48,236
Western Europe:				
– United Kingdom	23,008	–	7,842	30,850
– Other	81,089	1,430	6,207	88,726
	104,097	1,430	14,049	119,576

65 Comparative Figures

Certain comparative figures have been reclassified to conform with the current year's presentation.

66 Non-Adjusting Post Balance Sheet Event

On 5 February 2007, Industrial Bank Co., Ltd. ("Industrial Bank"), an associate of the Bank, issued 1,001 million new shares for a total consideration of RMB15,996 million. The Bank did not subscribe for any additional shares and, as a result, its interest in the equity of Industrial Bank decreased from 15.98 per cent to 12.78 per cent. While the Bank's interest has reduced, the assets of Industrial Bank have substantially increased as a result of this issue. Consequently, it is expected that this transaction would result in an increase of about RMB1.5 billion in the Group's share of the underlying net assets of Industrial Bank.

The decrease of the Bank's interest in the equity of Industrial Bank does not affect the influence that the Bank has over this associate, as there has been no change in the composition of major shareholders in Industrial Bank or in the Bank's representation in the Industrial Bank's Board of Directors or Executive Committee. The Bank will continue to have the power to participate in the financial and operating policy decisions of Industrial Bank, and its investment will continue to be accounted for using the equity method.

67 Parent And Ultimate Holding Company

The parent 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.

68 Approval Of Financial Statements

The financial statements were approved and authorised for issue by the Board of Directors on 5 March 2007.