NOTES TO THE FINANCIAL STATEMENTS

year ended 31 December 2008
(Figures expressed in millions of Hong Kong dollars unless otherwise indicated)

1. BASIS OF PREPARATION

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

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

The HKICPA has issued certain 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 5 provides information on the changes in accounting policies resulting from initial application of these developments to the extent that they are relevant to the Group for the current and prior accounting periods reflected in these financial statements.

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

– financial instruments classified as trading, designated at fair value and available-for-sale (see note 4(g));

– investment property (see note 4(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 4(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 4(s)).

(d) The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. The Group believes that the assumptions that have been made are approporiate and that the financial statments 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 6.

Disclosures under HKFRS4 "Insurance Contract" and HKFRS7 "Financial Instrument: Disclosure" relating to the nature and extent of risks have been included in note 62 "Financial risk management".

2. NATURE OF BUSINESS

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

3. BASIS OF CONSOLIDATION

The consolidated financial statements cover the consolidated positions of Hang Seng Bank Limited and all its subsidiaries, unless otherwise stated, and include the attributable share of results and reserves of its associates. For regulatory reporting, the bases of consolidation are different from the basis of consolidation for accounting purposes. They are set out in notes 34, 55 and 62 to the financial statements.

4. PRINCIPAL ACCOUNTING POLICIES

(a) Interest income and expense

Interest income and expense for all 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. Such transaction costs (for example, mortgage rebates) are incremental to the Group and are directly attributable to a transaction.

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 4(a)).

(ii) Rental income from operating lease

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

(iii) Dividend income

Dividend income from unlisted investments is recognised when the shareholder's right to receive payment is established. Dividend income from listed investments is recognised when the share price of the investment is quoted ex-dividend.

(iv) Trading income

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(b) Non-interest income (continued)

(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.

(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

Impairment losses on individually significant accounts are assessed by an evaluation of the exposures on a case-by-case basis. The Group assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant.

The criteria used by the Group to determine that there is such objective evidence include, inter alia:

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

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;

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(f) Loan impairment (continued)

(i) Individually assessed loans (continued)

- 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.

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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments

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

(i) Trading assets and trading liabilities

Financial instruments and short positions thereof which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as held-for-trading. Trading liabilities also include customer deposits and certificates of deposit with embedded options or other derivatives, the market risk of which 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.

(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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments (continued)

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

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

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

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

(iv) Held-to-maturity investments

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

(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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(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 qualify 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.

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

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

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".

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(j) Sale and repurchase agreements

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

(k) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(l) Application of trade date accounting

Except for loans and advances and deposits, all financial assets, liabilities and instruments are accounted for on trade date basis.

(m) Derecognition of financial assets and liabilities

Financial assets are derecognised when the rights to receive cash flows from the assets have expired; or where the Group has transferred its contractual rights to receive the cash flows of the financial assets and has transferred substantially all the risks and rewards of ownership; or where control is not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged or cancelled or expires.

(n) Determination of fair value

The fair value of financial instruments is based on their quoted market prices at the 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.

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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(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.

(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 allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Goodwill is tested for impairment annually by comparing the recoverable amount from a cash-generating unit with the carrying value of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of, its fair value less cost to sell, and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less any accumulated impairment losses.

Any excess of the Group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business over the cost to acquire is recognised immediately in the income statement.

At the date of disposal of a business, attributable goodwill is included in the Group's share of net assets in the calculation of the gain or loss on disposal.

(ii) Intangible assets include the value of in-force long-term 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 actuaries using the methodology as described in note 4(ac). Computer software acquired is stated at cost less amortisation and impairment allowances. Amortisation of computer software is charged to the income statement over its useful life. Costs incurred in the development phase of a project to produce application software for internal use are capitalised and amortised over the software's estimated useful life, usually five years. A periodic review is performed on intangible assets to confirm that there has been no impairment.

(r) Investment property

Investment properties are land and/or buildings which are owned 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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(s) Premises, plant and equipment (continued)

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.

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 4(r) & 4(s).

(i) Finance leases

Where the Group is a lessor under finance leases, an amount representing the net investment in the lease is included in the balance sheet as loans and advances to customers. Hire purchase contracts having the characteristics of a finance lease are accounted for in the same manner as finance leases. Impairment allowances are accounted for in accordance with the accounting policies set out in note 4(f).

Where the Group acquires the use of assets under finance leases, the amount representing the fair value of the leased asset, or, if lower, the present value of the minimum payments of such assets is included in fixed assets and the corresponding liabilities, net of finance charges, are recorded as obligations under finance leases. Depreciation is provided at rates which write off the cost or valuation of the assets over the term of the relevant lease or, where it is likely the Group will obtain ownership of the asset, the life of the asset, as set out in note 4(s). Impairment allowances are accounted for in accordance with the accounting policy as set out in note 4(v). Finance charges implicit in the lease payments are charged to the income statement over the period of the leases so as to produce an approximately constant periodic rate of charge on the remaining balance of the obligations for each accounting period. Contingent rentals are written off as an expense of the accounting period in which they are incurred.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(u) Finance and operating leases (continued)

(ii) Operating leases

Where the Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable. Rental revenue arising from operating lease is recognised in accordance with the Group's revenue recognition policies as set out in note 4(b)(ii).

(v) Impairment of assets

The carrying amount of the Group's assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, the carrying amount is reduced to the estimated recoverable amount by means of a charge to the income statement.

The accounting policies on impairment losses on loans and receivables and goodwill are set out in notes 4(f) and 4(q) respectively.

(i) Held-to-maturity investments

For held-to-maturity investments, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets) on an individual basis.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. The reversal of impairment is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years.

(ii) Available-for-sale financial assets

At each balance sheet date, an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of assets. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

If the available-for-sale financial asset is impaired, the difference between the financial asset's acquisition cost (net of any principal repayments and amortisation) and the current fair value, less any previous impairment loss recognised in the income statement, is removed from equity and recognised in the income statement.

Impairment losses on available-for-sale debt securities are recognised within "Loan impairment charges and other credit risk provisions" in the income statement and impairment losses on available-for-sale equity securities are recognised within 'Gains less losses from financial investments and fixed assets' in the income statement.

Once an impairment loss has been recognised on an available-for-sale financial asset, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the nature of the available-for-sale financial asset concerned:

– For an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if there is further objective evidence of impairment. Further objective evidence of impairment occurs when as a result of one or more loss events, the estimated future cash flows of the financial asset are further impacted that can be reliably measured. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised directly in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value;

– For an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in equity. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, only to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(v) Impairment of assets (continued)

(iii) Other assets

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following types of assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

– premises and equipment (other than properties carried at revalued amounts);

– pre-paid interests in leasehold land classified as "Interest in leasehold land held for own use under operating lease";

– investments in subsidiaries and associates; and

– intangible assets.

If any such indication exists, the asset's recoverable amount is estimated and impairment losses recognised.

Calculation of recoverable amount

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the assets. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

Recognition of impairment losses

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the cash-generating unit (or group of units) and then, to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

Reversals of impairment losses

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

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

(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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(w) Income tax (continued)

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.

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

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

(y) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to the "Other reserves". The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting, and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(z) Translation of foreign currencies

Foreign currency transactions during the year are translated at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated at the foreign exchange rates ruling at the balance sheet date. Exchange gains and losses are recognised in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated using the foreign exchange rates ruling at the dates the fair value was determined.

Exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are 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 instruments.

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

(ac) Insurance contracts

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

A contract issued by the Group that transfers financial risk, without significant insurance risk, is classified as an investment contract, and is accounted for as a financial instrument. The financial assets held by the Group for the purpose of meeting liabilities under insurance and investment contracts are classified and accounted for based on their classifications as set out in notes 4(d) to 4(i).

Insurance contracts are accounted for as follows:

Net earned insurance premiums

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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(ac) Insurance contracts (continued)

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, 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".

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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(af) Assets held for sale

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use are classified as held for sale. Immediately before classification as held for sale, the assets are remeasured in accordance with the Group's accounting policies set out elsewhere in note 4. Thereafter generally the assets are measured at the lower of their carrying amount and fair value less cost to sell. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

(ag) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are 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.

(ah) Dividends

Dividends proposed or declared after the balance sheet date are disclosed as a separate component of shareholders' equity.

5. CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued a number of new and revised HKFRSs and Interpretations that are first effective or available for early adoption for the current accounting period of the Group and the Bank. There have been no significant changes to the accounting policies applied in these financial statements for the years presented as a result of these developments.

Hong Kong (IFRIC) Interpretation 11 "Group and Treasury Share Transactions" ("HK(IFRIC) - Int 11") is effective for annual periods beginning on or after 1 March 2007. On application of this interpretation, with effect from 1 January 2008, the Group has recognised all share-based payment transactions as equity-settled, whereby the fair value of the awards at grant date is recognised in "Other reserves" under shareholders' equity. Previously, certain share-based payment transactions involving principally achievement and restricted share awards were recognised as cash-settled transactions, whereby a liability was recognised in respect of the fair value of such awards at each reporting date. The effect of the adoption of HK(IFRIC) - Int 11 was not considered to be material for the Group and therefore, the prior year figures have not been restated.

Hong Kong (IFRIC) Interpretation 12 "Service Concession Arrangements", which has no significant effect on the consolidated financial statements of the Group;

Hong Kong (IFRIC) Interpretation 14 "HKAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction", which had no effect on the consolidated financial statements of the Group; and

Amendment to HKAS 39 "Financial Instruments: Recognition and Measurement" and HKFRS 7 "Financial Instruments: Disclosures" on reclassification of financial assets and its related amendment on effective date and transition requirements, which had no effect on the consolidated financial statements of the Group.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 7).

6. ACCOUNTING ESTIMATES AND JUDGEMENTS

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

6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

(a) Key sources of estimation uncertainty

(i) Impairment allowances on loans and advances

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

(ii) Valuation of financial instruments

The Group's accounting policy for valuation of financial instruments is included in note 4(n) and is discussed further within note 63 "Fair value of financial instruments".

When fair values are determined by using valuation techniques which refer to observable market data because independent prices are not available, management will consider the following when applying a valuation model:

– The likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgment may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;

– An appropriate discount rate for the instrument. Management determines this rate based on its assessment of the appropriate spread of the rate for the instrument over the risk-free rate; and

– Judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative models.

When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared. When valuing instruments on a model basis using the fair value of underlying components, management also considers the need for adjustments to take account of factors such as bid-offer spread, credit profile and model limitation. These adjustments are based on defined policies which are applied consistently across the Group.

When unobservable market data have a significant impact on the valuation of derivatives, the entire initial change in fair value indicated by the valuation model is recognised on one of the following bases: over the life of the transaction on an appropriate basis; in the income statement when the inputs become observable; or when the transaction matures or is closed out.

Financial instruments measured at fair value through profit or loss comprise of financial instruments held for trading and financial instruments designated at fair value. Changes in their fair value directly impact the Group's income statement in the period in which they occur.

A change in the fair value of a financial asset which is classified as "available-for-sale" is recorded directly in equity until the financial asset is sold, when the cumulative change in fair value is charged or credited to the income statement. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in equity is removed from equity and recognised in the profit or loss, reducing the Group's operating profit.

6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

(a) Key sources of estimation uncertainty (continued)

(iii) Insurance contracts

Classification

HKFRS 4 – Insurance Contracts ("HKFRS 4") requires the Group to determine whether an insurance contract that transfers both insurance risk and financial risk is classified as an insurance contract, or as a financial instrument under HKAS 39, or whether the insurance and non-insurance elements of the contract should be accounted for separately. This process involves judgment and estimation of the amounts of different types of risks that are transferred or assumed under a contract. The estimation of such risks often involves the use of assumptions about future events and is thus subject to a degree of uncertainty.

Present value of in-force long-term assurance business ("PVIF")

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in note 42(a). The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

Insurance liabilities

The estimation of insurance claims liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in note 62(d).

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

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

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

(ii) Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity investments if the Group has the intention and ability to hold them until maturity. In evaluating whether the requirements to classify a financial asset as held-to-maturity are met, management makes significant judgements. Failure in correctly assessing the Group's intention and ability to hold specific investments until maturity may result in reclassification of the whole portfolio as available-for-sale.

(iii) Income taxes

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

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2008

The HKICPA has issued a number of amendments to HKFRS and Interpretations which are not yet effective for the year ended 31 December 2008 and which have not been adopted in these financial statements.

HKFRS 8 "Operating Segments" ("HKFRS 8"), which replaces HKAS 14 "Segment Reporting" ("HKAS 14"), was issued by the HKICPA in March 2007 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should report information about its operating segments, based on information about the components of the entity that the chief operating decision maker uses to make operating decisions. The Group currently presents two sets of segments in accordance with HKAS 14, one geographical and one based on customer groups, which reflect the way the businesses of the Group are managed. The Group expects to adopt HKFRS 8 with effect from 1 January 2009 and will accordingly present segmental information which reflects the operating segments used to make operating decisions at that time.

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2008 (continued)

The HKICPA issued a revised HKAS 23 "Borrowing Costs" in June 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard eliminates the option of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The Group does not expect the adoption of the revised standard to have a significant effect on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 13 "Customer Loyalty Programmes" ("HK(IFRIC)-Int 13") was issued by the HKICPA in September 2007 and is effective for annual periods beginning on or after 1 July 2008. HK(IFRIC)-Int 13 addresses how companies that grant their customers loyalty award credits (often called "points") when buying goods or services should account for their obligation to provide free or discounted goods and services, if and when the customers redeem the points. HK(IFRIC)-Int 13 requires companies to allocate some of the proceeds of the initial sale to the award credits and recognise these proceeds as revenue only when they have fulfilled their obligations to provide goods or services. The Group is currently assessing the effect of this interpretation on the consolidated financial statements.

The HKICPA issued a revised HKAS 1 "Presentation of Financial Statements" in December 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard aims to improve users' ability to analyse and compare information given in financial statements. Adoption of the revised standard will have no effect on the results reported in the Group's financial statements, other than a change in presentation in certain respects.

A revised HKFRS 3 "Business Combinations" and an amended HKAS27 "Consolidated and Separate Financial Statements" were issued by the HKICPA in March 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes are that:

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;
- changes in a parent's ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- an option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interests) in the entity either at fair value, or at the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired.

The effect that the changes will have on the results and financial position of the Group will depend on the incident and timing of business combinations occurring on or after 1 January 2010.

The HKICPA issued an amendment to HKFRS 2 "Share-based Payment" in March 2008. The amendment, which is applicable for annual periods beginning on or after 1 January 2009, clarifies that vesting conditions comprise only service conditions and performance conditions. It also specifies the accounting treatment for a failure to meet a non-vesting condition. The Group does not expect adoption of the amendment to have a significant effect on the Group's consolidated financial statements.

The HKICPA issued amendments to HKAS32 "Financial Instruments: Presentation" and HKAS1 "Presentation of Financial Statements" – "Puttable Financial Instruments and Obligations Arising on Liquidation", in June 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. The Group is currently assessing the effect of the amendments on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 15 "Agreements for the Construction of Real Estate" ("HK(IFRIC) - Int 15") was issued by the HKICPA in August 2008 and is effective for annual periods beginning on or after 1 January 2009. HK(IFRIC) - Int 15 provides guidance on the recognition of revenue among real estate developers for sales of units. The Group does not expect adoption of HK(IFRIC) - Int 15 to have a significant effect on the Group's consolidated financial statements.

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2008 (continued)

Hong Kong (IFRIC) Interpretation 16 "Hedges of a Net Investment in a Foreign Operation" ("HK(IFRIC) - Int 16") was issued by the HKICPA in August 2008 and is effective for annual periods beginning on or after 1 October 2008. HK(IFRIC) - Int 16 provides guidance on accounting for the hedge of a net investment in a foreign operation in an entity's consolidated financial statements. The main change introduced by HK(IFRIC) - Int 16 is to eliminate the possibility of an entity applying hedge accounting for a hedge of foreign exchange differences between the functional currency of a foreign operation and the presentation currency of the parent's consolidated financial statements. The adoption of HK(IFRIC) - Int 16 will have no effect on the Group's consolidated financial statements.

The HKICPA issued "Improvements to HKFRSs" in October 2008, which comprises a collection of necessary, but not urgent amendments to HKFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2009, with earlier application permitted. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued amendments to HKFRS 1 "First-time Adoption of Hong Kong Financial Reporting Standards" and HKAS 27 "Consolidated and Separate Financial Statements"–"Cost of an Investment in a subsidiary, Jointly Controlled Entity or Associate" in October 2008. The amendment is primarily effective for annual periods beginning on or after 1 January 2009. The main amendments relevant to the Group are to remove the definition of the "cost method" from HKAS 27 and require an entity to present dividends as income in the separate financial statement of the investor. The amendment to HKAS 27 will have no effect on the consolidated financial statements.

The HKICPA issued an amendment to HKAS 39 "Financial Instruments: Recognition and Measurement"–"Eligible Hedged Items" in November 2008, which is applicable for annual periods beginning on or after 1 July 2009. The amendment clarifies how the existing principles underlying hedge accounting should be applied. The Group is currently assessing the effect of the amendment on the consolidated financial statements.

Hong Kong (IFRIC) Interpretation 17 "Distributions of Non-cash Assets to Owners" ("HK(IFRIC) - Int 17") was issued in December 2008 and is effective for annual periods beginning on or after 1 July 2009. HK(IFRIC) - Int 17 provides guidance on how distributions of assets other than cash as dividends to its shareholders should be accounted for. The Group does not expect adoption of HK(IFRIC) - Int 17 to have a significant effect on the Group's consolidated financial statements.

The HKICPA issued HKFRS 1 (Revised) "First-time Adoption of Hong Kong Financial Reporting Standards" in December 2008, which is applicable for annual periods beginning on or after 1 July 2009. The revised version has an improved structure but does not contain any technical changes. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

8. INTEREST INCOME/INTEREST EXPENSE

(a) Interest income

	2008	2007
Interest income arising from:		
– financial assets that are not at fair value through profit or loss	**25,599**	33,701
– trading assets	**363**	591
– financial assets designated at fair value	**210**	114
	26,172	34,406
of which:		
– interest income from listed investments	**3,204**	4,384
– interest income from unlisted investments	**5,701**	8,451
– interest income from impaired financial assets	**18**	32

8. INTEREST INCOME/INTEREST EXPENSE (continued)

(b) Interest expense

	2008	2007
Interest expense arising from:		
– financial liabilities that are not at fair value through profit or loss	8,322	17,297
– trading liabilities	1,574	2,344
– financial liabilities designated at fair value	44	46
	9,940	19,687
of which:		
– interest expense from debt securities in issue maturing after five years	11	50
– interest expense from customer accounts maturing after five years	1	29
– interest expense from subordinated liabilities	396	500

9. NET FEE INCOME

	2008	2007
– stockbroking and related services	1,359	1,985
– retail investment funds	1,084	1,676
– structured investment products	341	661
– insurance	98	115
– account services	282	284
– private banking	234	1,000
– remittances	212	193
– cards	1,304	1,048
– credit facilities	132	110
– trade services	409	406
– other	249	204
Fee income	5,704	7,682
Fee expense	(735)	(796)
	4,969	6,886
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	1,586	1,454
– fee income	2,124	1,843
– fee expense	(538)	(389)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	620	1,297
– fee income	773	1,449
– fee expense	(153)	(152)

10. TRADING INCOME

	2008	2007
Foreign exchange	1,384	861
Gains/(losses) from hedging activities:		
– fair value hedge		
– on hedging instruments	(515)	(197)
– on the hedged items attributable to the hedged risk	496	214
– cash flow hedges		
– net hedging income	1	–
Securities, derivatives and other trading activities	89	801
	1,455	1,679

11. NET (LOSS)/INCOME FROM FINANCIAL INSTRUMENTS DESIGNATED AT FAIR VALUE

	2008	2007
Net (loss)/income on assets designated at fair value which back insurance and investment contracts	(1,045)	1,903
Net change in fair value of other financial instruments designated at fair value	14	4
	(1,031)	1,907
of which dividend income from:		
– listed investments	35	47
– unlisted investments	1	5
	36	52

12. DIVIDEND INCOME

	2008	2007
Dividend income:		
– listed investments	66	47
– unlisted investments	16	5
	82	52

13. NET EARNED INSURANCE PREMIUMS

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2008				
Gross written premiums	411	12,023	46	12,480
Movement in unearned premiums	(8)	–	–	(8)
Gross earned premiums	403	12,023	46	12,472
Gross written premiums ceded to reinsurers	(80)	(46)	–	(126)
Reinsurers' share of movement in unearned premiums	5	–	–	5
Reinsurers' share of gross earned premiums	(75)	(46)	–	(121)
Net earned insurance premiums	328	11,977	46	12,351
2007				
Gross written premiums	400	9,375	54	9,829
Movement in unearned premiums	(14)	–	–	(14)
Gross earned premiums	386	9,375	54	9,815
Gross written premiums ceded to reinsurers	(76)	(35)	–	(111)
Reinsurers' share of movement in unearned premiums	(2)	–	–	(2)
Reinsurers' share of gross earned premiums	(78)	(35)	–	(113)
Net earned insurance premiums	308	9,340	54	9,702

14. OTHER OPERATING INCOME

	2008	2007
Rental income from investment properties	138	139
Movement in present value of in-force long-term insurance business	382	397
Other	181	211
	701	747

15. NET INSURANCE CLAIMS INCURRED AND MOVEMENT IN POLICYHOLDERS' LIABILITIES

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2008				
Claims, benefits and surrenders paid	130	646	30	806
Movement in provisions	16	10,745	(41)	10,720
Gross claims incurred and movement in policyholders' liabilities	146	11,391	(11)	11,526
Reinsurers' share of claims, benefits and surrenders paid	(32)	(14)	–	(46)
Reinsurers' share of movement in provisions	(9)	(8)	–	(17)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(41)	(22)	–	(63)
Net insurance claims incurred and movement in policyholders' liabilities	105	11,369	(11)	11,463
2007				
Claims, benefits and surrenders paid	97	566	43	706
Movement in provisions	(1)	9,945	46	9,990
Gross claims incurred and movement in policyholders' liabilities	96	10,511	89	10,696
Reinsurers' share of claims, benefits and surrenders paid	(12)	(10)	–	(22)
Reinsurers' share of movement in provisions	11	(8)	–	3
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(1)	(18)	–	(19)
Net insurance claims incurred and movement in policyholders' liabilities	95	10,493	89	10,677

16. LOAN IMPAIRMENT CHARGES AND OTHER CREDIT RISK PROVISIONS

	Group		Bank	
	2008	2007	**2008**	2007
Loan impairment charges (note 35(b)):				
– individually assessed	(925)	(250)	(808)	(255)
– collectively assessed	(476)	(326)	(378)	(332)
	(1,401)	(576)	(1,186)	(587)
of which:				
– new and additional	(1,505)	(702)	(1,272)	(686)
– releases	48	64	43	50
– recoveries	56	62	43	49
	(1,401)	(576)	(1,186)	(587)
Other credit risk provisions	(1,375)	–	(846)	–
	(2,776)	(576)	(2,032)	(587)

Impairment charge of HK$1,375 million and HK$846 million were provided for certain available-for-sale debt securities of the Group and the Bank respectively (2007: Nil) while there was no impairment loss made in relation to held-to-maturity investments in 2008 (2007: Nil).

17. OPERATING EXPENSES

	2008	2007
Employee compensation and benefits:		
– salaries and other costs	2,817	2,443
– performance-related pay*	462	1,095
– retirement benefit costs		
– defined benefit scheme (note 59(a))	104	(9)
– defined contribution scheme (note 59(b))	69	56
	3,452	3,585
General and administrative expenses:		
– rental expenses	409	364
– amortisation of prepaid operating lease payment (note 41)	14	15
– other premises and equipment	926	820
– marketing and advertising expenses	516	601
– other operating expenses	986	884
	2,851	2,684
Depreciation of business premises and equipment (note 40(a))	432	348
Amortisation of intangible assets (note 42(c))	60	33
	6,795	6,650
* of which:		
share based payments (note 60(e))	109	88
Cost efficiency ratio	29.2%	26.6%

Included in operating expenses are minimum lease payments under operating leases of HK$437 million (2007: HK$467 million).

18. THE EMOLUMENTS OF THE FIVE HIGHEST PAID INDIVIDUALS

(a) The aggregate emoluments

	2008	2007
Salaries, allowances and benefits in kind	22	21
Retirement scheme contributions	3	3
Discretionary bonuses	18	12
Share-based payments	8	3
	51	39

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

	2008 Number of Individuals	2007 Number of Individuals
HK$		
4,500,001 – 5,000,000	–	1
5,000,001 – 5,500,000	–	1
6,000,001 – 6,500,000	–	1
6,500,001 – 7,000,000	1	–
7,000,001 – 7,500,000	–	1
7,500,001 – 8,000,000	2	–
9,000,001 – 9,500,000	1	–
14,500,001 – 15,000,000	–	1
19,500,001 – 20,000,000	1	–
	5	5

The emoluments of the five highest paid individuals set out above include the emoluments of three (2007: three) Executive Directors. Their respective directors' emoluments are included in note 19.

19. DIRECTORS' EMOLUMENTS

The emoluments of the Directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance were:

	Fees '000	Salaries, allowances and benefits in kind '000	Pension and pension contribution[5] '000	Discreationary bonuses '000	Share-based payments[6] '000	Total 2008 '000	Total 2007 '000
Executive Directors							
Mr Raymond C F Or	–[1]	7,759	975	7,415	3,497	19,646	14,958
Mr Joseph C Y Poon	–[2]	3,818	405	3,746	1,116	9,085	7,259
Mr Patrick K W Chan	–[2]	3,554	299	1,876	1,258	6,987	4,784
Non-Executive Directors							
Mr Raymond K F Ch'ien[4] (Appointed on 6 Aug 07)	360	–	–	–	–	360	96
Mr M R P Smith (Resigned on 15 Jun 07)	–	–	–	–	–	–	115[3]
Mr Edgar David Ancona	280[3]	–	–	–	–	280	150
Mr Alexander A Flockhart (Appointed on 6 Aug 07)	280[3]	–	–	–	–	280	63
Mr John C C Chan[4]	340	–	–	–	–	340	210
Dr Y T Cheng[4]	280	–	–	–	–	280	150
Dr Marvin K T Cheung[4]	360	–	–	–	–	360	230
Mr Jenkin Hui[4]	320	–	–	–	–	320	190
Mr Peter T C Lee[4]	320	–	–	–	–	320	190
Dr Eric K C Li[4]	400	–	–	–	–	400	270
Dr Vincent H S Lo	280	–	–	–	–	280	150
Dr David W K Sin[4]	280	–	–	–	–	280	150
Mr Richard Y S Tang[4]	473	–	–	–	–	473	230
Mr Peter T S Wong	280[3]	–	–	–	–	280	150
Past Directors	–	–	2,169	–	–	2,169	2,135
	4,253	15,131	3,848	13,037	5,871	42,140	31,480
2007	2,794	13,672	3,809	9,406	1,799		

Notes :

(1) Fee receivable as a Director of Hang Seng Bank Limited was waived by the Director in 2008 while fees related to 2007 was surrendered to The Hongkong and Shanghai Banking Corporation in accordance with the HSBC Group's internal policy.

(2) Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2008.

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

(4) Independent Non-Executive Director.

(5) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.169 million in 2008. The Bank made contributions during 2008 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.

(6) These represent the estimated fair value of share option granted to certain directors under the HSBC Group share option plan and the purchase cost 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 4(y). The details of these benefits in kind are also set out in note 60.

20. AUDITORS' REMUNERATION

	Group		Bank	
	2008	2007	**2008**	2007
Statutory audit services	**13**	12	**8**	8
Non-statutory audit services and others	**7**	6	**5**	3
	20	18	**13**	11

21. GAINS LESS LOSSES FROM FINANCIAL INVESTMENTS AND FIXED ASSETS

	2008	2007
Net gains from disposal of available-for-sale equity securities:		
– realisation of amounts previously recognised in reserves at 1 January	**2,199**	246
– net (losses)/gains arising in the year	**(1,553)**	203
	646	449
Net losses from disposal of available-for-sale debt securities	**(83)**	–
Impairment of available-for-sale equity securities	**(284)**	–
Gains less losses on disposal of investment properties	**–**	208
Gains less losses on disposal of fixed assets	**(12)**	59
	267	716

There was no profit or loss on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost during the year.

22. NET SURPLUS ON PROPERTY REVALUATION

	2008	2007
Surplus of revaluation on investment properties (note 39(a))	**8**	250
Surplus of revaluation on assets held for sale	**–**	95
Reversal of revaluation deficit on premises (note 40(a))	**71**	34
	79	379

23. TAX EXPENSE

(a) Taxation in the consolidated income statement represents:

	2008	2007
Current tax-provision for Hong Kong profits tax		
Tax for the year	**2,167**	2,912
Adjustment in respect of prior year	**(350)**	(141)
	1,817	2,771
Current tax-taxation outside Hong Kong		
Tax for the year	**(21)**	29
Deferred tax (note 50(b))		
Origination and reversal of temporary differences	**31**	65
Effect of decrease in tax rate on deferred tax balances at 1 January	**(48)**	–
	(17)	65
Total tax expense	**1,779**	2,865

The current tax provision is based on the estimated assessable profit for 2008, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2007: 17.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

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

	2008	2007
Profit before tax	**15,878**	21,471
Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2007: 17.5%)	**2,620**	3,757
Tax effect of:		
– different tax rates in other countries/areas	**(122)**	(295)
– non-taxable income and non-deductible expenses	**(68)**	(260)
– share of results of associates	**(298)**	(196)
– reduction in tax rate on deferred tax opening balance	**(48)**	–
– others	**(305)**	(141)
Actual charge for taxation	**1,779**	2,865

24. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to shareholders, HK$10,830 million (2007: HK$15,122 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:

	2008	2007
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	**10,598**	15,113
Dividends declared during the year by subsidiaries from retained profits	**232**	9
The Bank's profit for the year (note 53)	**10,830**	15,122

25. EARNINGS PER SHARE

The calculation of earnings per share for 2008 is based on earnings of HK$14,099 million (HK$18,242 million in 2007) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2007).

26. DIVIDENDS PER SHARE

(a) Dividends attributable to the year:

	2008		2007	
	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	**3.00**	**5,736**	3.00	5,736
	6.30	**12,045**	6.30	12,045

The fourth interim dividend proposed after the balance sheet date has not been recognised as a liability at the balance sheet date.

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

	2008	2007
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK$3.00 per share (2007: HK$1.90 per share)	**5,736**	3,633

27. 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 rates 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.

27. SEGMENTAL ANALYSIS (continued)

(a) By customer group (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Inter-segment elimination	Total
2008							
Net interest income	8,700	2,411	988	2,682	1,451	–	16,232
Net fee income/(expense)	3,696	1,066	127	(33)	113	–	4,969
Trading income/(loss)	743	245	18	641	(192)	–	1,455
Net (loss)/income from financial instruments designated at fair value	(1,043)	(2)	–	(10)	24	–	(1,031)
Dividend income	25	10	–	–	47	–	82
Net earned insurance premiums	12,135	213	3	–	–	–	12,351
Other operating income	439	54	2	4	202	–	701
Inter-segment income	–	–	–	–	469	(469)	–
Total operating income	24,695	3,997	1,138	3,284	2,114	(469)	34,759
Net insurance claims incurred and movement in policyholders' liabilities	(11,349)	(113)	(1)	–	–	–	(11,463)
Net operating income before loan impairment charges and other credit risk provisions	13,346	3,884	1,137	3,284	2,114	(469)	23,296
Loan impairment charges and other credit risk provisions	(347)	(853)	(201)	(1,375)	–	–	(2,776)
Net operating income	12,999	3,031	936	1,909	2,114	(469)	20,520
Total operating expenses*	(4,490)	(1,470)	(314)	(235)	(286)	–	(6,795)
Inter-segment expenses	(389)	(60)	(8)	(12)	–	469	–
Operating profit	8,120	1,501	614	1.662	1,828	–	13,725
Gains less losses from financial investments and fixed assets	156	85	31	(84)	79	–	267
Net surplus on property revaluation	–	–	–	–	79	–	79
Share of profits from associates	134	884	–	701	88	–	1,807
Profit before tax	8,410	2,470	645	2,279	2,074	–	15,878
Share of profit before tax	52.9%	15.6%	4.1%	14.4%	13.0%	–	100.0%
Operating profit excluding inter-segment transactions	8,509	1,561	622	1,674	1,359	–	13,725
Operating profit excluding loan impairment charges and other credit risk provisions	8,467	2,354	815	3,037	1,828	–	16,501
** Depreciation/amortisation included in operating expenses*	(140)	(24)	(7)	(3)	(318)	–	(492)
Total assets	211,092	85,791	93,570	345,920	25,795	–	762,168
Total liabilities	508,596	96,905	41,981	34,575	28,485	–	710,542
Investments in associates	501	3,194	–	2,784	2,391	–	8,870
Capital expenditure incurred during the year	374	52	14	3	223	–	666

27. SEGMENTAL ANALYSIS (continued)

(a) By customer group (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Inter-segment elimination	Total
2007							
Net interest income	8,701	2,364	719	1,312	1,623	–	14,719
Net fee income/(expense)	5,726	1,005	109	(25)	71	–	6,886
Trading income/(loss)	1,086	173	9	468	(57)	–	1,679
Net income from financial instruments designated at fair value	1,901	2	–	4	–	–	1,907
Dividend income	14	1	–	–	37	–	52
Net earned insurance premiums	9,519	181	2	–	–	–	9,702
Other operating income/(expense)	543	47	–	(3)	160	–	747
Inter-segment income	–	–	–	–	373	(373)	–
Total operating income	27,490	3,773	839	1,756	2,207	(373)	35,692
Net insurance claims incurred and movement in policyholders' liabilities	(10,584)	(92)	(1)	–	–	–	(10,677)
Net operating income before loan impairment charges and and other credit risk provisions	16,906	3,681	838	1,756	2,207	(373)	25,015
Loan impairment charges and other credit risk provisions	(277)	(165)	(134)	–	–	–	(576)
Net operating income	16,629	3,516	704	1,756	2,207	(373)	24,439
Total operating expenses*	(4,442)	(1,437)	(234)	(214)	(323)	–	(6,650)
Inter-segment expenses	(325)	(34)	(6)	(8)	–	373	–
Operating profit	11,862	2,045	464	1,534	1,884	–	17,789
Gain on dilution of investment in associate	–	–	–	–	1,465	–	1,465
Gains less losses from financial investments and fixed assets	4	1	11	–	700	–	716
Net surplus on property revaluation	–	–	–	–	379	–	379
Share of profits from associates	52	655	–	295	120	–	1,122
Profit before tax	11,918	2,701	475	1,829	4,548	–	21,471
Share of profit before tax	55.5%	12.6%	2.2%	8.5%	21.2%	–	100.0%
Operating profit excluding inter-segment transactions	12,187	2,079	470	1,542	1,511	–	17,789
Operating profit excluding loan impairment charges and other credit risk provisions	12,139	2,210	598	1,534	1,884	–	18,365
** Depreciation/amortisation included in operating expenses*	(118)	(21)	(5)	(3)	(234)	–	(381)
Total assets	190,696	80,479	79,419	358,306	37,099	–	745,999
Total liabilities	459,756	100,857	53,373	42,486	33,071	–	689,543
Investments in associates	201	2,520	–	1,138	2,318	–	6,177
Capital expenditure incurred during the year	226	76	21	3	215	–	541

27. 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.

	2008	%	2007	%
Total operating income				
– Hong Kong	31,381	90	33,259	93
– Americas	2,378	7	1,782	5
– Mainland and other	1,000	3	651	2
	34,759	100	35,692	100
Profit before tax				
– Hong Kong	12,834	81	17,150	80
– Americas	1,771	11	1,748	8
– Mainland and other	1,273	8	2,573	12
	15,878	100	21,471	100
Capital expenditure incurred during the year				
– Hong Kong	545	82	432	80
– Americas	–	–	–	–
– Mainland and other	121	18	109	20
	666	100	541	100
Total assets				
– Hong Kong	656,411	86	630,989	85
– Americas	55,365	7	71,082	9
– Mainland and other	50,392	7	43,928	6
	762,168	100	745,999	100
Total liabilities				
– Hong Kong	680,296	96	663,333	96
– Americas	1,238	–	4,020	1
– Mainland and other	29,008	4	22,190	3
	710,542	100	689,543	100
Contingent liabilities and commitments				
– Hong Kong	196,778	94	200,462	93
– Americas	–	–	–	–
– Mainland and other	13,464	6	15,007	7
	210,242	100	215,469	100

28. 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, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

	Group								
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2008									
Assets									
Cash and balances with banks and other financial institutions	24,822	–	–	–	–	–	–	–	24,822
Placings with and advances to banks and other financial institutions	6,440	40,585	15,934	6,620	–	–	–	–	69,579
Trading assets	–	–	–	–	–	–	108,389	–	108,389
Financial assets designated at fair value	–	35	91	1,052	6,004	230	–	386	7,798
Derivative financial instruments	–	129	252	744	285	–	5,694	–	7,104
Advances to customers	19,056	14,830	22,376	47,777	121,586	103,496	–	–	329,121
Financial investments									
– available-for-sale investments	5	9,921	15,507	27,129	89,357	2,452	–	583	144,954
– held-to-maturity debt securities	–	–	211	912	12,155	22,927	–	–	36,205
Investments in associates	–	–	–	–	–	–	–	8,870	8,870
Investment properties	–	–	–	–	–	–	–	2,593	2,593
Premises, plant and equipment	–	–	–	–	–	–	–	7,090	7,090
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	–	551	551
Intangible assets	–	–	–	–	–	–	–	3,385	3,385
Other assets	4,224	1,781	1,636	3,570	51	8	–	236	11,506
Deferred tax assets	–	–	–	–	–	–	–	201	201
	54,547	67,281	56,007	87,804	229,438	129,113	114,083	23,895	762,168
Liabilities									
Current, savings and other deposit accounts	358,976	128,083	60,146	13,916	777	285	–	–	562,183
Deposits from banks	5,712	4,274	1,279	291	–	–	–	–	11,556
Trading liabilities	–	–	–	–	–	–	48,282	–	48,282
Financial liabilities designated at fair value	3	–	–	–	998	–	–	406	1,407
Derivative financial instruments	–	1	–	5	304	259	14,376	–	14,945
Certificates of deposit and other debt securities in issue									
– certificates of deposit in issue	–	295	–	1,082	1,395	–	–	–	2,772
– other debt securities in issue	–	–	–	–	–	–	–	–	–
Other liabilities	4,657	2,154	1,225	2,996	69	116	–	4,231	15,448
Liabilities to customers under insurance contracts	–	–	–	–	–	–	–	43,835	43,835
Current tax liabilities	–	1	–	93	–	–	–	–	94
Deferred tax liabilities	–	–	–	–	–	–	–	711	711
Subordinated liabilities	–	–	–	–	9,309	–	–	–	9,309
	369,348	134,808	62,650	18,383	12,852	660	62,658	49,183	710,542
of which:									
Certificates of deposit:									
– included in trading assets	–	–	–	–	–	–	–	–	–
– included in financial assets designated at fair value	–	–	8	15	140	–	–	–	163
– included in available-for-sale investments	–	400	1,661	3,964	3,804	664	–	35	10,528
– included in held-to-maturity debt securities	–	–	43	427	1,066	807	–	–	2,343
	–	400	1,712	4,406	5,010	1,471	–	35	13,034
Debt securities:									
– included in trading assets	–	–	–	–	–	–	108,371	–	108,371
– included in financial assets designated at fair value	–	35	83	1,037	5,864	230	–	24	7,273
– included in available-for-sale investments	5	9,521	13,846	23,165	85,553	1,788	–	114	133,992
– included in held-to-maturity debt securities	–	–	168	485	11,089	22,120	–	–	33,862
	5	9,556	14,097	24,687	102,506	24,138	108,371	138	283,498
Certificates of deposit in issue:									
– included in trading liabilities	–	–	–	–	–	–	3,861	–	3,861
– included in financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– included in issue at amortised cost	–	295	–	1,082	1,395	–	–	–	2,772
	–	295	–	1,082	1,395	–	3,861	–	6,633

28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY (continued)

	Group								
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2007									
Assets									
Cash and balances with banks and other financial institutions	16,864	–	–	–	–	–	–	–	16,864
Placings with and advances to banks and other financial institutions	30,427	62,943	18,374	1,285	–	–	–	–	113,029
Trading assets	–	–	–	–	–	–	10,390	–	10,390
Financial assets designated at fair value	–	–	305	146	2,481	4,963	–	5,997	13,892
Derivative financial instruments	5	115	210	392	210	3	3,767	–	4,702
Advances to customers	19,863	15,111	24,885	50,290	93,575	104,632	–	–	308,356
Financial investments									
– available-for-sale investments	300	19,371	22,392	54,766	120,786	3,445	–	4,237	225,297
– held-to-maturity debt securities	–	–	66	305	5,609	13,017	–	–	18,997
Investments in associates	–	–	–	–	–	–	–	6,177	6,177
Investment properties	–	–	–	–	–	–	–	2,581	2,581
Premises, plant and equipment	–	–	–	–	–	–	–	6,794	6,794
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	–	565	565
Intangible assets	–	–	–	–	–	–	–	2,889	2,889
Other assets	6,476	4,200	2,630	1,492	262	8	–	397	15,465
Deferred tax assets	–	–	–	–	–	–	–	1	1
	73,935	101,740	68,862	108,676	222,923	126,068	14,157	29,638	745,999
Liabilities									
Current, savings and other deposit accounts	312,427	177,361	42,612	13,055	913	285	–	–	546,653
Deposits from banks	1,791	12,994	2,640	2,311	–	–	–	–	19,736
Trading liabilities	–	–	–	–	–	–	48,151	–	48,151
Financial liabilities designated at fair value	41	–	–	–	997	–	–	460	1,498
Derivative financial instruments	–	7	11	25	47	58	4,535	–	4,683
Certificates of deposit and other debt securities in issue									
– certificates of deposit in issue	–	8	–	2,857	2,820	–	–	–	5,685
– other debt securities in issue	–	–	–	–	–	–	–	–	–
Other liabilities	8,433	4,996	1,718	1,352	124	12	–	1,215	17,850
Liabilities to customers under insurance contracts	–	–	–	–	–	–	–	33,089	33,089
Current tax liabilities	–	–	–	1,479	–	–	–	–	1,479
Deferred tax liabilities	–	–	–	–	–	–	–	1,365	1,365
Subordinated liabilities	–	–	–	–	9,354	–	–	–	9,354
	322,692	195,366	46,981	21,079	14,255	355	52,686	36,129	689,543
of which:									
Certificates of deposit:									
– included in trading assets	–	–	–	–	–	–	–	–	–
– included in financial assets designated at fair value	–	–	5	8	39	–	–	–	52
– included in available-for-sale investments	–	3,295	2,965	11,276	10,815	661	–	–	29,012
– included in held-to-maturity debt securities	–	–	9	120	989	117	–	–	1,235
	–	3,295	2,979	11,404	11,843	778	–	–	30,299
Debt securities:									
– included in trading assets	–	–	–	–	–	–	10,361	–	10,361
– included in financial assets designated at fair value	–	–	300	138	2,442	4,963	–	17	7,860
– included in available-for-sale investments	300	16,076	19,427	43,490	109,971	2,784	–	(62)	191,986
– included in held-to-maturity debt securities	–	–	57	185	4,620	12,900	–	–	17,762
	300	16,076	19,784	43,813	117,033	20,647	10,361	(45)	227,969
Certificates of deposit in issue:									
– included in trading liabilities	–	–	–	–	–	–	3,527	–	3,527
– included in financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– included in issue at amortised cost	–	8	–	2,857	2,820	–	–	–	5,685
	–	8	–	2,857	2,820	–	3,527	–	9,212

28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY (continued)

	Bank								
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2008									
Assets									
Cash and balances with banks and other financial institutions	22,071	–	–	–	–	–	–	–	22,071
Placings with and advances to banks and other financial institutions	1,197	22,579	8,840	5,481	–	–	–	–	38,097
Trading assets	–	–	–	–	–	–	107,775	–	107,775
Financial assets designated at fair value	–	–	–	639	166	–	–	25	830
Derivative financial instruments	–	80	215	647	268	–	5,700	–	6,910
Advances to customers	18,610	12,528	18,378	37,867	104,217	88,655	–	–	280,255
Amounts due from subsidiaries	55,961	2,585	22,461	2,269	1,631	–	–	–	84,907
Financial investments – available-for-sale investments	5	5,566	10,928	22,112	70,514	2,452	–	423	112,000
Investments in subsidiaries	–	–	–	–	–	–	–	11,284	11,284
Investments in associates	–	–	–	–	–	–	–	2,543	2,543
Investment properties	–	–	–	–	–	–	–	1,714	1,714
Premises, plant and equipment	–	–	–	–	–	–	–	4,294	4,294
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	–	551	551
Intangible assets	–	–	–	–	–	–	–	342	342
Other assets	4,057	948	992	2,841	4	–	–	30	8,872
Deferred tax assets	–	–	–	–	–	–	–	187	187
	101,901	44,286	61,814	71,856	176,800	91,107	113,475	21,393	682,632
Liabilities									
Current, savings and other deposit accounts	354,184	126,950	54,895	10,948	123	285	–	–	547,385
Deposits from banks	5,712	1,829	722	–	–	–	–	–	8,263
Trading liabilities	–	–	–	–	–	–	43,467	–	43,467
Financial liabilities designated at fair value	–	–	–	–	998	–	–	(4)	994
Derivative financial instruments	–	2	–	5	297	258	14,376	–	14,938
Certificates of deposit and other debt securities in issue									
– certificates of deposit in issue	–	295	–	1,082	1,395	–	–	–	2,772
Amounts due to subsidiaries	3,532	5,023	20	–	–	–	–	–	8,575
Other liabilities	4,485	1,823	922	2,533	–	17	–	5,030	14,810
Current tax liabilities	–	–	–	66	–	–	–	–	66
Deferred tax liabilities	–	–	–	–	–	–	–	–	–
Subordinated liabilities	–	–	–	–	9,309	–	–	–	9,309
	367,913	135,922	56,559	14,634	12,122	560	57,843	5,026	650,579
of which:									
Certificates of deposit:									
– included in trading assets	–	–	–	–	–	–	–	–	–
– included in financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– included in available-for-sale investments	–	400	1,661	3,413	1,790	664	–	35	7,963
– included in held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	400	1,661	3,413	1,790	664	–	35	7,963
Debt securities:									
– included in trading assets	–	–	–	–	–	–	107,757	–	107,757
– included in financial assets designated at fair value	–	–	–	639	166	–	–	25	830
– included in available-for-sale investments	5	5,166	9,267	18,699	68,724	1,788	–	114	103,763
– included in held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	5	5,166	9,267	19,338	68,890	1,788	107,757	139	212,350
Certificates of deposit in issue:									
– included in trading liabilities	–	–	–	–	–	–	3,861	–	3,861
– included in financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– included in issue at amortised cost	–	295	–	1,082	1,395	–	–	–	2,772
	–	295	–	1,082	1,395	–	3,861	–	6,633

28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY (continued)

	Bank								
	Repayable on demand	One month or less but not on demand	One month to three months	Three months to one year	One year to five years	Over five years	Trading	No contractual maturity	Total
2007									
Assets									
Cash and balances with banks and other financial institutions	13,362	–	–	–	–	–	–	–	13,362
Placings with and advances to banks and other financial institutions	24,567	45,418	16,096	56	–	–	–	–	86,137
Trading assets	–	–	–	–	–	–	8,904	–	8,904
Financial assets designated at fair value	–	–	272	100	850	–	–	16	1,238
Derivative financial instruments	5	98	188	340	149	3	3,628	–	4,411
Advances to customers	19,698	13,557	21,315	40,305	74,179	86,359	–	–	255,413
Amounts due from subsidiaries	66,520	3,981	27,523	3,583	1,199	–	–	–	102,806
Financial investments – available-for-sale investments	300	15,042	18,468	45,480	89,573	3,294	–	442	172.599
Investments in subsidiaries	–	–	–	–	–	–	–	11,284	11,284
Investments in associates	–	–	–	–	–	–	–	1,634	1,634
Investment properties	–	–	–	–	–	–	–	1,708	1,708
Premises, plant and equipment	–	–	–	–	–	–	–	4,127	4,127
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	–	565	565
Intangible assets	–	–	–	–	–	–	–	234	234
Other assets	6,277	3,556	2,005	1,236	–	–	–	188	13,262
Deferred tax assets	–	–	–	–	–	–	–	–	–
	130,729	81,652	85,867	91,100	165,950	89,656	12,532	20,198	677,684
Liabilities									
Current, savings and other deposit accounts	307,776	171,785	41,231	11,673	580	285	–	–	533,330
Deposits from banks	1,654	9,625	1,015	299	–	–	–	–	12,593
Trading liabilities	–	–	–	–	–	–	47,150	–	47,150
Financial liabilities designated at fair value	–	–	–	–	997	–	–	(8)	989
Derivative financial instruments	–	7	9	21	46	58	4,290	–	4,431
Certificates of deposit and other debt securities in issue									
– certificates of deposit in issue	–	11	1,516	2,856	2,820	–	–	–	7,203
Amounts due to subsidiaries	3,124	2,241	–	–	–	–	–	–	5,365
Other liabilities	8,346	4,779	1,468	1,203	60	12	–	1,953	17,821
Current tax liabilities	–	–	–	1,332	–	–	–	–	1,332
Deferred tax liabilities	–	–	–	–	–	–	–	649	649
Subordinated liabilities	–	–	–	–	9,354	–	–	–	9,354
	320,900	188,448	45,239	17,384	13,857	355	51,440	2,594	640,217
of which:									
Certificates of deposit:									
– included in trading assets	–	–	–	–	–	–	–	–	–
– included in financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– included in available-for-sale investments	–	1,028	2,449	8,703	7,301	661	–	–	20,142
– included in held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	1,028	2,449	8,703	7,301	661	–	–	20,142
Debt securities:									
– included in trading assets	–	–	–	–	–	–	8,875	–	8,875
– included in financial assets designated at fair value	–	–	272	100	850	–	–	16	1,238
– included in available-for-sale investments	300	14,014	16,019	36,777	82,272	2,633	–	(50)	151,965
– included in held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	300	14,014	16,291	36,877	83,122	2,633	8,875	(34)	162,078
Certificates of deposit in issue:									
– included in trading liabilities	–	–	–	–	–	–	3,527	–	3,527
– included in financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– included in issue at amortised cost	–	11	1,516	2,856	2,820	–	–	–	7,203
	–	11	1,516	2,856	2,820	–	3,527	–	10,730

29. ACCOUNTING CLASSIFICATIONS

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

	Group						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2008							
Cash and balances with banks and other financial institutions	–	–	–	–	–	24,822	24,822
Placings with and advances to banks and other financial institutions	–	–	–	–	69,579	–	69,579
Derivative financial instruments	5,663	31	1,410	–	–	–	7,104
Advances to customers	–	–	–	–	329,121	–	329,121
Investment securities	108,371	7,798	144,954	36,205	–	–	297,328
Acceptances and endorsements	–	–	–	–	–	3,090	3,090
Other financial assets	18	–	–	–	–	8,033	8,051
Total financial assets	114,052	7,829	146,364	36,205	398,700	35,945	739,095
Non-financial assets							23,073
Total assets							762,168
Current, savings and other deposit accounts	29,785	–	–	–	–	562,183	591,968
Deposits from banks	–	–	–	–	–	11,556	11,556
Derivative financial instruments	14,346	30	569	–	–	–	14,945
Certificates of deposit and other debt securities in issue	9,716	–	–	–	–	2,772	12,488
Other financial liabilities	8,781	–	–	–	–	4,583	13,364
Subordinated liabilities	–	994	–	–	–	9,309	10,303
Liabilities to customers under investment contracts	–	413	–	–	–	–	413
Acceptances and endorsements	–	–	–	–	–	3,090	3,090
Total financial liabilities	62,628	1,437	569	–	–	593,493	658,127
Non-financial liabilities							52,415
Total liabilities							710,542

29. ACCOUNTING CLASSIFICATIONS (continued)

	Group						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2007							
Cash and balances with banks and other financial institutions	–	–	–	–	–	16,864	16,864
Placings with and advances to banks and other financial institutions	–	–	–	–	113,029	–	113,029
Derivative financial instruments	3,750	17	935	–	–	–	4,702
Advances to customers	–	–	–	–	308,356	–	308,356
Investment securities	10,363	13,892	225,297	18,997	–	–	268,549
Acceptances and endorsements	–	–	–	–	–	3,294	3,294
Other financial assets	27	–	–	–	–	11,789	11,816
Total financial assets	14,140	13,909	226,232	18,997	421,385	31,947	726,610
Non-financial assets							19,389
Total assets							745,999
Current, savings and other deposit accounts	24,162	–	–	–	–	546,653	570,815
Deposits from banks	–	–	–	–	–	19,736	19,736
Derivative financial instruments	4,462	73	148	–	–	–	4,683
Certificates of deposit and other debt securities in issue	14,087	–	–	–	–	5,685	19,772
Other financial liabilities	9,902	–	–	–	–	8,407	18,309
Subordinated liabilities	–	989	–	–	–	9,354	10,343
Liabilities to customers under investment contracts	–	509	–	–	–	–	509
Acceptances and endorsements	–	–	–	–	–	3,294	3,294
Total financial liabilities	52,613	1,571	148	–	–	593,129	647,461
Non-financial liabilities							42,082
Total liabilities							689,543

29. ACCOUNTING CLASSIFICATIONS (continued)

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2008							
Cash and balances with banks and other financial institutions	–	–	–	–	–	22,071	22,071
Placings with and advances to banks and other financial institutions	–	–	–	–	38,097	–	38,097
Derivative financial instruments	5,669	31	1,210	–	–	–	6,910
Advances to customers	–	–	–	–	280,255	–	280,255
Investment securities	107,757	830	112,000	–	–	–	220,587
Amounts due from subsidiaries	–	–	–	–	–	84,907	84,907
Acceptances and endorsements	–	–	–	–	–	2,255	2,255
Other financial assets	18	–	–	–	–	6,372	6,390
Total financial assets	113,444	861	113,210	–	318,352	115,605	661,472
Non-financial assets							21,160
Total assets							682,632
Current, savings and other deposit accounts	24,970	–	–	–	–	547,385	572,355
Deposits from banks	–	–	–	–	–	8,263	8,263
Derivative financial instruments	14,346	30	562	–	–	–	14,938
Certificates of deposit and other debt securities in issue	9,716	–	–	–	–	2,772	12,488
Amounts due to subsidiaries	–	–	–	–	–	8,575	8,575
Other financial liabilities	8,781	–	–	–	–	4,575	13,356
Subordinated liabilities	–	994	–	–	–	9,309	10,303
Acceptances and endorsements	–	–	–	–	–	2,255	2,255
Total financial liabilities	57,813	1,024	562	–	–	583,134	642,533
Non-financial liabilities							8,046
Total liabilities							650,579

29. ACCOUNTING CLASSIFICATIONS (continued)

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2007							
Cash and balances with banks and other financial institutions	–	–	–	–	–	13,362	13,362
Placings with and advances to banks and other financial institutions	–	–	–	–	86,137	–	86,137
Derivative financial instruments	3,622	6	783	–	–	–	4,411
Advances to customers	–	–	–	–	255,413	–	255,413
Investment securities	8,877	1,238	172,599	–	–	–	182,714
Amounts due from subsidiaries	–	–	–	–	–	102,806	102,806
Acceptances and endorsements	–	–	–	–	–	2,930	2,930
Other financial assets	27	–	–	–	–	10,010	10,037
Total financial assets	12,526	1,244	173,382	–	341,550	129,108	657,810
Non-financial assets							19,874
Total assets							677,684
Current, savings and other deposit accounts	23,161	–	–	–	–	533,330	556,491
Deposits from banks	–	–	–	–	–	12,593	12,593
Derivative financial instruments	4,276	14	141	–	–	–	4,431
Certificates of deposit and other debt securities in issue	14,087	–	–	–	–	7,203	21,290
Amounts due to subsidiaries	–	–	–	–	–	5,365	5,365
Other financial liabilities	9,902	–	–	–	–	8,407	18,309
Subordinated liabilities	–	989	–	–	–	9,354	10,343
Acceptances and endorsements	–	–	–	–	–	2,930	2,930
Total financial liabilities	51,426	1,003	141	–	–	579,182	631,752
Non-financial liabilities							8,465
Total liabilities							640,217

30. CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Bank	
	2008	2007	**2008**	2007
Cash in hand	**3,696**	3,308	**3,488**	3,118
Balances with central banks	**2,426**	6,004	**896**	4,119
Balances with banks and other financial institutions	**18,700**	7,552	**17,687**	6,125
	24,822	16,864	**22,071**	13,362

31. PLACINGS WITH AND ADVANCES TO BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Bank	
	2008	2007	**2008**	2007
Placings with and advances to banks and other financial institutions maturing within one month	**47,025**	93,370	**23,776**	69,984
Placings with and advances to banks and other financial institutions maturing after one month but less than one year	**22,554**	19,659	**14,321**	16,153
Placings with and advances to banks and other financial institutions maturing after one year	**–**	–	**–**	–
	69,579	113,029	**38,097**	86,137

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2008 by the Group and the Bank. (2007: Nil).

32. TRADING ASSETS

	Group		Bank	
	2008	2007	**2008**	2007
Treasury bills	**103,621**	6,303	**103,463**	5,645
Certificates of deposit	**–**	–	**–**	–
Other debt securities	**4,750**	4,058	**4,294**	3,230
Debt securities	**108,371**	10,361	**107,757**	8,875
Equity shares	**–**	2	**–**	2
Total trading securities	**108,371**	10,363	**107,757**	8,877
Other*	**18**	27	**18**	27
Total trading assets	**108,389**	10,390	**107,775**	8,904
Debt securities:				
– listed in Hong Kong	**3,631**	2,564	**3,631**	2,564
– listed outside Hong Kong	**269**	796	**269**	315
	3,900	3,360	**3,900**	2,879
– unlisted	**104,471**	7,001	**103,857**	5,996
	108,371	10,361	**107,757**	8,875
Equity shares:				
– listed in Hong Kong	**–**	2	**–**	2
– unlisted	**–**	–	**–**	–
	–	2	**–**	2
Total trading securities	**108,371**	10,363	**107,757**	8,877
Debt securities				
Issued by public bodies:				
– central governments and central banks	**107,428**	9,061	**106,814**	7,922
– other public sector entities	**378**	387	**378**	387
	107,806	9,448	**107,192**	8,309
Issued by other bodies:				
– banks and other financial institutions	**306**	562	**306**	215
– corporate entities	**259**	351	**259**	351
	565	913	**565**	566
	108,371	10,361	**107,757**	8,875
Equity shares				
Issued by corporate entities	**–**	2	**–**	2
Total trading securities	**108,371**	10,363	**107,757**	8,877

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

33. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Bank	
	2008	2007	**2008**	2007
Certificates of deposit	**163**	52	**–**	–
Other debt securities	**7,273**	7,860	**830**	1,238
Debt securities	**7,436**	7,912	**830**	1,238
Equity shares	**362**	5,980	**–**	–
	7,798	13,892	**830**	1,238
Debt securities:				
– listed in Hong Kong	**834**	1,113	**449**	700
– listed outside Hong Kong	**1,004**	1,377	**276**	291
	1,838	2,490	**725**	991
– unlisted	**5,598**	5,422	**105**	247
	7,436	7,912	**830**	1,238
Equity shares:				
– listed in Hong Kong	**26**	1,976	**–**	–
– listed outside Hong Kong	**57**	1,600	**–**	–
	83	3,576	**–**	–
– unlisted	**279**	2,404	**–**	–
	362	5,980	**–**	–
	7,798	13,892	**830**	1,238
Debt securities				
Issued by public bodies:				
– central governments and central banks	**924**	2,004	**517**	763
– other public sector entities	**564**	395	**226**	250
	1,488	2,399	**743**	1,013
Issued by other bodies:				
– banks and other financial institutions	**5,317**	4,682	**65**	182
– corporate entities	**631**	831	**22**	43
	5,948	5,513	**87**	225
	7,436	7,912	**830**	1,238
Equity shares				
Issued by corporate entities	**362**	5,980	**–**	–
	7,798	13,892	**830**	1,238

34. DERIVATIVE FINANCIAL INSTRUMENTS

Derivatives are financial contracts whose values and characteristics are derived from underlying assets, exchange and interest rates, and indices. Derivative instruments are subject to both credit risk and market risk. The credit risk relating to a derivative contract is principally the replacement cost of the contract when it has a positive mark-to-market value and the estimated potential future change in value over the residual maturity of the contract. The nominal value of the contracts does not represent the amount of the Group's exposure to credit risk. All activities relating to derivatives are subject to the same credit approval and monitoring procedures used for other credit transactions. Market risk from derivative positions is controlled individually and in combination with on-balance sheet market risk positions within the Group's market risk limits regime as described in note 62(c).

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading or designated as either fair value hedge or cash flow hedges.

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.

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.

(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.

(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.

There was no ineffectiveness recognised in the Group's income statement arising from cash flow hedges during the years 2008 and 2007.

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(b) Cash flow hedges (continued)

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 2008			
Cash inflows from assets	73,395	52,855	12,844
Cash outflows from liabilities	–	–	–
Net cash inflows	73,395	52,855	12,844
At 31 December 2007			
Cash inflows from assets	50,981	37,578	12,922
Cash outflows from liabilities	–	–	–
Net cash inflows	50,981	37,578	12,922

During the years 2008 and 2007, there was no forecast transaction for which hedge accounting had previously been used but which were no longer expected to occur.

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(c) The following table shows the nominal contract amounts and marked-to-market value of assets and liabilities by each class of derivatives.

	Group					
	2008			2007		
	Contract amounts	**Derivative assets**	**Derivative liabilities**	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Foreign exchange contracts:						
– spot and forward foreign exchange	570,950	2,676	5,144	636,076	2,074	1,716
– currency swaps	18,356	337	229	3,136	44	41
– currency options purchased	32,729	287	–	22,930	143	–
– currency options written	33,601	–	340	62,329	–	315
– other exchange rate contracts	141	–	4	30	–	–
	655,777	3,300	5,717	724,501	2,261	2,072
Interest rate contracts:						
– interest rate swaps	161,018	2,120	2,249	127,263	697	763
– interest rate options purchased	142	–	–	312	–	–
– interest rate options written	142	–	–	79	–	–
– other interest rate contracts	217	1	–	–	–	–
	161,519	2,121	2,249	127,654	697	763
Equity and other contracts:						
– equity swaps	13,025	1	6,271	12,371	14	1,139
– equity options purchased	2,680	113	–	14,338	527	–
– equity options written	2,770	–	100	14,374	–	487
– other equity contracts	8	–	–	2	–	–
– spot and forward contracts	2,685	128	9	1,361	251	1
	21,168	242	6,380	42,446	792	1,627
Total derivatives held for trading	838,464	5,663	14,346	894,601	3,750	4,462
Derivatives designated at fair value						
Interest rate contracts:						
– interest rate swaps	1,797	31	30	2,207	6	14
Equity contracts:						
– other equity contracts	–	–	–	2,898	11	59
	1,797	31	30	5,105	17	73
Cash Flow hedges derivatives						
Interest rate contracts:						
– interest rate swaps	73,394	1,410	14	51,258	888	28
Fair value hedge derivatives						
Interest rate contracts:						
– interest rate swaps	12,548	–	555	8,974	47	120
Total derivatives	926,203	7,104	14,945	959,938	4,702	4,683

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

	Bank					
	2008			2007		
	Contract amounts	**Derivative assets**	**Derivative liabilities**	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Foreign exchange contracts:						
– spot and forward foreign exchange	567,613	2,621	5,145	627,410	1,948	1,534
– currency swaps	18,356	337	229	3,136	44	41
– currency options purchased	32,735	287	–	22,977	143	–
– currency options written	33,601	–	356	62,330	–	314
– other exchange rate contracts	141	–	4	30	–	–
	652,446	3,245	5,734	715,883	2,135	1,889
Interest rate contracts:						
– interest rate swaps	160,254	2,119	2,232	126,839	696	760
– interest rate options purchased	142	–	–	312	–	–
– interest rate options written	142	–	–	79	–	–
– other interest rate contracts	217	1	–	–	–	–
	160,755	2,120	2,232	127,230	696	760
Equity and other contracts:						
– equity swaps	14,097	62	6,271	12,847	14	1,139
– equity options purchased	2,680	114	–	14,338	526	–
– equity options written	2,770	–	100	14,376	–	487
– other equity contracts	8	–	–	2	–	–
– spot and forward contracts	2,685	128	9	1,361	251	1
	22,240	304	6,380	42,924	791	1,627
Total derivatives held for trading	835,441	5,669	14,346	886,037	3,622	4,276
Derivatives designated at fair value						
Interest rate contracts:						
– interest rate swaps	1,797	31	30	2,207	6	14
Cash Flow hedges derivatives						
Interest rate contracts:						
– interest rate swaps	68,165	1,210	14	45,763	756	26
Fair value hedge derivatives						
Interest rate contracts:						
– interest rate swaps	12,428	–	548	7,104	27	115
Total derivatives	917,831	6,910	14,938	941,111	4,411	4,431

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.

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(d) Contract amounts, credit equivalent amounts and risk-weighted amounts

The table below gives the contract amounts, credit equivalent amounts and risk-weighted amounts of derivatives. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

Derivatives arise from futures, forward, swap and option transactions undertaken by the Group in the foreign exchange, interest rate, equity, credit and commodity markets. The contract amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date, they do not represent amounts at risk.

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Capital Rules and depend on the status of the counterparty and maturity characteristics of the instrument.

The netting adjustments represent amounts where the Group has in place legally enforceable rights of offset with individual counterparties to offset the gross amount of positive marked-to-market assets with any negative marked-to-market liabilities with the same customer. These offsets are recognised by the HKMA in the calculation of risk assets for the capital adequacy ratio.

With effect from 1 January 2008, the Group uses the foundation internal ratings-based ("IRB") approach approved by the Hong Kong Monetary Authority for calculating the credit risks for the majority of its non-securitisation exposures, with the remainder of its credit risks assessed using the standardised (credit risk) approach. In 2007, the Group used the standardised (credit risk) approach. The figures are therefore not strictly comparable.

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2008						
Exchange rate contracts:						
– spot and forward foreign exchange	500,166	7,364	1,872	497,408	7,277	1,823
– currency swaps	18,356	1,185	324	18,356	1,185	324
– currency option purchased	32,729	649	454	32,729	649	454
– other exchange rate contracts	141	2	–	141	2	–
	551,392	9,200	2,650	548,634	9,113	2,601
Interest rate contracts:						
– interest rate swaps	248,758	4,144	1,117	242,583	3,940	1,083
– interest rate options purchased	142	1	–	152	1	–
– other interest rate contracts	–	–	–	–	–	–
	248,900	4,145	1,117	242,735	3,941	1,083
Equity contracts:						
– equity swaps	13,025	867	149	13,025	867	149
– equity options purchased	2,680	274	194	2,680	274	194
– other equity contracts	–	–	–	–	–	–
	15,705	1,141	343	15,705	1,141	343

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(d) Contract amounts, credit equivalent amounts and risk-weighted amounts (continued)

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2007						
Exchange rate contracts:						
– spot and forward foreign exchange	580,889	7,606	2,196	576,133	7,467	2,114
– currency swaps	3,136	170	49	3,136	170	49
– currency option purchased	22,821	633	140	22,821	633	140
– other exchange rate contracts	–	–	–	–	–	–
	606,846	8,409	2,385	602,090	8,270	2,303
Interest rate contracts:						
– interest rate swaps	189,703	2,121	520	181,913	1,945	475
– interest rate options purchased	312	–	–	312	–	–
– other interest rate contracts	–	–	–	–	–	–
	190,015	2,121	520	182,225	1,945	475
Equity contracts:						
– equity swaps	12,362	905	183	12,838	944	202
– equity options purchased	14,347	1,389	1,080	14,347	1,389	1,080
– other equity contracts	–	–	–	–	–	–
	26,709	2,294	1,263	27,185	2,333	1,282

35. ADVANCES TO CUSTOMERS

(a) Advances to customers

	Group		**Bank**	
	2008	2007	**2008**	2007
Gross advances to customers	**331,164**	309,409	**281,996**	256,370
Less: loan impairment allowances				
– individually assessed	**(1,241)**	(417)	**(1,046)**	(330)
– collectively assessed	**(802)**	(636)	**(695)**	(627)
	329,121	308,356	**280,255**	255,413
Included in advances to customers are:				
– trade bills	**2,899**	3,690	**2,806**	3,590
– loan impairment allowances	**(30)**	(14)	**(30)**	(13)
	2,869	3,676	**2,776**	3,577

35. ADVANCES TO CUSTOMERS (continued)

(a) Advances to customers (continued)

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

	Group		Bank	
	2008	2007	**2008**	2007
	%	%	**%**	%
Loan impairment allowances:				
– individually assessed	**0.37**	0.13	**0.37**	0.13
– collectively assessed	**0.24**	0.21	**0.25**	0.24
Total loan impairment allowances	**0.61**	0.34	**0.62**	0.37

(b) Loan impairment allowances against advances to customers

	Group		
	Individually assessed	**Collectively assessed**	**Total**
2008			
At 1 January	**417**	**636**	**1,053**
Amounts written off	**(110)**	**(346)**	**(456)**
Recoveries of advances written off in previous years	**20**	**36**	**56**
New impairment allowances charged to income statement (note 16)	**993**	**512**	**1,505**
Impairment allowances released to income statement (note 16)	**(68)**	**(36)**	**(104)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(11)**	**–**	**(11)**
At 31 December	**1,241**	**802**	**2,043**
2007			
At 1 January	406	518	924
Amounts written off	(242)	(249)	(491)
Recoveries of advances written off in previous years	21	41	62
New impairment allowances charged to income statement (note 16)	335	367	702
Impairment allowances released to income statement (note 16)	(85)	(41)	(126)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(18)	–	(18)
At 31 December	417	636	1,053

35. ADVANCES TO CUSTOMERS (continued)

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

	Bank		
	Individually assessed	Collectively assessed	Total
2008			
At 1 January	330	627	957
Amounts written off	(91)	(346)	(437)
Recoveries of advances written off in previous years	7	36	43
New impairment allowances charged to income statement (note 16)	858	414	1,272
Impairment allowances released to income statement (note 16)	(50)	(36)	(86)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(8)	–	(8)
At 31 December	1,046	695	1,741
2007			
At 1 January	332	504	836
Amounts written off	(219)	(249)	(468)
Recoveries of advances written off in previous years	9	40	49
New impairment allowances charged to income statement (note 16)	314	372	686
Impairment allowances released to income statement (note 16)	(59)	(40)	(99)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(8)	–	(8)
Transfer to subsidiaries	(39)	–	(39)
At 31 December	330	627	957

(c) Impaired advances and allowances

	Group		Bank	
	2008	2007	**2008**	2007
Gross impaired advances	3,404	1,261	2,032	766
Individually assessed allowances	(1,241)	(417)	(1,046)	(330)
Net impaired advances	2,163	844	986	436
Individually assessed allowances as a percentage of gross impaired advances	36.5%	33.1%	51.5%	43.1%
Gross impaired advances as a percentage of gross advances to customers	1.0%	0.4%	0.7%	0.3%

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

35. ADVANCES TO CUSTOMERS (continued)

(c) Impaired advances and allowances (continued)

	Group		Bank	
	2008	2007	**2008**	2007
Gross individually assessed impaired advances	**3,297**	1,183	**1,925**	688
Individually assessed allowances	**(1,241)**	(417)	**(1,046)**	(330)
	2,056	766	**879**	358
Gross individually assessed impaired advances as a percentage of gross advances to customers	**1.0%**	0.4%	**0.7%**	0.3%
Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**1,502**	754	**1,102**	495

Collateral includes any tangible security that carries a fair market value and is readily marketable. This includes (but is not limited to) cash and deposits, stocks and bonds, mortgages over properties and charges over other fixed assets such as plant and equipment. Where collateral values are greater than gross advances, only the amount of collateral up to the gross advance was included.

35. ADVANCES TO CUSTOMERS (continued)

(d) Overdue advances

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

	Group		Bank	
		%		%
2008				
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– more than three months but not more than six months	340	0.1	183	0.1
– more than six months but not more than one year	419	0.1	380	0.1
– more than one year	311	0.1	95	–
	1,070	0.3	658	0.2
of which:				
– individually impaired allowances	(554)		(501)	
– covered portion of overdue loans and advances	574		373	
– uncovered portion of overdue loans and advances	496		285	
– current market value held against the covered portion of overdue loans and advances	697		549	
2007				
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– more than three months but not more than six months	329	0.1	165	0.1
– more than six months but not more than one year	312	0.1	61	–
– more than one year	112	–	102	–
	753	0.2	328	0.1
of which:				
– individually impaired allowances	(278)		(215)	
– covered portion of overdue loans and advances	401		204	
– uncovered portion of overdue loans and advances	352		124	
– current market value held against the covered portion of overdue loans and advances	796		421	

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

35. ADVANCES TO CUSTOMERS (continued)

(e) Rescheduled advances

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

	Group		Bank	
		%		%
2008	281	0.1	169	0.1
2007	352	0.1	208	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.

Rescheduled advances to customers are stated net of any advances which have subsequently become overdue for more than three months and which are included in "Overdue advances" (note 35(d)).

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

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area that is different from that of the counterparty. At 31 December 2008, about 90 per cent (over 90 per cent at 31 December 2007) of the Group's advances to customers, including related impaired advances and overdue advances, were classified under Hong Kong. There was no geographical segment other than Hong Kong to which the Bank's advances to customers is not less than 10 per cent of the total loans and advances.

35. ADVANCES TO CUSTOMERS (continued)

(g) Gross advances to customers by industry sector

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

	Group			
	2008		2007	
		% of gross advances covered by collateral		% of gross advances covered by collateral
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	25,314	32.7	20,431	32.8
– property investment	66,179	87.4	54,676	84.3
– financial concerns	3,146	60.7	3,232	20.0
– stockbrokers	526	39.2	524	81.9
– wholesale and retail trade	6,183	54.3	6,034	46.5
– manufacturing	12,828	27.0	8,311	29.7
– transport and transport equipment	8,400	78.3	9,368	69.9
– recreational activities	26	64.6	218	1.4
– information technology	1,075	4.6	913	2.3
– other	21,553	41.7	21,396	51.0
	145,230	62.4	125,103	61.3
Individuals				
– advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	16,739	99.9	18,437	99.8
– advances for the purchase of other residential properties	89,669	99.4	85,923	99.6
– credit card advances	12,841	–	11,354	–
– other	11,892	33.0	13,155	30.6
	131,141	83.7	128,869	83.8
Total gross advances for use in Hong Kong	276,371	72.5	253,972	72.7
Trade finance	19,039	41.5	22,995	32.7
Gross advances for use outside Hong Kong	35,754	59.4	32,442	50.8
Gross advances to customers	331,164	69.3	309,409	67.4

35. ADVANCES TO CUSTOMERS (continued)

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

	Bank			
	2008		2007	
		% of gross advances covered by collateral		% of gross advances covered by collateral
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	25,004	31.9	20,153	31.9
– property investment	64,869	88.0	53,170	84.9
– financial concerns	3,146	60.7	3,232	20.0
– stockbrokers	526	39.2	524	81.9
– wholesale and retail trade	6,181	54.3	6,031	46.5
– manufacturing	12,826	27.0	8,298	29.6
– transport and transport equipment	5,620	67.5	6,168	55.8
– recreational activities	26	64.6	218	1.4
– information technology	1,075	4.6	913	2.3
– other	21,524	41.6	21,220	51.3
	140,797	61.6	119,927	60.3
Individuals				
– advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	3,318	99.5	2,457	99.3
– advances for the purchase of other residential properties	84,971	99.4	79,835	99.6
– credit card advances	12,841	–	11,354	–
– other	11,880	32.9	13,134	30.6
	113,010	81.1	106,780	80.5
Total gross advances for use in Hong Kong	253,807	70.3	226,707	69.8
Trade finance	19,039	41.5	22,995	32.7
Gross advances for use outside Hong Kong	9,150	26.9	6,668	21.7
Gross advances to customers	281,996	67.0	256,370	65.2

35. ADVANCES TO CUSTOMERS (continued)

(h) Net investments in finance leases

Advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring 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	
	2008	2007	**2008**	2007
Finance leases	**51**	69	**51**	59
Hire purchase contracts	**7,329**	7,422	**4,515**	4,024
	7,380	7,491	**4,566**	4,083

	Group		
	Present value of minimum lease payments receivable	**Interest income relating to future periods**	**Total minimum lease payments receivable**
2008			
Amounts receivable:			
– within one year	**598**	**148**	**746**
– after one year but within five years	**1,981**	**485**	**2,466**
– after five years	**4,825**	**865**	**5,690**
	7,404	**1,498**	**8,902**
Loans impairment allowances	**(24)**		
Net investments in finance leases and hire purchase contracts	**7,380**		
2007			
Amounts receivable:			
– within one year	701	293	994
– after one year but within five years	1,716	940	2,656
– after five years	5,098	1,967	7,065
	7,515	3,200	10,715
Loans impairment allowances	(24)		
Net investments in finance leases and hire purchase contracts	7,491		

35. ADVANCES TO CUSTOMERS (continued)

(h) Net investments in finance leases (continued)

	Bank		
	Present value of minimum lease payments receivable	**Interest income relating to future periods**	**Total minimum lease payments receivable**
2008			
Amounts receivable:			
– within one year	395	88	483
– after one year but within five years	1,315	288	1,603
– after five years	2,875	580	3,455
	4,585	956	5,541
Loans impairment allowances	(19)		
Net investments in finance leases and hire purchase contracts	4,566		
2007			
Amounts receivable:			
– within one year	400	154	554
– after one year but within five years	968	485	1,453
– after five years	2,718	1,227	3,945
	4,086	1,866	5,952
Loans impairment allowances	(3)		
Net investments in finance leases and hire purchase contracts	4,083		

36. FINANCIAL INVESTMENTS

	Group		Bank	
	2008	2007	**2008**	2007
Financial investments:				
– which may be repledged or resold by counterparties	**1,260**	–	**219**	–
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**179,899**	244,294	**111,781**	172,599
	181,159	244,294	**112,000**	172,599
Held-to-maturity debt securities at amortised cost	**36,205**	18,997	**–**	–
Available-for-sale at fair value:				
– debt securities	**144,520**	220,998	**111,726**	172,107
– equity shares	**434**	4,299	**274**	492
	181,159	244,294	**112,000**	172,599
Treasury bills	**9,927**	3,089	**4,304**	3,089
Certificates of deposit	**12,871**	30,247	**7,963**	20,142
Other debt securities	**157,927**	206,659	**99,459**	148,876
Debt securities	**180,725**	239,995	**111,726**	172,107
Equity shares	**434**	4,299	**274**	492
	181,159	244,294	**112,000**	172,599

(a) Held-to-maturity debt securities

	Group		Bank	
	2008	2007	**2008**	2007
Listed in Hong Kong	**1,227**	35	**–**	–
Listed outside Hong Kong	**3,301**	656	**–**	–
	4,528	691	**–**	–
Unlisted	**31,677**	18,306	**–**	–
	36,205	18,997	**–**	–
Issued by public bodies:				
– central goverments and central banks	**240**	246	**–**	–
– other public sector entities	**2,343**	727	**–**	–
	2,583	973	**–**	–
Issued by other bodies:				
– banks and other financial institutions	**29,604**	17,463	**–**	–
– corporate entities	**4,018**	561	**–**	–
	33,622	18,024	**–**	–
	36,205	18,997	**–**	–
Fair value of held-to-maturity debt securities:				
– listed	**4,849**	719	**–**	–
– unlisted	**34,466**	18,807	**–**	–
	39,315	19,526	**–**	–

There were no held-to-maturity debt securities determined to be impaired at 31 December 2008 for the Group and the Bank (2007: Nil).

36. FINANCIAL INVESTMENTS (continued)

(b) Available-for-sale debt securities

	Group		Bank	
	2008	2007	**2008**	2007
Listed in Hong Kong	**4,377**	5,199	**4,369**	5,199
Listed outside Hong Kong	**63,717**	71,341	**50,273**	49,523
	68,094	76,540	**54,642**	54,722
Unlisted	**76,426**	144,458	**57,084**	117,385
	144,520	220,998	**111,726**	172,107
Issued by public bodies:				
– central goverments and central banks	**16,403**	8,280	**10,238**	7,745
– other public sector entities	**2,010**	4,961	**2,010**	4,686
	18,413	13,241	**12,248**	12,431
Issued by other bodies:				
– banks and other financial institutions	**114,563**	194,105	**91,096**	149,860
– corporate entities	**11,544**	13,652	**8,382**	9,816
	126,107	207,757	**99,478**	159,676
	144,520	220,998	**111,726**	172,107

As at 31 December 2008, certain of the Group's and the Bank's available-for-sale debt securities were individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in Note 4(v)(ii).

(c) Available-for-sale equity shares

	Group		Bank	
	2008	2007	**2008**	2007
Listed in Hong Kong	**37**	3,449	**3**	10
Listed outside Hong Kong	**68**	188	**68**	161
	105	3,637	**71**	171
Unlisted	**329**	662	**203**	321
	434	4,299	**274**	492
Issued by corporate entities	**434**	4,299	**274**	492

During the year of 2008, certain of the Group's and the Bank's available-for-sale equity securities were individually determined to be impaired. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in note 4(v)(ii).

37. INVESTMENTS IN SUBSIDIARIES

	Bank	
	2008	2007
Unlisted shares, at cost	11,284	11,284

(a) The principal subsidiaries of the Bank are:

Name of company	Place of incorporation	Principal activities	Issued equity capital
Hang Seng Bank (China) Limited	People's Republic of China	Banking	RMB4,500,000,000
Hang Seng Finance Limited	Hong Kong SAR	Lending	HK$1,000,000,000
Hang Seng Credit Limited	Hong Kong SAR	Lending	HK$200,000,000
Hang Seng Bank (Bahamas) Limited	Bahamas	Banking	US$1,000,000
Hang Seng Finance (Bahamas) Limited	Bahamas	Finance	US$5,000
Hang Seng Bank (Trustee) Limited	Hong Kong SAR	Trustee service	HK$3,000,000
Hang Seng (Nominee) Limited	Hong Kong SAR	Nominee service	HK$100,000
Hang Seng Life Limited	Hong Kong SAR	Retirement benefits and life assurance	HK$970,000,000
Hang Seng Insurance Company Limited	Hong Kong SAR	Retirement benefits and life assurance	HK$4,326,184,570
Hang Seng General Insurance (Hong Kong) Company Limited	Hong Kong SAR	General insurance	HK$620,000,000
Hang Seng Asset Management Pte Ltd	Singapore	Fund management	SG$2,000,000
Hang Seng Investment Management Limited	Hong Kong SAR	Fund management	HK$10,000,000
Haseba Investment Company Limited	Hong Kong SAR	Investment holding	HK$6,000
Hang Seng Securities Limited	Hong Kong SAR	Stockbroking	HK$26,000,000
Yan Nin Development Company Limited	Hong Kong SAR	Investment holding	HK$100,000
Hang Seng Indexes Company Limited	Hong Kong SAR	Compilation and dissemination of the Hang Seng share index	HK$10,000
Hang Seng Real Estate Management Limited	Hong Kong SAR	Property management	HK$10,000

All the above companies are wholly-owned subsidiaries and unlisted. All subsidiaries are held directly by the Bank except for Hang Seng Life Limited and Hang Seng Indexes Company Limited. The principal places of operation are the same as the places of incorporation.

Some principal subsidiaries are regulated banking and insurance entities and as such, are required to maintain certain minimum levels of capital and liquid assets to support their operations. The effect of these regulatory requirements is to limit the extent to which the subsidiaries may transfer funds to the Bank in the form of repayment of certain shareholder loans or cash dividends.

37. INVESTMENTS IN SUBSIDIARIES (continued)

(b) Acquisition

On 25 September 2007, the wholly-owned subsidiary, Hang Seng Insurance Company Limited ("HSIC"), acquired 50 per cent of the issued share capital of Hang Seng Life Limited ("HSLL") from HSBC Insurance (Asia-Pacific) Holdings Limited, an indirect wholly-owned subsidiary of HSBC Holdings plc, for a consideration of HK$2,400 million. HSIC also acquired the remaining 50 per cent of the issued share capital of HSLL from the Bank for a consideration of HK$2,400 million. After the transactions, the Group has increased its stake in its existing subsidiary HSLL's issued share capital from 50 per cent to 100 per cent. The amount of goodwill arising from acquisition at Group level was HK$329 million.

(c) Incorporation

Hang Seng Bank (China) Limited, a wholly-owned subsidiary of the Bank, was incorporated in mainland China in May 2007. It is registered as "Limited liability company (solely funded by Taiwan, Hong Kong or Macao corporate body)" under the PRC law.

38. INVESTMENTS IN ASSOCIATES

	Group		Bank	
	2008	2007	**2008**	2007
Unlisted investments, at cost	**–**	–	**909**	–
Listed investments, at cost	**–**	–	**1,634**	1,634
Share of net assets	**8,314**	5,894	**–**	–
Goodwill	**399**	283	**–**	–
Intangible asset	**157**	–	**–**	–
	8,870	6,177	**2,543**	1,634

The associates are:

Name of company	Place of incorporation and operation	Principal activity	Group's interest in equity capital	Issued equity capital
Unlisted				
Barrowgate Limited	Hong Kong SAR	Property investment	24.64%	HK$10,000
Yantai City Commercial Bank	People's Republic of China	Banking	20.00%	RMB2,000,000,000
Listed				
Industrial Bank Co., Ltd.	People's Republic of China	Banking	12.78%	RMB5,000,000,000

Investment in associates included listed investment of HK$7,078 million (2007: HK$5,325 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$10,599 million (2007: HK$35,386 million).

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. The investments are recognised at cost and dividends accounted for as declared.

The Group acquired 20 per cent of Yantai City Commercial Bank on 31 December 2008 for a consideration of HK$909 million. This investment will be equity accounted with effect from January 2009, reflecting the Group's significant influence over this associate.

38. INVESTMENTS IN ASSOCIATES (continued)

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. and Yantai City Commercial Bank are owned directly by the Bank.

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.

For the year ended 31 December 2008, the financial results of Industrial Bank Co., Ltd. was included in the financial statements based on financial statements drawn up to 30 September 2008, but taking into account any changes in the subsequent period from 1 October 2008 to 31 December 2008 that would materially affect the results. The Group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 "Investments in Associates" whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

On 5 February 2007, Industrial Bank Co., Ltd. issued 1,001 million new shares in an Initial Public Offer for a total consideration of RMB15,996 million. The Bank did not subscribe for any additional shares and, thus, its interest in the equity of IB decreased from 15.98 per cent to 12.78 per cent. The dilution in investment resulted in a gain of HK$1,465 million, as represented in the Bank's increase in share of the net assets of IB, which had risen as a result of the issue of the new shares. The gain on dilution was recognised in the income statement in 2007.

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

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

	Assets	Liabilities	Equity	Revenue	Expenses	Profit
2008						
100 per cent	1,087,222	1,027,344	59,878	32,594	18,783	13,811
Group's effective interest	141,824	133,510	8,314	4,216	2,409	1,807
2007						
100 per cent	920,620	877,720	42,900	21,141	13,246	7,895
Group's effective interest	118,299	112,405	5,894	2,964	1,842	1,122

There is no impairment loss of our investments in associates for the years ended 31 December 2008 and 2007.

39. 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 2008, and were adjusted for material change in the valuation as at 31 December 2008. 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.

39. INVESTMENT PROPERTIES (continued)

(a) Movement of investment properties

	Group		Bank	
	2008	2007	**2008**	2007
At 1 January	**2,581**	2,732	**1,708**	1,557
Surplus on revaluation credited to income statement (note 22)	**8**	250	**1**	187
Transfer to assets held for sale	**–**	(411)	**–**	(46)
Transfer from premises (note 40(a))	**4**	10	**5**	10
At 31 December	**2,593**	2,581	**1,714**	1,708

(b) Terms of lease

	Group		Bank	
	2008	2007	**2008**	2007
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,137**	1,112	**467**	452
– medium leases (10 to 50 years unexpired)	**1,456**	1,469	**1,247**	1,256
Held outside Hong Kong:				
– medium leases (10 to 50 years unexpired)	**–**	–	**–**	–
	2,593	2,581	**1,714**	1,708

(c) The Group leases out investment properties under operating leases. The leases typically run for an initial period of 2 years, and may contain an option to renew the lease after that date at which time all terms are renegotiated. None of the leases includes contingent rentals.

The direct operating expenses arising from investment properties were HK$18 million in 2008 (2007: HK$21 million). Of this amount, HK$17 million (2007: HK$20 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	
	2008	2007	**2008**	2007
Less than one year	**117**	95	**77**	63
Five years or less but over one year	**72**	59	**57**	47
	189	154	**134**	110

40. PREMISES, PLANT AND EQUIPMENT

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 September 2008, and were adjusted for material change in the valuation as at 31 December 2008. 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
2008			
Cost or valuation:			
At 1 January	6,082	3,186	9,268
Exchange adjustments	6	16	22
Additions	–	491	491
Disposals	–	(272)	(272)
Elimination of accumulated depreciation on revalued premises	(165)	–	(165)
Surplus on revaluation:			
– credited to premises revaluation reserve	171	–	171
– credited to income statement (note 22)	71	–	71
Transfer to assets held for sale	–	–	–
Transfer to investment property (note 39(a))	(4)	–	(4)
At 31 December	6,161	3,421	9,582
Accumulated depreciation:			
At 1 January	–	(2,474)	(2,474)
Exchange adjustments	–	(6)	(6)
Charge for the year (note 17)	(165)	(267)	(432)
Written off on disposal	–	254	254
Transfer to assets held for sale	–	1	1
Elimination of accumulated depreciation on revalued premises	165	–	165
At 31 December	–	(2,492)	(2,492)
Net book value at 31 December	6,161	929	7,090

40. PREMISES, PLANT AND EQUIPMENT (continued)

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

	Group		
	Premises	Plant and equipment	Total
2007			
Cost or valuation:			
At 1 January	6,022	2,894	8,916
Exchange adjustments	6	13	19
Additions	–	414	414
Disposals	–	(135)	(135)
Elimination of accumulated depreciation on revalued premises	(145)	–	(145)
Surplus on revaluation:			
– credited to premises revaluation reserve	531	–	531
– credited to income statement (note 22)	34	–	34
Transfer to assets held for sale	(356)	–	(356)
Transfer to investment property (note 39(a))	(10)	–	(10)
At 31 December	6,082	3,186	9,268
Accumulated depreciation:			
At 1 January	–	(2,400)	(2,400)
Exchange adjustments	–	(5)	(5)
Charge for the year (note 17)	(147)	(201)	(348)
Written off on disposal	–	132	132
Transfer to assets held for sale	2	–	2
Elimination of accumulated depreciation on revalued premises	145	–	145
At 31 December	–	(2,474)	(2,474)
Net book value at 31 December	6,082	712	6,794

40. PREMISES, PLANT AND EQUIPMENT (continued)

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

	Bank		
	Premises	Plant and equipment	Total
2008			
Cost or valuation:			
At 1 January	3,578	2,927	6,505
Additions	–	378	378
Disposals	–	(255)	(255)
Elimination of accumulated depreciation on revalued premises	(102)	–	(102)
Surplus on revaluation:			
– credited to premises revaluation reserve	49	–	49
– credited to income statement	71	–	71
Transfer to investment property (note 39(a))	(5)	–	(5)
At 31 December	3,591	3,050	6,641
Accumulated depreciation:			
At 1 January	–	(2,378)	(2,378)
Charge for the year	(102)	(210)	(312)
Written off on disposal	–	241	241
Elimination of accumulated depreciation on revalued premises	102	–	102
At 31 December	–	(2,347)	(2,347)
Net book value at 31 December	3,591	703	4,294

40. PREMISES, PLANT AND EQUIPMENT (continued)
(a) Movement of premises, plant and equipment (continued)

	Bank		
	Premises	Plant and equipment	Total
2007			
Cost or valuation:			
At 1 January	3,728	2,869	6,597
Exchange adjustments	–	4	4
Additions	–	311	311
Disposals	–	(117)	(117)
Elimination of accumulated depreciation on revalued premises	(92)	–	(92)
Surplus on revaluation:			
– credited to premises revaluation reserve	289	–	289
– credited to income statement	28	–	28
Transfer to assets held for sale	(289)	–	(289)
Transfer to investment property (note 39(a))	(10)	–	(10)
Transfer to subsidiaries	(76)	(140)	(216)
At 31 December	3,578	2,927	6,505
Accumulated depreciation:			
At 1 January	–	(2,378)	(2,378)
Exchange adjustments	–	(2)	(2)
Charge for the year	(94)	(181)	(275)
Written off on disposal	–	114	114
Transfer to assets held for sale	2	–	2
Elimination of accumulated depreciation on revalued premises	92	–	92
Transfer to subsidiaries	–	69	69
At 31 December	–	(2,378)	(2,378)
Net book value at 31 December	3,578	549	4,127

40. PREMISES, PLANT AND EQUIPMENT (continued)

(b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2008	2007	**2008**	2007
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,448**	1,421	**717**	718
– medium leases (10 to 50 years unexpired)	**4,601**	4,550	**2,874**	2,860
Held outside Hong Kong:				
– long leases (over 50 years unexpired)	**6**	6	**–**	–
– medium leases (10 to 50 years unexpired)	**106**	105	**–**	–
	6,161	6,082	**3,591**	3,578

(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	
	2008	2007	**2008**	2007
Cost less accumulated depreciation at 31 December	**1,879**	1,928	**725**	747

41. 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	
	2008	2007	**2008**	2007
At 1 January	**565**	580	**565**	580
Amortisation of prepaid operating lease payment (note 17)	**(14)**	(15)	**(14)**	(15)
At 31 December	**551**	565	**551**	565

42. INTANGIBLE ASSETS

	Group		Bank	
	2008	2007	**2008**	2007
Present value of in-force long-term insurance business	**2,707**	2,324	**–**	–
Internally developed software	**321**	212	**321**	212
Acquired software	**28**	24	**21**	22
Goodwill	**329**	329	**–**	–
	3,385	2,889	**342**	234

The goodwill of HK$329 million was related to the acquisition of the remaining 50 per cent of Hang Seng Life Limited from HSBC Insurance (Asia-Pacific) Holdings Limited in 2007.

42. INTANGIBLE ASSETS (continued)

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

	Group	
	2008	2007
At 1 January	**2,324**	1,927
Addition from current year new business	**838**	624
Movement from in-force business	**(425)**	(165)
Other movement	**(30)**	(62)
At 31 December	**2,707**	2,324

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

	2008	2007
Risk discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Average lapse rate:		
– 1st year	**2.9%**	6.0%
– 2nd year onwards	**1.6%**	2.0%

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

(b) Goodwill

	Group		Bank	
	2008	2007	**2008**	2007
At 1 January	**329**	–	**–**	–
Additions	**–**	329	**–**	–
At 31 December	**329**	329	**–**	–

Goodwill arising from acquisition of the remaining 50 per cent of Hang Seng Life Limited amounted to HK$329 million is allocated to cash-generating units of Personal Financial Services (Life Insurance) – Hang Seng Insurance Company Limited ("HSIC") for the purpose of impairment testing.

During 2008, there was no impairment of goodwill (2007: Nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating unit based on appraisal value with the carrying amount of its net assets, including attributable goodwill.

The appraisal value comprises HSIC's net assets (other than value of business acquired and goodwill) as at 31 December 2008, the present value of in-force long-term insurance business and the expected value of future business. The present value of the in-force long-term insurance business is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 42(a) and 62(d).

42. INTANGIBLE ASSETS (continued)

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

	Group		Bank	
	2008	2007	**2008**	2007
Cost:				
At 1 January	**366**	244	**364**	244
Additions	**175**	127	**166**	125
Disposals	**(9)**	(5)	**(8)**	(5)
At 31 December	**532**	366	**522**	364
Accumulated amortisation:				
At 1 January	**(130)**	(101)	**(130)**	(101)
Charge for the year (note 17)	**(60)**	(33)	**(58)**	(33)
Written off on disposals	**8**	4	**8**	4
Transfer from plant and equipment	**(1)**	–	**–**	–
At 31 December	**(183)**	(130)	**(180)**	(130)
Net book value at 31 December	**349**	236	**342**	234

During 2008, there was no impairment on internally developed application software and acquired software (2007: Nil).

43. OTHER ASSETS

	Group		Bank	
	2008	2007	**2008**	2007
Items in the course of collection from other banks	**4,028**	6,193	**4,017**	6,091
Prepayments and accrued income	**2,711**	4,433	**1,616**	3,361
Assets held for sale*				
– repossessed assets	**136**	116	**104**	70
– other assets held for sale	**16**	83	**16**	83
Acceptances and endorsements	**3,090**	3,294	**2,255**	2,930
Retirement benefit assets	**30**	108	**30**	108
Other accounts	**1,495**	1,238	**834**	619
	11,506	15,465	**8,872**	13,262

* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2008 (accumulated income in 2007: HK$14 million).

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

44. CURRENT, SAVINGS AND OTHER DEPOSIT ACCOUNTS

	Group		Bank	
	2008	2007	**2008**	2007
Current, savings and other deposit accounts:				
– as stated in balance sheet	**562,183**	546,653	**547,385**	533,330
– structured deposits reported as trading liabilities (note 45)	**29,785**	24,162	**24,970**	23,161
	591,968	570,815	**572,355**	556,491
By type:				
– demand and current accounts	**36,321**	34,130	**37,616**	34,028
– savings accounts	**294,556**	254,976	**289,296**	251,191
– time and other deposits	**261,091**	281,709	**245,443**	271,272
	591,968	570,815	**572,355**	556,491

45. TRADING LIABILITIES

	Group		Bank	
	2008	2007	**2008**	2007
Structured certificates of deposit in issue (note 47)	**3,861**	3,527	**3,861**	3,527
Other debt securities in issue (note 47)	**5,855**	10,560	**5,855**	10,560
Structured deposits (note 44)	**29,785**	24,162	**24,970**	23,161
Short positions in securities and other	**8,781**	9,902	**8,781**	9,902
	48,282	48,151	**43,467**	47,150

46. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

	Group		Bank	
	2008	2007	**2008**	2007
4.125% callable fixed rate subordinated notes	**994**	989	**994**	989
Liabilities to customers under investment contracts	**413**	509	**–**	–
	1,407	1,498	**994**	989

At 31 December 2008, the difference between the carrying amount and the contractual amount of subordinated notes payable at maturity for the Group and the Bank amounted to HK$6 million (2007: HK$11 million). The accumulated amount of the change in fair value attributable to change in credit risk for the Group and the Bank was HK$54 million (2007: HK$12 million). The change for the year ended 31 December 2008 was HK$42 million (2007: HK$11 million) for the Group and the Bank.

47. CERTIFICATES OF DEPOSIT AND OTHER DEBT SECURITIES IN ISSUE

	Group		Bank	
	2008	2007	**2008**	2007
Certificates of deposit and other debt securities in issue:				
– as stated in balance sheet	**2,772**	5,685	**2,772**	7,203
– structured certificates of deposit in issue reported as trading liabilities (note 45)	**3,861**	3,527	**3,861**	3,527
– other structured debt securities in issue reported as trading liabilities (note 45)	**5,855**	10,560	**5,855**	10,560
	12,488	19,772	**12,488**	21,290
By type:				
– certificates of deposit in issue	**6,633**	9,212	**6,633**	10,730
– other debt securities in issue	**5,855**	10,560	**5,855**	10,560
	12,488	19,772	**12,488**	21,290

48. OTHER LIABILITIES

	Group		Bank	
	2008	2007	**2008**	2007
Items in the course of transmission to other banks	**4,583**	8,407	**4,575**	8,407
Accruals	**2,924**	3,836	**2,471**	3,532
Acceptances and endorsements	**3,090**	3,294	**2,255**	2,930
Retirement benefit liabilities	**3,532**	633	**3,532**	633
Other	**1,319**	1,680	**1,977**	2,319
	15,448	17,850	**14,810**	17,821

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS

	Group					
	2008			2007		
	Gross	**Reinsurance**	**Net**	Gross	Reinsurance	Net
Non-life insurance						
Unearned premiums	**199**	**(42)**	**157**	191	(37)	154
Notified claims	**162**	**(22)**	**140**	147	(12)	135
Claims incurred but not reported	**43**	**(8)**	**35**	42	(10)	32
Other	**26**	**(3)**	**23**	30	(1)	29
	430	**(75)**	**355**	410	(60)	350
Policyholders' liabilities						
Life (non-linked)	**43,211**	**(18)**	**43,193**	32,444	(10)	32,434
Life (linked)	**194**	**–**	**194**	235	–	235
	43,405	**(18)**	**43,387**	32,679	(10)	32,669
	43,835	**(93)**	**43,742**	33,089	(70)	33,019

Amounts recoverable from reinsurance of liabilities under insurance contracts issued are included in the consolidated balance sheet in "Other assets".

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

The movement of liabilities under insurance contracts was as follows:

(a) Non-life insurance

	Group		
	Gross	Reinsurance	Net
2008			
Unearned premiums			
At 1 January	191	(37)	154
Gross written premiums	411	(80)	331
Gross earned premiums	(403)	75	(328)
At 31 December	199	(42)	157
Notified and incurred but not reported claims			
At 1 January			
– notified claims	147	(12)	135
– claims incurred but not reported	42	(10)	32
	189	(22)	167
Claims paid	(130)	33	(97)
Claims incurred	146	(41)	105
	16	(8)	8
At 31 December			
– notified claims	162	(22)	140
– claims incurred but not reported	43	(8)	35
	205	(30)	175
Other	26	(3)	23
	430	(75)	355

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(a) Non-life insurance (continued)

	Group		
	Gross	Reinsurance	Net
2007			
Unearned premiums			
At 1 January	177	(39)	138
Gross written premiums	400	(76)	324
Gross earned premiums	(386)	78	(308)
At 31 December	191	(37)	154
Notified and incurred but not reported claims			
At 1 January			
– notified claims	147	(22)	125
– claims incurred but not reported	43	(11)	32
	190	(33)	157
Claims paid	(97)	12	(85)
Claims incurred	96	(1)	95
	(1)	11	10
At 31 December			
– notified claims	147	(12)	135
– claims incurred but not reported	42	(10)	32
	189	(22)	167
Other	30	(1)	29
	410	(60)	350

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(b) Policyholders' liabilities

	Group		
	Gross	Reinsurance	Net
2008			
Life (non-linked)			
At 1 January	32,444	(10)	32,434
Benefits paid	(646)	14	(632)
Claims incurred and movement in policyholders' liabilities	11,391	(22)	11,369
Exchange and other movements	22	–	22
At 31 December	43,211	(18)	43,193
Life (linked)			
At 1 January	235	–	235
Benefits paid	(30)	–	(30)
Claims incurred and movement in policyholders' liabilities	(11)	–	(11)
At 31 December	194	–	194
	43,405	(18)	43,387
2007			
Life (non-linked)			
At 1 January	22,382	(2)	22,380
Benefits paid	(566)	10	(556)
Claims incurred and movement in policyholders' liabilities	10,512	(18)	10,494
Exchange and other movements	116	–	116
At 31 December	32,444	(10)	32,434
Life (linked)			
At 1 January	187	–	187
Benefits paid	(41)	–	(41)
Claims incurred and movement in policyholders' liabilities	89	–	89
At 31 December	235	–	235
	32,679	(10)	32,669

50. CURRENT TAX AND DEFERRED TAX

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

	Group		Bank	
	2008	2007	**2008**	2007
Current taxation recoverable (included in "Other assets")	25	10	–	–
Deferred taxation	201	1	187	–
	226	11	187	–
Provision for Hong Kong profits tax	91	1,471	65	1,326
Provision for taxation outside Hong Kong	3	8	1	6
Deferred taxation	711	1,365	–	649
	805	2,844	66	1,981

50. CURRENT TAX AND DEFERRED TAX (continued)

(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
2008							
At 1 January	98	1,149	(97)	(69)	29	254	1,364
Charged/(credited) to income statement (note 23(a))	26	(32)	(2)	–	–	(9)	(17)
(Credited)/charged to reserves	–	(19)	–	(407)	75	(486)	(837)
At 31 December	124	1,098	(99)	(476)	104	(241)	510
2007							
At 1 January	74	1,112	(84)	(34)	(39)	458	1,487
Charged/(credited) to income statement (note 23(a))	24	(6)	(13)	–	–	60	65
Charged/(credited) to reserves	–	43	–	(35)	68	(264)	(188)
At 31 December	98	1,149	(97)	(69)	29	254	1,364

	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
2008							
At 1 January	105	820	(96)	(100)	29	(109)	649
Charged/(credited) to income statement	21	(22)	(2)	–	–	(16)	(19)
(Credited)/charged to reserves	–	(27)	–	(380)	75	(485)	(817)
At 31 December	126	771	(98)	(480)	104	(610)	(187)
2007							
At 1 January	74	779	(82)	(47)	(39)	123	808
Charged/(credited) to income statement	31	21	(14)	–	–	31	69
Charged/(credited) to reserves	–	20	–	(53)	68	(263)	(228)
At 31 December	105	820	(96)	(100)	29	(109)	649

(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 amounting to HK$29 million (2007: HK$28 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 2008 (2007: Nil).

51. SUBORDINATED LIABILITIES

		Group		Bank	
		2008	2007	**2008**	2007
Nominal value	Description				
Amount owed to third parties					
HK$1,500 million	Callable floating rate subordinated notes due June 2015 [(1)]	**1,498**	1,497	**1,498**	1,497
HK$1,000 million	4.125% callable fixed rate subordinated notes due June 2015 [(2)]	**994**	989	**994**	989
US$450 million	Callable floating rate subordinated notes due July 2016 [(3)]	**3,478**	3,497	**3,478**	3,497
US$300 million	Callable floating rate subordinated notes due July 2017 [(4)]	**2,318**	2,332	**2,318**	2,332
Amount owed to HSBC Group undertakings					
US$260 million	Callable floating rate subordinated loan debt due December 2015 [(5)]	**2,015**	2,028	**2,015**	2,028
		10,303	10,343	**10,303**	10,343
Representing:					
– measured at amortised cost		**9,309**	9,354	**9,309**	9,354
– designated at fair value (note 46)		**994**	989	**994**	989
		10,303	10,343	**10,303**	10,343

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 0.25 per cent, payable quarterly, to the call option date. Thereafter, it will be reset to three-month US dollar LIBOR plus 0.75 per cent, payable quarterly.

(5) 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.

52. SHARE CAPITAL

Authorised:

The authorised share capital of the Bank is HK$11,000 million (2007: HK$11,000 million) divided into 2,200 million shares (2007: 2,200 million shares) of HK$5 each.

	2008	2007
Issued and fully paid:		
1,911,842,736 shares (2007: 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 (2007: Nil).

53. RESERVES

	Group	Bank	Associates
2008			
Retained profits	32,518	15,563	4,154
Premises revaluation reserve	3,711	2,503	–
Cash flow hedges reserve	562	528	–
Available-for-sale investments reserve			
– on debt securities	(4,137)	(2,532)	(43)
– on equity securities	314	177	–
Capital redemption reserve	99	99	–
Other reserves	3,264	420	2,217
Total reserves	36,331	16,758	6,328
Retained profits			
At 1 January	32,873	19,211	2,634
Exchange and other adjustments	1	2	–
Profit attributable to shareholders	14,099	10,830	1,807
Dividends	(12,045)	(12,045)	(287)
Transfer from premises revaluation reserve:			
– depreciation on revaluation surplus	94	69	–
– realisation of revaluation surplus on disposal of premises	26	26	–
Actuarial losses on defined benefit plans	(2,518)	(2,518)	–
Effect of decrease in tax rate in deferred tax balance at 1 January	(12)	(12)	–
At 31 December	32,518	15,563	4,154
Premises revaluation reserve, net of tax			
At 1 January	3,639	2,522	–
Exchange adjustments	2	–	–
Unrealised surplus on revaluation	143	42	–
Transfer to retained profits:			
– depreciation on revaluation surplus	(94)	(69)	–
– realisation of revaluation surplus on disposal of premises	(22)	(22)	–
Effect of decrease in tax rate in deferred tax balance at 1 January	43	30	–
At 31 December	3,711	2,503	–
Cash flow hedges reserve, net of tax			
At 1 January	144	137	–
Amounts recognised in equity during the year	735	688	–
Amounts transferred from equity			
– to the income statement for the year	(317)	(297)	–
– to initial carrying amount of non-financial hedged items	–	–	–
At 31 December	562	528	–
Available-for-sale investments reserve, net of tax			
At 1 January	1,892	(95)	12
Amounts recognised in equity during the year	(5,272)	(1,742)	(55)
Transfer to income statement:			
– on impairment	543	141	–
– change in fair value of hedged items	(418)	(397)	–
– on disposal	(568)	(262)	–
At 31 December	(3,823)	(2,355)	(43)
Capital redemption reserve			
At 1 January and 31 December	99	99	–
Other reserves			
At 1 January	2,514	298	1,897
Foreign exchange reserve	622	(5)	320
Share based payment reserve	127	127	–
Other	1	–	–
At 31 December	3,264	420	2,217
Total reserves at 31 December	36,331	16,758	6,328

Amounts transferred to the income statement in respect of cash flow hedges include HK$316 million and HK$1 million taken to "Net interest income" and "Trading income" respectively.

53. RESERVES (continued)

	Group	Bank	Associates
2007			
Retained profits	32,873	19,211	2,634
Premises revaluation reserve	3,639	2,522	–
Cash flow hedges reserve	144	137	–
Available-for-sale investments reserve			
– on debt securities	(841)	(520)	12
– on equity securities	2,733	425	–
Capital redemption reserve	99	99	–
Other reserves	2,514	298	1,897
Total reserves	41,161	22,172	4,543
Retained profits			
At 1 January	29,044	17,281	1,719
Exchange and other adjustments	–	–	–
Profit attributable to shareholders	18,242	15,122	2,587
Dividends	(12,045)	(12,045)	(207)
Transfer from premises revaluation reserve:			
– depreciation on revaluation surplus	80	61	–
– realisation of revaluation surplus on disposal of premises	260	172	–
Actuarial losses on defined benefit plans	(1,243)	(1,243)	–
Transfer to subsidiaries	–	(137)	–
Transfer to other reserves on dilution gain of investment in associate	(1,465)	–	(1,465)
At 31 December	32,873	19,211	2,634
Premises revaluation reserve, net of tax			
At 1 January	3,491	2,486	–
Unrealised surplus on revaluation	443	239	–
Transfer to retained profits:			
– depreciation on revaluation surplus	(80)	(61)	–
– realisation of revaluation surplus on disposal of premises	(215)	(142)	–
At 31 December	3,639	2,522	–
Cash flow hedges reserve, net of tax			
At 1 January	(220)	(192)	–
Amounts recognised in equity during the year	146	134	–
Amounts transferred from equity			
– to the income statement for the year	218	195	–
– to initial carrying amount of non-financial hedged items	–	–	–
At 31 December	144	137	–
Available-for-sale investments reserve, net of tax			
At 1 January	923	(165)	10
Amounts recognised in equity during the year	1,594	253	2
Transfer to income statement:			
– on impairment	–	–	–
– change in fair value of hedged items	(181)	(159)	–
– on disposal	(444)	(24)	–
At 31 December	1,892	(95)	12
Capital redemption reserve			
At 1 January and 31 December	99	99	–
Other reserves			
At 1 January	452	318	125
Transfer from income statement on dilution gain of investment in associate	1,465	–	1,465
Foreign exchange reserve	527	(90)	307
Share based payment reserve	70	70	–
At 31 December	2,514	298	1,897
Total reserves at 31 December	41,161	22,172	4,543

Amounts transferred from the income statement in respect of cash flow hedges include HK$218 million taken from “Net interest income”.

53. RESERVES (continued)

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.

Regulatory reserve

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" of HK$854 million (2007: HK$911 million) from retained profits in order to satisfy the provisions of the Hong Kong Banking Ordinance for prudential supervision purposes in respect of losses which the Group will or may incur on loans and advances in addition to impairment losses recognised. Movements in the regulatory reserve are earmarked directly through retained profits and in consultation with the HKMA.

Retained profits

Retained profits are the cumulative net earnings of the Group that have not been paid out as dividends, but retained to be reinvested in the business.

Premises revaluation reserve

The premises revaluation reserve represents the difference between the current fair value of the premises and its original depreciated cost.

The premises revaluation reserve included nil amount in relation to properties classified as assets held for sale, included in "Other assets" in the consolidated balance sheet at 31 December 2008 (31 December 2007: HK$26 million).

Cash flow hedges reserve

The cash flow hedges reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions.

Available-for-sale investments reserve

The available-for-sale investments reserve includes the cumulative net change in the fair value of available-for-sale investments other than impairments which have been recognised in the income statement.

Capital redemption reserve

Capital redemption reserve represents the difference between the capital payment and the nominal value of the redeemed share capital.

Other reserves

Other reserves mainly comprise foreign exchange reserve, share based payment reserve and other non-distributable reserves. The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations. The share based payment reserve is used to record the corresponding amount of share options granted by ultimate holding company to the Group's employees and other cost of share based payment arrangement.

"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.

54. RECONCILIATION OF CASH FLOW STATEMENT

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

	2008	2007
Operating profit	13,725	17,789
Net interest income	(16,232)	(14,719)
Dividend income	(82)	(52)
Loan impairment charges and other credit risk provisions	2,776	576
Impairment of available-for-sale equity securities	284	–
Depreciation	432	348
Amortisation of intangible assets	60	33
Amortisation of available-for-sale investments	(398)	(838)
Amortisation of held-to-maturity debt securities	1	(1)
Advances written off net of recoveries	(400)	(429)
Interest received	16,232	25,530
Interest paid	(9,249)	(19,208)
Operating profit before changes in working capital	7,149	9,029
Change in treasury bills and certificates of deposit with original maturity more than three months	14,016	(5,958)
Change in placings with and advances to banks maturing after one month	(2,895)	4,324
Change in trading assets	(100,363)	1,160
Change in financial assets designated at fair value	(276)	362
Change in derivative financial instruments	7,848	349
Change in advances to customers	(21,766)	(29,150)
Change in other assets	(3,474)	(11,612)
Change in financial liabilities designated at fair value	5	2
Change in current, savings and other deposit accounts	15,530	63,832
Change in deposits from banks	(8,300)	2,056
Change in trading liabilities	131	(11,942)
Change in certificates of deposit and other debt securities in issue	(2,913)	(1,910)
Change in other liabilities	7,150	10,963
Elimination of exchange differences and other non-cash items	4,542	(7,892)
Cash (used in)/generated from operating activities	(83,616)	23,613
Taxation paid	(3,214)	(2,543)
Net cash (outflow)/inflow from operating activities	(86,830)	21,070

54. RECONCILIATION OF CASH FLOW STATEMENT (continued)

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

	2008	2007
Cash and balances with banks and other financial institutions	**24,822**	16,864
Placings with and advances to banks and other financial institutions maturing within one month	**44,572**	89,895
Treasury bills	**6,722**	4,114
Certificates of deposit	**–**	2,601
	76,116	113,474

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$5,085 million at 31 December 2008 (2007: HK$9,171 million).

55. CONTINGENT LIABILITIES AND COMMITMENTS

The tables below give the contract amounts, credit equivalent amounts and risk-weighted amounts of contingent liabilities and commitments. The information is consistent with that in the "Capital Adequacy Ratio" return submitted to the Hong Kong Monetary Authority by the Group. The return is prepared on a consolidated basis as specified by the Hong Kong Monetary Authority under the requirement of section 98(2) of the Banking Ordinance.

For the purposes of these financial statements, acceptances and endorsements are recognised on the balance sheet in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK$3,090 million (2007: HK$3,294 million) and HK$2,255 million (2007: HK$2,930 million) respectively.

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

The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Capital Rules and depend on the status of the counterparty and maturity characteristics of the instrument.

With the Capital Rules effective from 1 January 2007, the Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2008 were calculated based on the "foundation internal ratings-based approach" and the risk-weighted assets for 2007 were calculated based on the "standardised (credit risk) approach". The figures are therefore not strictly comparable.

55. CONTINGENT LIABILITIES AND COMMITMENTS (continued)

	Group			Bank		
	Contract amounts	**Credit equivalent amounts**	**Risk-weighted amounts**	**Contract amounts**	**Credit equivalent amounts**	**Risk-weighted amounts**
2008						
Direct credit substitutes	4,174	4,174	2,132	4,174	4,174	2,132
Transaction-related contingencies	1,016	507	418	675	337	283
Trade-related contingencies	7,046	1,409	922	6,088	1,217	735
Forward asset purchases	59	59	59	59	59	59
Undrawn formal standby facilities, credit lines and other commitments to lend:						
– not unconditionally cancellable*	23,708	15,992	6,389	22,388	15,007	6,011
– unconditionally cancellable	155,505	30,971	3,586	147,415	30,971	3,586
	191,508	53,112	13,506	180,799	51,765	12,806

* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of "not more than one year" and "more than one year" as at 31 December 2008 were HK$10,444 million and HK$13,264 million respectively.

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2007						
Direct credit substitutes	4,651	4,651	3,638	4,651	4,651	3,638
Transaction-related contingencies	812	406	398	511	256	249
Trade-related contingencies	10,274	2,055	2,045	9,255	1,851	1,848
Forward asset purchases	115	115	115	115	115	115
Undrawn formal standby facilities, credit lines and other commitments to lend:						
– not unconditionally cancellable						
– not more than one year	20,253	4,051	4,051	18,801	3,760	3,760
– more than one year	15,973	7,986	6,752	14,771	7,385	6,151
– unconditionally cancellable	145,641	–	–	136,840	–	–
	197,719	19,264	16,999	184,944	18,018	15,761

56. ASSETS PLEDGED AS SECURITY FOR LIABILITIES

At 31 December 2008, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements amounted to HK$9,807 million and HK$8,766 million respectively (Group and Bank in 2007: HK$8,410 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK$10,110 million and HK$9,069 million respectively (Group and Bank in 2007: HK$8,474 million) and mainly comprised items included in "Trading assets" and "Financial investments".

These transactions are conducted under terms that are usual and customary to standard lending activities.

57. CAPITAL COMMITMENTS

	Group		Bank	
	2008	2007	**2008**	2007
Expenditure authorised and contracted for	**141**	350	**138**	320
Expenditure authorised but not contracted for	**–**	–	**–**	–

58. LEASE COMMITMENTS

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

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

	Group		Bank	
	2008	2007	**2008**	2007
Within one year	**398**	396	**284**	311
Between one and five years	**497**	618	**361**	500
Over five years	**2**	53	**–**	46
	897	1,067	**645**	857

59. EMPLOYEE RETIREMENT BENEFITS

(a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 50 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS 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 2008 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.

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(i) The amounts recognised in the balance sheets are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2008			
Present value of funded obligations (note 59(a)(iii))	(6,961)	(219)	(3)
Fair value of scheme assets (note 59(a)(iv))	3,430	218	33
Net (liabilities)/assets recognised in the balance sheet (note 59(a)(v))	(3,531)	(1)	30
Reported as "Assets"	–	–	30
Reported as "Liabilities"	(3,531)	(1)	–
	(3,531)	(1)	30
Obligations covered by scheme assets (%)	49	100	1,100
2007			
Present value of funded obligations (note 59(a)(iii))	(5,722)	(188)	(3)
Fair value of scheme assets (note 59(a)(iv))	5,089	267	32
Net (liabilities)/assets recognised in the balance sheet (note 59(a)(v))	(633)	79	29
Reported as "Assets"	–	79	29
Reported as "Liabilities"	(633)	–	–
	(633)	79	29
Obligations covered by scheme assets (%)	89	142	1,067

The Occupational Retirement Schemes Ordinance (Cap.426 of the laws of Hong Kong) ("the Ordinance") requires that registered retirement benefit schemes shall at all time be fully funded to meet its aggregate vested liability (i.e. on a wind-up basis) in accordance with the recommendations contained in an actuarial certificate supplied under the Ordinance. Any shortfall must be made up within the specified time under the Ordinance. Any deficits to meet the aggregate past service liability (i.e. on an on-going basis) can however be eliminated over a period of time in accordance with the funding recommendations of an actuary.

On an on-going basis, the actuarial value of the principal scheme assets of HSBDBS represented 89 per cent (2007: 120 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK$453 million (surplus in 2007: HK$857 million). On a wind-up basis, the actuarial value of the scheme assets represented 90 per cent (2007: 134 per cent) of the members' vested benefits, based on salaries at that date, and the resulting deficit amounted to HK$379 million (surplus in 2007: HK$1,288 million).

59. 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
2008			
Equity	787	15	–
Bonds	2,055	162	–
Certificates of deposit issued by the Bank	–	–	–
Ordinary shares issued by ultimate holding company	44	–	–
Other	544	41	33
	3,430	218	33
2007			
Equity	1,886	37	–
Bonds	2,291	204	–
Certificates of deposit issued by the Bank	4	–	–
Ordinary shares issued by ultimate holding company	65	–	–
Other	843	26	32
	5,089	267	32

(iii) Change in the present value of scheme obligations

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2008			
At 1 January	5,722	188	3
Current service cost	296	–	–
Interest cost	195	6	–
Actuarial losses	987	40	–
Benefits paid	(239)	(15)	–
At 31 December	6,961	219	3
2007			
At 1 January	3,727	175	3
Current service cost	194	–	–
Interest cost	137	6	–
Actuarial losses	1,900	22	1
Benefits paid	(236)	(15)	(1)
At 31 December	5,722	188	3

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(iv) Change in the fair value of scheme assets

	Group and Bank		
	HSBDBS	**HSBPS**	**HSBNTBS**
2008			
At 1 January	**5,089**	**267**	**32**
Contributions by the Bank	**143**	**–**	**–**
Expected return on scheme assets	**382**	**10**	**1**
Experience losses	**(1,945)**	**(44)**	**–**
Benefits paid	**(239)**	**(15)**	**–**
At 31 December	**3,430**	**218**	**33**
2007			
At 1 January	4,454	242	32
Contributions by the Bank	142	8	–
Expected return on scheme assets	336	9	1
Experience gains	393	23	–
Benefits paid	(236)	(15)	(1)
At 31 December	5,089	267	32

The Group and the Bank expect to make HK$400 million of contributions to defined benefit schemes during the following year (2007: HK$149 million).

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

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

	Group and Bank		
	HSBDBS	**HSBPS**	**HSBNTBS**
2008			
At 1 January	(633)	79	29
Contributions by the Bank	143	–	–
Net (expense)/income recognised in the income statement (note 59(a)(vi))	(109)	4	1
Net actuarial losses	(2,932)	(84)	–
At 31 December	(3,531)	(1)	30
Experience gains on scheme liabilities	258	2	–
Experience losses on scheme assets	(1,945)	(44)	–
Losses from change in actuarial assumptions	(1,245)	(42)	–
Net actuarial losses	(2,932)	(84)	–
2007			
At 1 January	727	67	29
Contributions by the Bank	142	8	–
Net income recognised in the income statement (note 59(a)(vi))	5	3	1
Net actuarial (losses)/gains	(1,507)	1	(1)
At 31 December	(633)	79	29
Experience losses on scheme liabilities	(197)	(15)	–
Experience gains on scheme assets	393	23	–
Losses from change in actuarial assumptions	(1,703)	(7)	(1)
Net actuarial (losses)/gains	(1,507)	1	(1)

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

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

	Group		
	HSBDBS	HSBPS	HSBNTBS
2008			
Current service cost	(296)	–	–
Interest cost	(195)	(6)	–
Expected return on scheme assets	382	10	1
Net (expense)/income for the year (note 17)	(109)	4	1
Actual return on scheme assets	(1,563)	(33)	–
2007			
Current service cost	(194)	–	–
Interest cost	(137)	(6)	–
Expected return on scheme assets	336	9	1
Net income for the year (note 17)	5	3	1
Actual return on scheme assets	729	32	1

The net actuarial losses recognised in the Group's retained profit during 2008 in respect of defined benefit schemes were HK$2,529 million (net actuarial losses of HK$1,243 million during 2007). The total cumulative amount of actuarial losses recognised in the retained profit was HK$3,479 million (2007: the cumulative amount of actuarial losses was HK$950 million). The total effect of the limit on schemes surpluses in 2008 and 2007 in respect of defined benefit schemes was HK$ nil.

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

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2008	%	%	%
Discount rate	1.2	1.2	1.2
Expected rate of return on scheme assets	6.0	4.0	3.0
Expected rate of salary increases	5.0	5.0	5.0
Expected rate of pension increases	–	1.5	–
2007	%	%	%
Discount rate	3.5	3.5	3.5
Expected rate of return on scheme assets	7.5	4.0	3.0
Expected rate of salary increases	5.0	5.0	5.0
Expected rate of pension increases	–	1.5	–

The expected rate of return on scheme assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates.

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(viii) Amounts for the current and previous years

	Group and Bank				
	2008	2007	2006	2005	2004
Defined benefit obligations	**7,183**	5,913	3,905	3,742	3,849
Plan assets	**3,681**	5,388	4,728	4,199	3,989
Net (deficits)/surpluses	**(3,502)**	(525)	823	457	140
Experience gains/(losses) on scheme liabilities	**260**	(212)	(36)	19	(60)
Experience (losses)/gains on scheme assets	**(1,989)**	416	413	68	80
(Losses)/gains from change in actuarial assumptions	**(1,287)**	(1,711)	(113)	104	(181)

(b) Defined contribution schemes

The principal defined contribution scheme for Group employees joining on or after 1 April 1999 is the HSBC Group Hong Kong Local Staff Defined Contribution Scheme. The Group also operates three other defined contribution schemes, the Hang Seng Bank Provident Fund Scheme which was closed to new entrants since 31 December 1986, the Hang Seng Insurance Company Limited Employees' Provident Fund and the Hang Seng Bank (Bahamas) Limited Defined Contribution Scheme for employees of the respective subsidiaries. The Bank and relevant Group entities also participated in mandatory provident fund schemes ("MPF schemes") registered under the Hong Kong Mandatory Provident Fund Ordinance, which are also defined contribution schemes.

Contributions made in accordance with the relevant scheme rules to these defined contribution schemes (including MPF schemes) are charged to the income statement as below:

	2008	2007
Amounts charged to the income statement (note 17)	**69**	56

Under the Schemes, the Group's contributions are reduced by contributions forfeited by those employees who leave the Schemes prior to the contributions vesting fully. There was no forfeited contributions utilised during the year or available at the year-end to reduce future contributions (2007: Nil).

60. SHARE-BASED PAYMENTS

The Group participated in various share compensation plans operated by the HSBC Group for acquiring of HSBC Holdings plc shares. They are the Savings-Related Share Option Plan, Executive/Group Share Option Plan and Restricted Share Plan/Performance Share Awards/Achievement Share Awards. These are to be settled by the delivery of shares of HSBC Holdings plc.

(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 three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contract depending on conditions set at grant. There is generally one Savings-Related Share Option Plan grant each year (in April or May). The exercise price is at a 20 per cent (2007: 20 per cent) discount to the market value at the date of grant.

The employee has the right to withdraw their accumulated savings and withdraw from the plan at any time. Upon voluntary withdrawal, any remaining unamortised compensation expense is recognised in the current period.

60. SHARE-BASED PAYMENTS (continued)

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

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, are as follows:

	2008		2007	
	Weighted average exercise price £	**Number ('000)**	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	6.43	1,922	10.63	3,408
Granted in the year	–	–	–	–
Exercised in the year	6.36	(1,235)	6.46	(1,318)
Lapsed in the year	6.43	(144)	10.63	(168)
Outstanding at 31 December	6.55	543	6.43	1,922
Exercisable at 31 December	6.68	2	–	–

The weighted average share price at the date of exercise for share options exercised during the year was £6.36 (2007: £6.46).

The options outstanding at the year end had an exercise price in the range of £6.47 to £6.68 (2007: £5.35 to £6.68), and a weighted average remaining contractual life of 1.45 years (2007: 1.57 years).

	2008		2007	
	Weighted average exercise price HK$	**Number ('000)**	Weighted average exercise price HK$	Number ('000)
Outstanding at 1 January	106.73	3,363	103.44	1,617
Granted in the year	106.25	2,034	108.45	2,347
Exercised in the year	108.45	(584)	103.44	(350)
Lapsed in the year	106.73	(2,517)	103.44	(251)
Outstanding at 31 December	106.14	2,296	106.73	3,363
Exercisable at 31 December	–	–	–	–

The weighted average share price at the date of exercise for share options exercised during the year was HK$108.45 (2007: HK$103.44).

The options outstanding at the year end had an exercise price in the range of HK$103.44 to HK$108.45 (2007: HK$103.44 to HK$108.45), and a weighted average remaining contractual life of 2.42 years (2007: 2.97 years).

The weighted average fair value of options granted during the year was HK$29.42 (2007: HK$33.55).

60. SHARE-BASED PAYMENTS (continued)

(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.

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, are as follows:

	2008		2007	
	Weighted average exercise price £	**Number ('000)**	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	7.89	2,976	7.86	3,465
Exercised in the year	7.03	(158)	7.48	(356)
Lapsed in the year	7.89	(71)	7.86	(133)
Outstanding at 31 December	7.93	2,747	7.89	2,976
Exercisable at 31 December	7.93	2,747	7.89	2,976

The options outstanding at the year end had an exercise price in the range of £6.38 to £8.71 (2007: £6.38 to £8.71), and a weighted average remaining contractual life of 4.58 years (2007: 5.51 years).

The weighted average share price at the date of exercise for share options exercised during the year was £7.99 (2007: £9.03).

(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.

60. SHARE-BASED PAYMENTS (continued)

(c) Calculation of fair value (continued)

The significant weighted average assumptions used to estimate the fair value of the options granted during the year were as follows:

	1-year Savings-Related Share Option Plan	3-year Savings-Related Share Option Plan	5-year Savings-Related Share Option Plan
2008			
Risk-free interest rate (%)	4.5	4.5	4.5
Expected life (years)	1	3	5
Expected volatility (%)	25	25	25
Share price at grant date (HK$)	106.25	106.25	106.25
2007			
Risk-free interest rate (%)	4.9	4.5	4.5
Expected life (years)	1	3	5
Expected volatility (%)	17	17	17
Share price at grant date (HK$)	108.45	108.45	108.45

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.

	2008 Number ('000)	2007 Number ('000)
Outstanding at 1 January	500	302
Additions during the year	462	231
Released in the year	(45)	(33)
Lapsed in the year	–	–
Outstanding at 31 December	917	500

The closing price of the HSBC Holdings plc share at 31 December 2008 was £6.62 (2007: £8.42).

The weighted average remaining vesting period as at 31 December 2008 was 1.86 years (2007: 2.00 years).

60. SHARE-BASED PAYMENTS (continued)

(e) Employee expenses

During 2008, HK$109 million was charged to the income statement in respect of share-based payment transactions settled in equity (2007: HK$88 million). This expense, which was computed from the fair values of the share-based payment transactions when granted, arose under employee share awards made in accordance with the Group's reward structures.

61. MATERIAL RELATED-PARTY TRANSACTIONS

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

In 2008, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The Group used the IT service of, and shared an automated teller machine network with, its immediate holding company. The Group also shared certain IT projects with and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. A fellow subsidiary company was appointed as fund manager to manage the Group's investment portfolios. The Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies. On 25 September 2007 ("Completion Date"), the acquisition of 50 per cent of the issued share capital of Hang Seng Life Limited ("HSLL") from a fellow subsidiary by Hang Seng Insurance Company Limited ("HSIC"), a wholly-owned subsidiary of the Bank, for a consideration of HK$2,400 million was completed.

During 2007, an arrangement whereby a fellow subsidiary provided certain management services, being services related to risk management, back office processing and administration, development and pricing of selected products, information technology and business recovery, financial control and actuarial services, to the HSIC. The premiums, commissions and other fees on these transactions are determined on an arm's length basis.

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

The aggregate amount of income and expenses arising from these transactions during the year, the balances of amounts due to and from the relevant related parties, and the total contract sum of off-balance sheet transactions at the year-end are as follows:

	Group					
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Associates	
	2008	2007	**2008**	2007	**2008**	2007
Interest income	**315**	207	**57**	111	**1**	9
Interest expense	**(314)**	(863)	**(12)**	(25)	**(13)**	(11)
Other operating (expense)/income	**(52)**	27	**12**	(5)	**2**	–
Operating expenses*	**(696)**	(694)	**(388)**	(290)	**(13)**	(15)
Amounts due from:						
Cash and balances with banks and other financial institutions	**6,765**	341	**267**	520	**245**	20
Placings with and advances to banks and other financial institutions	**10,899**	1,802	**–**	3,975	**–**	–
Derivative financial instruments	**602**	258	**33**	128	**–**	7
Financial assets designated at fair value	**3,545**	3,672	**–**	–	**–**	–
Advances to customers	**–**	–	**–**	–	**233**	233
Financial investments	**692**	909	**–**	–	**–**	–
Other assets	**108**	73	**118**	55	**3**	7
	22,611	7,055	**418**	4,678	**481**	267
Amounts due to:						
Current, savings and other deposit accounts	**36**	1,779	**141**	151	**51**	63
Deposits from banks	**5,478**	3,406	**–**	65	**441**	366
Derivative financial instruments	**7,390**	1,720	**35**	53	**–**	12
Subordinated liabilities	**2,015**	2,028	**–**	–	**–**	–
Other liabilities	**194**	243	**80**	73	**–**	–
	15,113	9,176	**256**	342	**492**	441
Derivative contracts:						
Contract amount	**136,269**	96,684	**8,593**	14,284	**–**	716

* 2008 Operating expenses included payment of HK$127 million (2007: HK$87 million) of software costs which were capitalised as intangible assets in the balance sheet of the Group.

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

	Bank							
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Subsidiaries		Associates	
	2008	2007	**2008**	2007	**2008**	2007	**2008**	2007
Amounts due from:								
Cash and balances with banks and other financial institutions	**6,724**	256	**261**	520	**–**	–	**–**	–
Placings with and advances to banks and other financial institutions	**6,192**	499	**–**	3,975	**–**	–	**–**	–
Derivative financial instruments	**592**	222	**33**	128	**62**	–	**–**	–
Financial assets designated at fair value	**–**	–	**–**	–	**–**	–	**–**	–
Advances to customers	**–**	–	**–**	–	**–**	–	**–**	–
Amounts due from subsidiaries	**–**	–	**–**	–	**84,907**	102,806	**–**	–
Financial investments	**–**	134	**–**	–	**–**	–	**–**	–
Other assets	**59**	23	**94**	33	**–**	–	**3**	7
	13,567	1,134	**388**	4,656	**84,969**	102,806	**3**	7
Amounts due to:								
Current, savings and other deposit accounts	**36**	1,779	**141**	151	**–**	–	**51**	63
Deposits from banks	**4,958**	2,183	**–**	65	**–**	–	**–**	–
Derivative financial instruments	**7,379**	1,700	**35**	53	**74**	–	**–**	–
Subordinated liabilities	**2,015**	2,028	**–**	–	**–**	–	**–**	–
Amounts due to subsidiaries	**–**	–	**–**	–	**8,575**	5,365	**–**	–
Other liabilities	**162**	194	**75**	63	**–**	–	**–**	–
	14,550	7,884	**251**	332	**8,649**	5,365	**51**	63
Derivative contracts:								
Contract amount	**135,420**	94,489	**8,593**	14,284	**3,636**	948	**–**	–

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(b) Key management personnel remuneration

Remuneration for key management personnel, including amounts paid to the Bank's directors as disclosed in note 19 and highest paid employees as disclosed in note 18, is as follows:

	Group		Bank	
	2008	2007	**2008**	2007
Employee benefits	**51**	35	**51**	35
Post-employment benefits	**5**	5	**5**	5
Share-based payments	**8**	3	**8**	3
	64	43	**64**	43

(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	
	2008	2007	**2008**	2007
Interest received	**444**	610	**432**	589
Interest paid	**137**	294	**137**	294
Fees and exchange income received	**20**	16	**20**	16
Loans and advances	**17,749**	13,472	**16,385**	12,041
Deposits	**5,348**	8,611	**5,348**	8,611
Undrawn commitments	**4,182**	4,530	**4,182**	4,403
Maximum aggregate amount of loans and advances during the year	**21,020**	18,632	**19,424**	16,898

The Group adheres to section 83 of the Hong Kong Banking Ordinance regarding lending to related parties; this includes unsecured lending to key management personnel, their relatives and companies that may be directly or indirectly influenced or controlled by such individuals.

No impairment losses have been recorded against balances outstanding during the year with key management personnel, and there is no specific impairment allowances on balances with key management personnel at the year-end.

(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	
	2008	2007	**2008**	2007
Aggregate amount of relevant transactions outstanding at 31 December	**50**	88	**45**	83
Maximum aggregate amount of relevant transactions during the year	**174**	154	**168**	148

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(e) Associates

Information relating to associates and transactions with associates can be found in note 38 and note 61(a).

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2008 was HK$233 million (2007: 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 and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the Group. As disclosed in note 60, the Group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under "Other reserves". The balance of this reserve as at 31 December 2008 amounted to HK$411 million comprising HK$371 million relating to share option schemes and HK$40 million relating to share award schemes (2007: HK$284 million relating to share option schemes only).

(g) Employee retirement benefits

At 31 December 2008, defined benefit scheme assets amounted to HK$1,387 million (2007: HK$1,127 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK$4 million (2007: HK$4 million).

62. FINANCIAL RISK MANAGEMENT

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

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various management committees, including the Executive Committee, Audit Committee, Asset and Liability Management Committee ("ALCO"), Credit Committee and Risk Management Committee ("RMC") which was set up in July 2008 to centralise the risk management oversight function of the Bank and to review, analyse, evaluate, recognise and manage various risks of the Bank. RMC is constituted by the Board but reports to Executive Committee.

There are existing approval procedures for the launch of new business and products. The procedures include initiatives and due diligence are signed off by major operational and control (including compliance, credit, legal, tax, financial, IT development and corporate communication) functions, reviewed by senior executives and approved by at least 2 ALCO members. ALCO is also required to formally endorse the launch of new products. In addition, RMC also reviews the new services and activities approved by ALCO from risk management perspective. Each new business and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new product and business in development prior to implementation.

(a) Credit risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, 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 categorise exposures and facilitate focused management;
- reporting to senior executives and various committees on aspects of the Group loan portfolio;
- managing and directing credit-related systems initiatives; and
- providing advice and guidance to business units on various credit-related issues.

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 need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

Risk rating framework

A more sophisticated risk rating framework on counterparty credit risk based on default probability and loss estimates is being implemented across the Group. The rating methodology of this framework is based upon a wide range of financial analytics. This new approach will allow a more granular analysis of risk and trends. The information generated from the risk rating framework is used but not limited to credit approval, credit monitoring, pricing, loan classification and capital adequacy assessment. The Bank also has control mechanisms in place to validate the performance and accuracy of the risk rating framework.

To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies.

Collateral and other credit enhancements

The Group has implemented guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determined the valuation parameters. Such parameters are established prudently and are reviewed regularly in light of changing market environment and empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfill their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the Group's policy to establish that loans are within the customer's capacity to repay rather than to rely excessively on security. Facilities may be granted on unsecured basis depending on the customer's standing and the type of product. The principal collateral types are as follows:

- in the personal sector, charges over the properties, securities, investment funds and deposits;
- in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery;
- 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 27 and credit risk concentration of respective financial assets is disclosed in notes 32, 33, 35 and 36.

62. 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	
	2008	2007	2008	2007
Cash and balances with banks and other financial institutions	24,822	16,864	22,071	13,362
Placings with and advances to banks and other financial institutions	69,579	113,029	38,097	86,137
Trading assets	108,389	10,390	107,775	8,904
Financial assets designated at fair value	7,798	13,892	830	1,238
Derivative financial instruments	7,104	4,702	6,910	4,411
Advances to customers	329,121	308,356	280,255	255,413
Financial investments	181,159	244,294	112,000	172,599
Amounts due from subsidiaries	–	–	84,907	102,806
Other assets	11,123	15,083	8,627	12,940
Financial guarantees and other credit related contingent liabilities	8,744	12,037	8,682	11,651
Loan commitments and other credit related commitments	285,507	276,227	273,210	262,071
	1,033,346	1,014,874	943,364	931,532

(ii) Credit quality

Four broad classifications describe the credit quality of the Group's lending and debt securities portfolios. These classifications each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external ratings attributed by external agencies to debt securities, as follows:

There is no direct correlation between the internal and external ratings at granular level, except insofar as both fall within one of the four classifications.

Quality classification	Wholesale lending and derivatives	Retail lending	Debt securities/other
Strong	CRR 1 to CRR 2	EL 1 to EL 2*	A– and above
Medium	CRR 3 to CRR 5	EL 3 to EL 5*	B+ to BBB+ and unrated
Sub-standard	CRR 6 to CRR 8	EL 6 to EL 8*	B and below
Impaired	CRR 9 to CRR 10	EL 9 to EL 10 and all EL 1 to EL 8 exposures past due 90 days and above	Individually identified

* All retail exposures past due 90 days and above are classified as "impaired".

Quality classification definitions:

– Strong: Exposures demonstrate a strong capacity to meet commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.

– Medium: Exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery process.

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.
- Impaired: have been assessed, individually or collectively, as impaired.

The Group's policy in respect of impairment on loans and advances and debt securities is set out in Note 4 on the financial statements.

The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

Granular risk rating scales:

The CRR ("Customer Risk Rating") 10-grade scale maps to an underlying 22-grade scale of obligor probability of default. These scales are used Group-wide for all distinct customers, depending on which Basel II approach is adopted for the assets in question. The EL ("Expected Loss") scale summarises an underlying 10-grade, granular scale combining Basel II PD and LGD factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classification defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

The basis of reporting has been changed from previous year in order to reflect the risk rating systems introduced under the Group's Basel II programme and to extend the range of financial instruments covered in the presentation of portfolio quality.

Impairment is not measured for debt securities held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through profit and loss statement. Consequently, all such balances are reported under "neither past due nor impaired".

62. FINANCIAL RISK MANAGEMENT (continued)
(a) Credit risk (continued)
(ii) Credit quality (continued)
Distribution of financial instruments by credit quality

	Group						
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub-standard				
2008							
Items in the course of collection from other banks	4,028	–	–	–	–	–	4,028
Trading assets:							
– treasury and eligible bills*	103,621	–	–	–	–	–	103,621
– debt securities*	4,530	220	–	–	–	–	4,750
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	18	–	–	–	–	18
	108,151	238	–	–	–	–	108,389
Financial assets designated at fair value:							
– treasury and eligible bills*	–	–	–	–	–	–	–
– debt securities*	7,194	242	–	–	–	–	7,436
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	7,194	242	–	–	–	–	7,436
Derivatives	5,916	1,137	51	–	–	–	7,104
Loans and advances held at amortised cost:							
– loans and advances to banks	87,724	2,981	–	–	–	–	90,705
– loans and advances to customers	199,384	115,184	6,355	6,837	3,404	(2,043)	329,121
	287,108	118,165	6,355	6,837	3,404	(2,043)	419,826
Financial investments:							
– treasury and similar bills	9,927	–	–	–	–	–	9,927
– debt securities	158,655	11,983	–	–	160	–	170,798
	168,582	11,983	–	–	160	–	180,725
Other assets:							
– acceptances and endorsements	775	2,237	74	–	4	–	3,090
– other	3,032	946	16	11	–	–	4,005
	3,807	3,183	90	11	4	–	7,095

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

	Group						
	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2007							
Items in the course of collection from other banks	6,193	–	–	–	–	–	6,193
Trading assets:							
– treasury and eligible bills*	6,303	–	–	–	–	–	6,303
– debt securities*	3,911	147	–	–	–	–	4,058
– loans and advances to banks	–	22	–	–	–	–	22
– loans and advances to customers	–	5	–	–	–	–	5
	10,214	174	–	–	–	–	10,388
Financial assets designated at fair value:							
– treasury and eligible bills*	–	–	–	–	–	–	–
– debt securities*	7,721	191	–	–	–	–	7,912
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	7,721	191	–	–	–	–	7,912
Derivatives	3,797	903	2	–	–	–	4,702
Loans and advances held at amortised cost:							
– loans and advances to banks	115,474	11,111	–	–	–	–	126,585
– loans and advances to customers	188,776	107,672	5,381	6,319	1,261	(1,053)	308,356
	304,250	118,783	5,381	6,319	1,261	(1,053)	434,941
Financial investments:							
– treasury and similar bills	3,089	–	–	–	–	–	3,089
– debt securities	219,922	16,984	–	–	–	–	236,906
	223,011	16,984	–	–	–	–	239,995
Other assets:							
– acceptances and endorsements	1,140	2,056	98	–	–	–	3,294
– other	4,334	1,234	16	12	–	–	5,596
	5,474	3,290	114	12	–	–	8,890

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

	Bank						
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub-standard				
2008							
Items in the course of collection from other banks	4,017	–	–	–	–	–	4,017
Trading assets:							
– treasury and eligible bills*	103,463	–	–	–	–	–	103,463
– debt securities*	4,074	220	–	–	–	–	4,294
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	18	–	–	–	–	18
	107,537	238	–	–	–	–	107,775
Financial assets designated at fair value:							
– treasury and eligible bills*	–	–	–	–	–	–	–
– debt securities*	830	–	–	–	–	–	830
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	830	–	–	–	–	–	830
Derivatives	5,722	1,137	51	–	–	–	6,910
Loans and advances held at amortised cost:							
– loans and advances to banks	54,929	1,751	–	–	–	–	56,680
– loans and advances to customers	172,761	97,222	5,260	4,721	2,032	(1,741)	280,255
	227,690	98,973	5,260	4,721	2,032	(1,741)	336,935
Financial investments:							
– treasury and similar bills	4,304	–	–	–	–	–	4,304
– debt securities	99,110	8,250	–	–	62	–	107,422
	103,414	8,250	–	–	62	–	111,726
Other assets:							
– acceptances and endorsements	683	1,494	74	–	4	–	2,255
– other	1,693	644	10	8	–	–	2,355
	2,376	2,138	84	8	4	–	4,610

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

	Bank						
	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2007							
Items in the course of collection from other banks	6,091	–	–	–	–	–	6,091
Trading assets:							
– treasury and eligible bills*	5,645	–	–	–	–	–	5,645
– debt securities*	3,083	147	–	–	–	–	3,230
– loans and advances to banks	–	22	–	–	–	–	22
– loans and advances to customers	–	5	–	–	–	–	5
	8,728	174	–	–	–	–	8,902
Financial assets designated at fair value:							
– treasury and eligible bills*	–	–	–	–	–	–	–
– debt securities*	1,238	–	–	–	–	–	1,238
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	1,238	–	–	–	–	–	1,238
Derivatives	3,536	873	2	–	–	–	4,411
Loans and advances held at amortised cost:							
– loans and advances to banks	90,052	6,329	–	–	–	–	96,381
– loans and advances to customers	159,505	86,495	4,923	4,680	766	(956)	255,413
	249,557	92,824	4,923	4,680	766	(956)	351,794
Financial investments:							
– treasury and similar bills	3,089	–	–	–	–	–	3,089
– debt securities	156,656	12,362	–	–	–	–	169,018
	159,745	12,362	–	–	–	–	172,107
Other assets:							
– acceptances and endorsements	1,011	1,822	97	–	–	–	2,930
– other	3,140	757	10	12	–	–	3,919
	4,151	2,579	107	12	–	–	6,849

* Impairment is not measured for debt securities held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the profit and loss statement. Consequently, all such balances are reported under "neither past due nor impaired".

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Aging analysis of financial instruments which were past due but not impaired

Examples of exposures designated past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment; loans fully secured by cash collateral; residential mortgages in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

	Group					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2008						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers*	5,224	1,141	408	32	32	6,837
	5,224	1,141	408	32	32	6,837
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	8	2	1	–	–	11
	8	2	1	–	–	11

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

	Group					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2007						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers*	4,884	459	865	80	31	6,319
	4,884	459	865	80	31	6,319
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	9	2	1	–	–	12
	9	2	1	–	–	12

62. FINANCIAL RISK MANAGEMENT (continued)
(a) Credit risk (continued)
(ii) Credit quality (continued)

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2008						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers*	3,843	648	173	28	29	4,721
	3,843	648	173	28	29	4,721
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	7	1	–	–	–	8
	7	1	–	–	–	8

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2007						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers*	3,991	437	203	18	31	4,680
	3,991	437	203	18	31	4,680
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	9	2	1	–	–	12
	9	2	1	–	–	12

* Impaired loans and advances.

Special attention is paid to problem loans and appropriate action is initiated to protect the Group's position on a timely basis and to ensure that loan impairment methodologies result in losses being recognised when they are incurred.

The Group's policy for recognising and measuring impairment allowances on both individually assessed advances and those which are collectively assessed on a portfolio basis is described in note 4(f) to the financial statements.

Analyses of impairment allowances at 31 December 2008 and the movement of such allowances during the year are disclosed in note 35.

62. FINANCIAL RISK MANAGEMENT (continued)
(a) Credit risk (continued)
(ii) Credit quality (continued)

Other than gross loans and advances, no financial assets was past due but not impaired at the balance sheet dates of 2008 and 2007.

Renegotiated loans that would otherwise be past due or impaired

	Group		Bank	
	2008	2007	**2008**	2007
Renegotiated loans that would otherwise be past due or impaired	**296**	247	**228**	158

(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	
	2008	2007	**2008**	2007
Nature of assets:				
Residential properties	**115**	198	**103**	114
Commercial and industrial properties	**14**	–	**14**	–
Other	**1**	–	**1**	–
	130	198	**118**	114

(b) Liquidity risk
Liquidity relates to the ability of a company to meet its obligations as they fall due. The Group maintains a stable and diversified funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets. The objective of the Group's liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due.

Management of liquidity is carried out both at Group and Bank level as well as in individual branches and subsidiaries. The Group requires branches and subsidiaries to maintain a strong liquidity position and to manage the liquidity structure of their assets, liabilities and commitments so that cash flows are approximately balanced and all funding obligations are met when due.

It is the responsibility of the Group's management to ensure compliance with local regulatory requirements and limits set by Executive Committee. Liquidity is managed on a daily basis by the Bank's treasury functions and overseas treasury sites.

62. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (continued)

Compliance with liquidity requirements is monitored by the Asset and Liability Management Committee ("ALCO") and is reported to the Risk Management Committee, Executive Committee and the Board of Directors. This process includes:

- projecting cash flows and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- monitoring of depositor concentration contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systematic or other crises, while minimising adverse long-term implications for the business.

Current accounts and savings deposits payable on demand or at short notice form a significant part of the Group's overall funding. The Group places considerable importance on the stability of these deposits, which is achieved through the Group's retail banking activities and by maintaining depositor confidence in the Group's capital strength. Professional markets are accessed for the purposes of providing additional funding, maintaining a presence in local money markets and optimising asset and liability maturities. Although the contractual repayments of many customer accounts are on demand or short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.

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

	Group	
	2008	2007
The Bank and its subsidiaries designated by the HKMA	**46.4%**	52.9%

The following tables give the undiscounted 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.

62. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (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	Total
At 31 December 2008						
Current, savings and other deposit accounts	359,235	188,640	14,338	817	348	563,378
Deposits from banks	5,712	5,578	299	–	–	11,589
Financial liabilities designated at fair value	3	10	31	1,021	410	1,475
Derivative financial instruments	–	37	(46)	248	52	291
Certificates of deposit and other debt securities in issue	–	337	1,154	1,443	–	2,934
Other financial liabilities	4,254	2,616	2,796	58	117	9,841
Subordinated liabilities	–	91	272	9,960	–	10,323
	369,204	197,309	18,844	13,547	927	599,831
Commitments:						
Documentary credits and short term related transactions	270	2,731	939	6	10	3,956
Forward asset purchases	253	16	43	–	–	312
Undrawn formal standby facilities, credit lines and other commitments to lend	2,759	29,340	11,224	154,772	–	198,095
	3,282	32,087	12,206	154,778	10	202,363
At 31 December 2007						
Current, savings and other deposit accounts	312,458	221,304	13,320	1,012	359	548,453
Deposits from banks	1,793	15,741	2,395	–	–	19,929
Financial liabilities designated at fair value	41	10	31	1,062	468	1,612
Derivative financial instruments	–	116	(2)	73	17	204
Certificates of deposit and other debt securities in issue	–	85	3,023	2,996	–	6,104
Other financial liabilities	8,003	5,576	1,261	42	99	14,981
Subordinated liabilities	–	122	366	10,607	–	11,095
	322,295	242,954	20,394	15,792	943	602,378
Commitments:						
Documentary credits and short term related transactions	484	4,863	1,432	17	15	6,811
Forward asset purchases	231	110	5	–	–	346
Undrawn formal standby facilities, credit lines and other commitments to lend	2,863	39,643	29,329	127,957	–	199,792
	3,578	44,616	30,766	127,974	15	206,949

62. 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	Total
At 31 December 2008						
Current, savings and other deposit accounts	354,343	182,448	11,096	123	348	548,358
Deposits from banks	5,711	2,560	–	–	–	8,271
Financial liabilities designated at fair value	–	10	31	1,021	–	1,062
Derivative financial instruments	–	38	(48)	245	52	287
Certificates of deposit and other debt securities in issue	–	337	1,154	1,443	–	2,934
Amounts due to subsidiaries	3,532	5,044	–	–	–	8,576
Other financial liabilities	4,159	2,071	2,398	2	910	9,540
Subordinated liabilities	–	91	272	9,960	–	10,323
	367,745	192,599	14,903	12,794	1,310	589,351
Commitments:						
Documentary credits and short term related transactions	265	2,619	933	6	10	3,833
Forward asset purchases	–	16	43	–	–	59
Undrawn formal standby facilities, credit lines and other commitments to lend	–	28,067	6,777	153,841	–	188,685
	265	30,702	7,753	153,847	10	192,577
At 31 December 2007						
Current, savings and other deposit accounts	307,976	214,085	11,842	638	359	534,900
Deposits from banks	1,502	10,401	300	–	–	12,203
Financial liabilities designated at fair value	–	10	31	1,062	–	1,103
Derivative financial instruments	–	47	3	72	17	139
Certificates of deposit and other debt securities in issue	–	1,598	3,039	2,996	–	7,633
Amounts due to subsidiaries	3,147	2,220	–	–	–	5,367
Other financial liabilities	7,918	6,077	1,146	2	–	15,143
Subordinated liabilities	–	122	366	10,607	–	11,095
	320,543	234,560	16,727	15,377	376	587,583
Commitments:						
Documentary credits and short term related transactions	423	4,274	1,432	17	15	6,161
Forward asset purchases	–	110	5	–	–	115
Undrawn formal standby facilities, credit lines and other commitments to lend	1,375	35,849	24,763	126,350	–	188,337
	1,798	40,233	26,200	126,367	15	194,613

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk

Market risk is the risk that foreign exchange rates, interest rates, equity and commodity prices and indices will move and result in profits or losses for the Group. The objective of the Group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the Group's status as a premier provider of financial products and services.

The Group separates exposures to market risk into either trading or non-trading portfolios. Trading portfolios include those positions arising from market-making, proprietary position-taking and other marked-to-market positions with trading intent. Non-trading portfolios primarily arise from the effective interest rate management of the Group's retail and commercial banking assets and liabilities.

The management of market risk is principally undertaken in Treasury using risk limits approved by the Risk Management Committee. Limits are set for each portfolio, product and risk type, with market liquidity being a principal factor in determining the level of limits set. The Group has dedicated standards, policies and procedures in place to control and monitor the market risk. An independent market risk control function is responsible for measuring market risk exposures, monitoring and reporting these exposures against the prescribed limits on a daily basis. The market risks which arise on each business are assessed and transferred to either Treasury for management, or to separate books managed under the supervision of ALCO.

Value at risk ("VAR")

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR. 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. Historical simulation uses scenarios derived from historical market rates and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The assumed holding period is a 1-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

VAR is calculated daily. The Group validates the accuracy of its VAR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the Group would expect to see losses in excess of VAR only one per cent of the time over a 1-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

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

– the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;

– the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and

– VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

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

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 2008 and 2007 are shown in the table below.

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

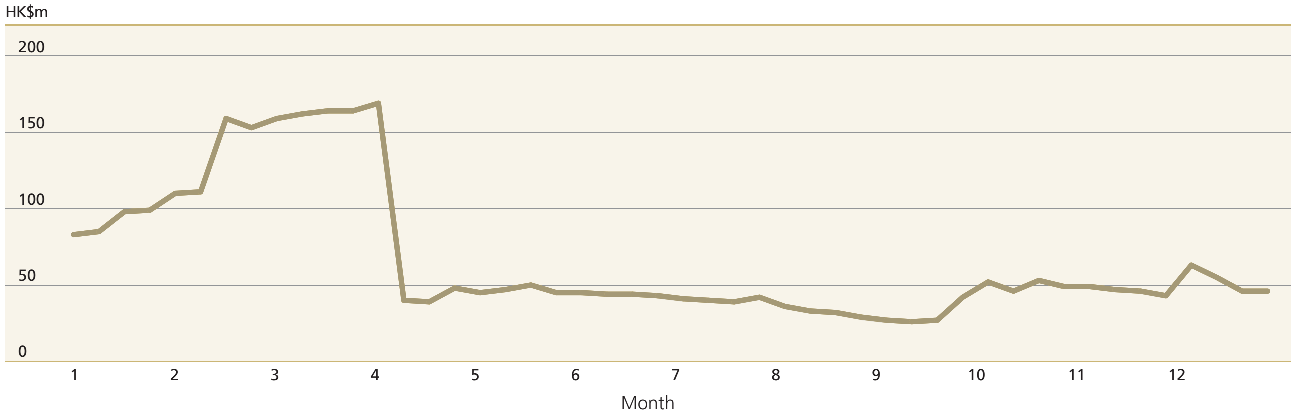
Value at risk (continued)

	At 31 December 2008	**Minimum during the year**	**Maximum during the year**	**Average for the year**
VAR for all interest rate risk and foreign exchange risk	46	24	169	65
VAR for foreign exchange risk (trading)	10	2	13	6
VAR for interest rate risk:				
– trading	8	1	12	4
– non-trading	46	24	163	63

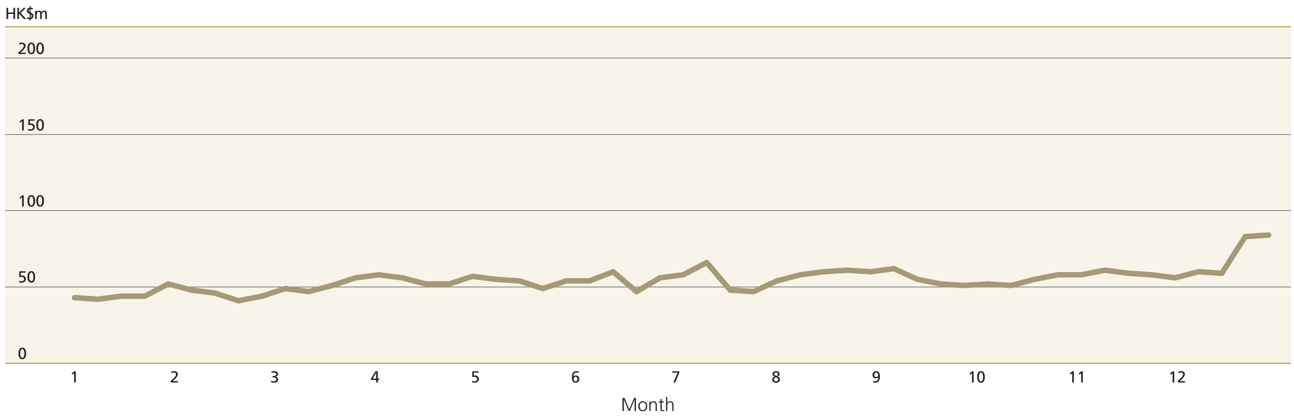
	At 31 December 2007 *(restated)*	Minimum during the year *(restated)*	Maximum during the year *(restated)*	Average for the year *(restated)*
VAR for all interest rate risk and foreign exchange risk	86	39	86	54
VAR for foreign exchange risk (trading)	6	1	15	6
VAR for interest rate risk:				
– trading	2	2	9	5
– non-trading	86	39	87	57

The definition of trading VAR and interest rate trading VAR has been amended to apply trading intent VAR (excluding trading in accrual position). Therefore, the 2007 figures have been amended to reflect this.

Value at Risk for 2008



Value at Risk for 2007



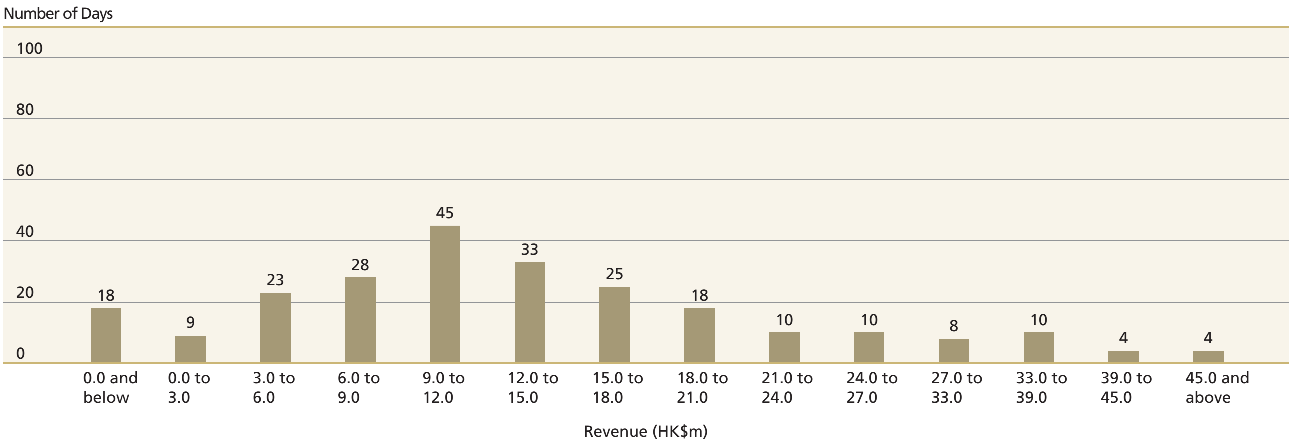
62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

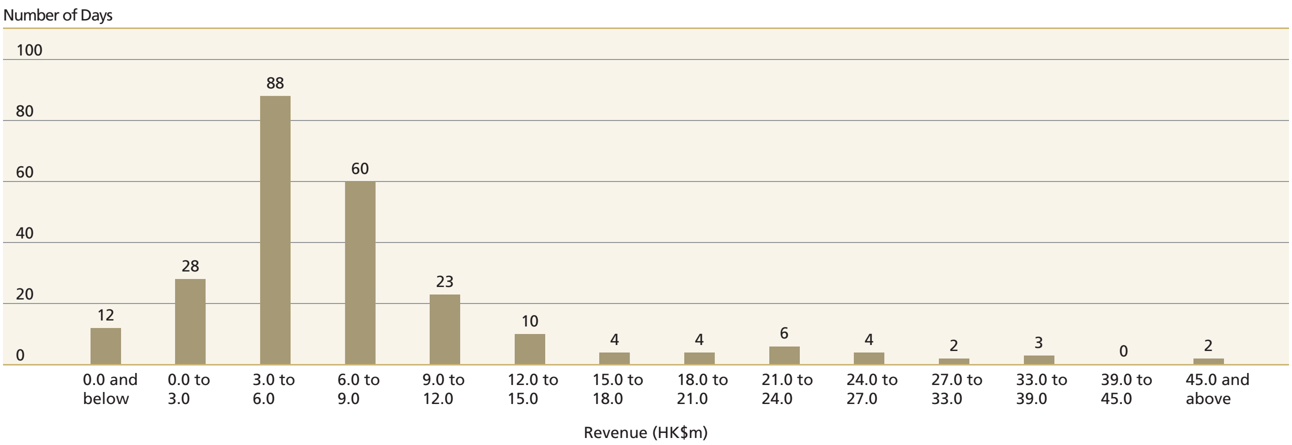
The average daily revenue earned from market risk-related treasury activities in 2008, including non-trading book net interest income and funding related to trading positions, was HK$14 million (2007: HK$8 million). The standard deviation of these daily revenues was HK$11 million, compared with HK$8 million for 2007.

An analysis of the frequency distribution of daily revenue shows that out of 245 trading days in 2008, losses were recorded on 18 days (2007: 12 days) and the maximum daily loss was HK$25 million (2007: HK$13 million). The most frequent result was a daily revenue of between HK$3 million and HK$15 million, with 129 occurrences (2007: 181 occurrences). The highest daily revenue was HK$52 million (2007: HK$63 million).

Daily Distribution of Market Risk Revenues for 2008



Daily Distribution of Market Risk Revenues for 2007



62. FINANCIAL RISK MANAGEMENT (continued)

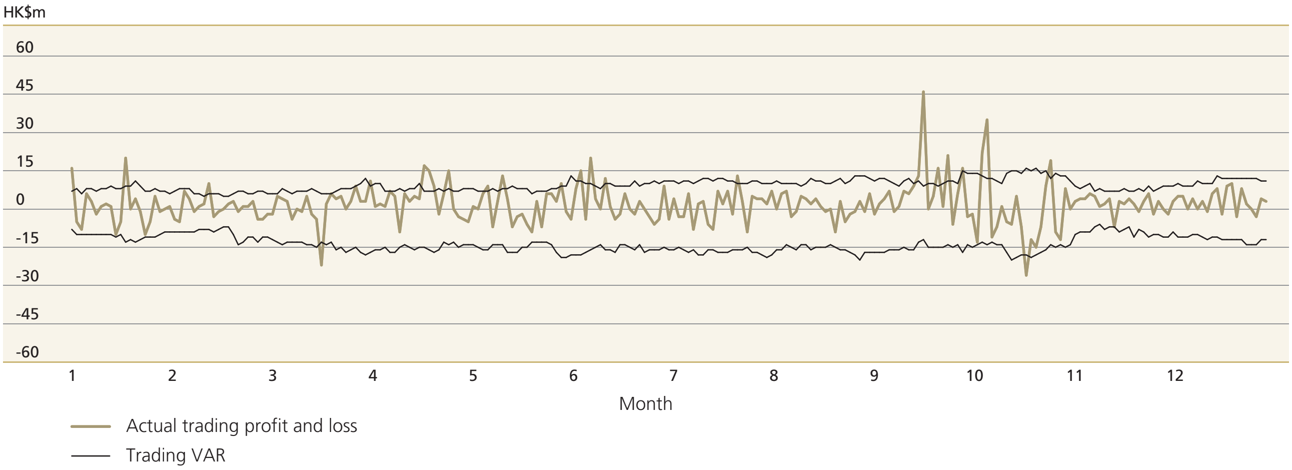
(c) Market risk (continued)

Back-testing of the interest rate and foreign exchange model uses cleaned profits and losses from trading operations and compares these to overall, foreign exchange and interest rate level VAR on a daily basis.

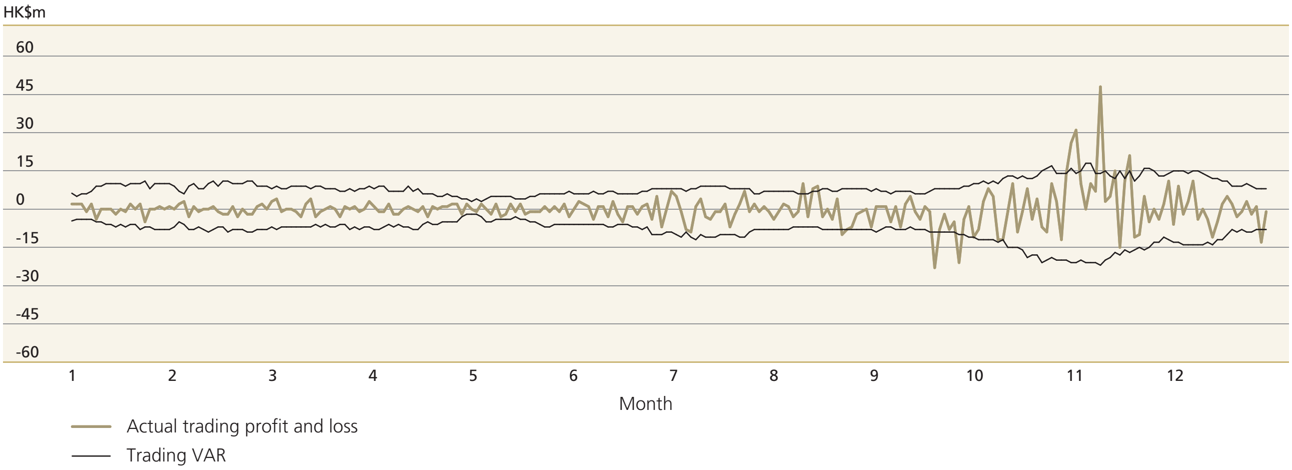
The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2008 and 2007 are shown in the table below. The exceptions of the back-testing mainly resulting from unanticipated market movement.

A Comparison of Trading VAR with Actual Trading Profit and Loss for 2008



A Comparison of Trading VAR with Actual Trading Profit and Loss for 2007



62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios which include structural interest rate exposures. Treasury manages interest rate risks within the limits approved by the Risk Management Committee and under the monitoring of 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 Risk Management Committee, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Structural interest rate risk 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-in yield curves at the beginning of year from 1 January 2009 and 25 basis points parallel fall or rise in all-in yield curves at the beginning of each quarter during the 12 month period from 1 January 2009.

Assuming no management actions, such a series of incremental parallel rises in all-in yield curves would increase planned net interest income for the year to 31 December 2009 by HK$533 million for 100 basis points case and by HK$170 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK$1,181 million for 100 basis points case and by HK$668 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.

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Projected Net Interest Income

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

	100bp parallel increase	100bp parallel decrease	25bp increase at the beginning of each quarter	25bp decrease at the beginning of each quarter
Change in 2009 projected net interest income				
– HKD	147	(1,012)	2	(677)
– USD	276	(58)	138	39
– other	110	(111)	30	(30)
Total	533	(1,181)	170	(668)
Change in 2008 projected net interest income				
– HKD	84	78	(12)	99
– USD	151	227	75	155
– other	153	(154)	79	(79)
Total	388	151	142	175

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-in 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 2008	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(725)	(1,053)	(725)
As a percentage of shareholders' funds at 31 December 2008 (%)	(1.4)	(2.0)	(1.4)
– 100 basis points parallel move in all-in yield curves	725	1,053	725
As a percentage of shareholders' funds at 31 December 2008 (%)	1.4	2.0	1.4

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Sensitivity of reserves (continued)

	At 31 December 2007	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(1,141)	(1,465)	(1,141)
As a percentage of shareholders' funds at 31 December 2007 (%)	(2.0)	(2.6)	(2.0)
– 100 basis points parallel move in all-in yield curves	1,141	1,465	1,141
As a percentage of shareholders' funds at 31 December 2007 (%)	2.0	2.6	2.0

The sensitivities included in the table are illustrative only and are based on simplified scenarios. Moreover, the table shows only those interest rate risk exposures arising in available-for-sale portfolios and from cash flow hedges. These particular exposures form only a part of the Group's overall interest rate exposures.

Foreign exchange exposure

The Group's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the Board of Directors. Net option position is calculated on the basis of delta-weighted positions of all foreign exchange options contract. Structural foreign exchange positions arising from capital investments in associate, subsidiaries and branches outside Hong Kong, mainly in US dollar and Chinese renminbi as set out below, are managed by ALCO.

The tables below summarise the net structural and non-structural foreign currency positions of the Group and the Bank.

	Group			
	USD	**RMB**	**Other foreign currencies**	**Total foreign currencies**
2008				
Non-structural position				
Spot assets	**240,624**	**37,665**	**154,872**	**433,161**
Spot liabilities	**(200,971)**	**(37,568)**	**(89,134)**	**(327,673)**
Forward purchases	**269,935**	**26,549**	**44,434**	**340,918**
Forward sales	**(303,047)**	**(27,082)**	**(110,258)**	**(440,387)**
Net options position	**(1)**	**–**	**2**	**1**
Net long/(short) non-structural position	**6,540**	**(436)**	**(84)**	**6,020**
Structural position	**285**	**13,343**	**202**	**13,830**
2007				
Non-structural position				
Spot assets	227,698	26,160	118,436	372,294
Spot liabilities	(184,258)	(26,149)	(101,406)	(311,813)
Forward purchases	298,806	26,549	21,023	346,378
Forward sales	(335,592)	(28,330)	(38,084)	(402,006)
Net options position	32	–	(32)	–
Net long/(short) non-structural position	6,686	(1,770)	(63)	4,853
Structural position	286	10,752	187	11,225

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Foreign exchange exposure (continued)

	Bank			
	USD	RMB	Other foreign currencies	Total foreign currencies
2008				
Non-structural position				
Spot assets	202,503	13,718	125,155	341,376
Spot liabilities	(164,750)	(12,320)	(59,144)	(236,214)
Forward purchases	266,721	23,991	43,605	334,317
Forward sales	(300,209)	(23,931)	(109,700)	(433,840)
Net options position	(1)	–	2	1
Net long/(short) non-structural position	4,264	1,458	(82)	5,640
Structural position	285	13,343	202	13,830
2007				
Non-structural position				
Spot assets	184,703	7,740	76,200	268,643
Spot liabilities	(142,145)	(6,988)	(59,167)	(208,300)
Forward purchases	293,360	23,098	21,021	337,479
Forward sales	(332,143)	(22,935)	(38,081)	(393,159)
Net options position	32	–	(32)	–
Net long/(short) non-structural position	3,807	915	(59)	4,663
Structural position	286	10,752	187	11,225

Equities exposure

The Group's equities exposures in 2008 and 2007 are mainly in long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk

Risk management objectives and policies for management of insurance risk

Through its insurance subsidiaries, the Group offers comprehensive insurance products, including life and non-life insurance, to both personal and commercial customers. These insurance operating subsidiaries are subject to the supervision of the Office of the Commissioner of Insurance ("OCI") and are required to observe the relevant compliance requirements stipulated by the Insurance Commissioner.

The Group is exposed to the uncertainty surrounding the timing and severity of insurance claims under its insurance contracts. The Group also has exposure to market risk through its insurance and investment contracts.

The Group manages its insurance risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues.

The Group uses several methods to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. The principal risk is that the frequency and severity of claims is greater than expected. Insurance events are, by their nature, random, and the actual number of events during any one year may vary from those estimated using established statistical techniques.

Asset/liability management

The Group actively manages its assets using an approach that considers asset quality, diversification, asset/liability matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Market and Liquidity Risk Committee of the Group's insurance subsidiaries review and approve target portfolios on a periodic basis, establishes investment guidelines and limits, and provides oversight of the asset/liability management process.

The Group establishes target asset portfolios for each major insurance product category according to local regulatory requirements. The investment strategy and asset allocations consider yield, duration, sensitivity, market risk, volatility, liquidity, asset concentration, foreign exchange and credit quality. The estimates and assumptions used in determining the approximate amounts and timing of payments to or on behalf of policyholders for insurance liabilities are regularly re-evaluated. Many of these estimates and assumptions are inherently subjective and could impact the Group's ability to achieve its asset/liability management goals and objectives.

The following table shows the composition of assets and liabilities for each major insurance product category.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Balance sheet of insurance subsidiaries by type of contract

	Life linked contracts[1]	Life non-linked contracts[2]	Non-life insurance[3]	Other assets[4]	Total
2008					
Financial assets:					
– financial assets designated at fair value	144	6,064	–	757	6,965
– derivatives	–	–	–	–	–
– financial investments	–	34,646	–	1,829	36,475
– other financial assets	136	2,448	491	734	3,809
Total financial assets	280	43,158	491	3,320	47,249
Reinsurance assets	–	16	49	22	87
PVIF[5]	–	–	–	2,707	2,707
Other assets	–	468	8	404	880
Total assets	280	43,642	548	6,453	50,923
Liabilities under investment contracts designated at fair value	85	328	–	–	413
Liabilities under insurance contracts	191	43,214	430	–	43,835
Deferred tax	–	–	–	375	375
Other liabilities	–	–	–	313	313
Total liabilities	276	43,542	430	688	44,936
Shareholders' equity	–	–	–	5,987	5,987
Total liabilities and shareholders' equity	276	43,542	430	6,675	50,923
2007					
Financial assets:					
– financial assets designated at fair value	203	12,375	–	74	12,652
– derivatives	–	12	–	–	12
– financial investments	–	17,694	–	1,815	19,509
– other financial assets	159	3,380	473	1,005	5,017
Total financial assets	362	33,461	473	2,894	37,190
Reinsurance assets	–	10	40	23	73
PVIF[5]	–	–	–	2,325	2,325
Other assets	–	235	11	44	290
Total assets	362	33,706	524	5,286	39,878
Liabilities under investment contracts designated at fair value	125	384	–	–	509
Liabilities under insurance contracts	235	32,524	408	–	33,167
Deferred tax	–	–	–	414	414
Other liabilities	–	–	–	321	321
Total liabilities	360	32,908	408	735	34,411
Shareholders' equity	–	–	–	5,467	5,467
Total liabilities and shareholders' equity	360	32,908	408	6,202	39,878

1 Comprises life linked insurance contracts and linked investment contracts

2 Comprises life non-linked insurance contracts and non-linked investment contracts

3 Comprises non-life insurance contracts

4 Comprises shareholder assets

5 Present value of in-force long-term insurance contracts

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Underwriting strategy

The Group's underwriting strategy seeks diversity to ensure a balanced portfolio and is based on a large portfolio of similar risks over a number of years and, as such, it is believed that this reduces the variability of the outcome.

Reinsurance strategy

The Group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The Group uses non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

Ceded reinsurance contains credit risk, and to minimise such risk, only those reinsurers meeting the Group's credit rating standard, either assessed from public rating information or from internal investigations, will be used.

Nature of risks covered

The following gives an assessment of the nature of risks inherent in the Group's main products.

(i) Insurance contracts – non-linked products

The basic feature of long-term non-linked insurance business is to provide guaranteed death benefit determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender benefit, guaranteed maturity benefit, crediting rate guarantees and/or non-lapse guarantee features are usually provided. Discretionary participating features allow policyholders to participate in the profits of the life fund by means of annual bonus. The Group has complete contractual discretion on the bonuses declared. It is the Group's goal to maintain a smooth dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable.

(ii) Insurance contracts – unit-linked products

The Group writes unit-linked life insurance policies, which typically provide policyholders with life insurance protection and investment in a variety of funds. Premiums received are deposited into the chosen funds after deduction of premium fees. Other charges for the cost of insurance and administration are deducted from the funds accumulated.

(iii) Investment contracts – non-linked return guaranteed products

The Group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the Group provides an investment return guarantees for some specific funds. The guarantee risks are managed through investment in good quality fixed rate bonds. Investment strategy is set with the objective of providing return that is sufficient to meet at least the minimum guarantee.

(iv) Investment contracts – unit-linked products

The Group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the Group does not bear investment risk for most of the funds. Although scheme members bear the market risk on the funds, the Group must manage the scheme members' exposure to market risk in a manner consistent with any parameters set out in the policy documents.

(v) Non-life insurance contracts

The Group assumes the risk of loss from persons and organisations that are directly subject to the risk. Such risk may relate to property, liability, life, accident, health, financial or other perils that may arise from an insurable event. The Group manages the risks through underwriting limits, approval procedures for transactions that involve new products or that exceed set authority limits, risk diversification, underwriting guidelines, reinsurance and centralised management of reinsurance and monitoring of emerging issues. The Group also assesses and monitors insurance risk exposures both for individual types of risks insured and overall risks.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Concentration of insurance risks

Within the insurance process, concentrations of risk may arise where a particular event or series of events could impact heavily upon the Group's liabilities. Such concentrations may arise from a single insurance contract or through a small number of related contracts, and relate to circumstances where significant liabilities could arise.

The Group is subject to concentration risk arising from accidents relating to common carriers, conflagration, epidemics, earthquakes and other natural disasters that affect the properties, physical conditions and lives of the policyholders insured by the Group. To mitigate these risks, excess of loss and catastrophe reinsurance arrangements have been made by the Group.

For contracts where death is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics (such as AIDS, SARS or a human form of avian flu) or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected. For contracts where survival is the insured risk, the most significant factor is improvement in medical science and social conditions that would increase longevity. The policyholders of the insurance contracts issued by the Group are mainly residents of Hong Kong.

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the Group. Total loss is estimated based on the chosen stress level. Details of the Group's reinsurance strategy are disclosed in the above.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities are therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. Details of the analysis of life insurance liabilities are disclosed in note 49. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

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

	2008	2007
Accident and health	**120**	97
Fire and other damage	**183**	174
Motor	**29**	31
Liability	**52**	52
Marine, aviation and transport	**44**	43
Other (non-life)	**6**	4
	434	401

Financial risks

The Group's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk. Each of these financial risks is described below, together with a summary of the ways in which the Group manages these risks arising from underwriting insurance business.

The Group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders for its long-term insurance business. The risk is that the yield on the assets held by the Group to meet these guarantees may fall short of the guaranteed return. The framework for the management of this risk is to adopt a matching approach whereby assets held are managed to meet the liability to policyholders. An additional provision is established where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

The following table analyses the assets held in the Group's insurance underwriting subsidiaries at 31 December 2008 by type of liability, and provides a view of the exposure to financial risk:

Financial assets held by insurance operations

	Group				
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2008					
Financial assets designated at fair value:					
– debt securities	–	5,847	–	757	6,604
– equity securities	144	217	–	–	361
	144	6,064	–	757	6,965
Financial investments					
Held-to-maturity:					
– debt securities	–	34,646	–	1,559	36,205
	–	34,646	–	1,559	36,205
Available-for-sale:					
– debt securities	–	–	–	266	266
– equity securities	–	–	–	4	4
	–	–	–	270	270
Derivatives	–	–	–	–	–
Other financial assets	136	2,448	491	734	3,809
	280	43,158	491	3,320	47,249
2007					
Financial assets designated at fair value:					
– debt securities	–	6,597	–	74	6,671
– equity securities	203	5,778	–	–	5,981
	203	12,375	–	74	12,652
Financial investments					
Held-to-maturity:					
– debt securities	–	17,694	–	1,302	18,996
	–	17,694	–	1,302	18,996
Available-for-sale:					
– debt securities	–	–	–	255	255
– equity securities	–	–	–	258	258
	–	–	–	513	513
Derivatives	–	12	–	–	12
Other financial assets	159	3,380	473	1,005	5,017
	362	33,461	473	2,894	37,190

The table demonstrates that for linked contracts, the Group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 0.6% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2008 (2007: 1.0%). The table also shows that approximately 91.2% of financial assets was invested in debt securities at 31 December 2008 (2007: 69.7%) with 0.8% (2007: 16.8%) invested in equity securities.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Market risk

Market risk can be described as the risk of change in fair value of a financial instrument due to change in interest rate, equity prices and foreign currency rates. Each of these categories is discussed further below.

Interest rate risk

The Group's exposure to interest rate risk arises mainly from its debt securities holdings. The held-to-maturity strategy accounts for a significant portion of the debt securities holdings and which is managed to match expected liability payments. The Group monitors this exposure through periodic reviews of its asset and liability positions. Estimates of cash flows, as well as the impact of interest rate fluctuations relating to the investment portfolio and insurance reserves, are modelled and reviewed regularly. The overall objective of these strategies is to limit the net changes in the value of assets and liabilities arising from interest rate movements.

For participating products, interest rate risk related to non-linked policies can also be mitigated through sharing of risk with policyholders under the discretionary participation feature.

An immediate and permanent movement in interest yield curves as at 31 December 2008 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	2008		2007	
	Impact on profit for the year	**Impact on net assets**	Impact on profit for the year	Impact on net assets
+ 100 basis points shift in yield curves	**210**	**208**	319	313
– 100 basis points shift in yield curves	**(139)**	**(136)**	(361)	(355)

The interest rate sensitivities set out above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The sensitivities do not incorporate actions that could be taken by management to mitigate the effect of the interest rate movements, nor do they take account of any resultant changes in policyholder behaviour.

Equity risk

The portfolio of marketable equity securities, which the Group carries on the balance sheet at fair value, has exposure to price risk. This risk is defined as the potential loss in market value resulting from an adverse change in prices. The risk is mainly mitigated through dynamic asset allocation and sharing the risk with policyholders through the discretionary participation feature. The Group's objective is to earn competitive relative returns by investing in a diversified portfolio of high quality, liquid securities. Portfolio characteristics are analysed regularly and equity price risk is regularly reviewed . The Group's investment portfolios are diversified across industries, and concentrations in any one company or industry are limited by parameters established by senior management, as well as by statutory requirements.

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

	2008		2007	
	Impact on profit for the year	**Impact on net assets**	Impact on profit for the year	Impact on net assets
10 per cent increase in equity prices	**18**	**18**	475	500
10 per cent decrease in equity prices	**(18)**	**(18)**	(475)	(500)

The substantial decrease in the impact to profit and net assets for 2008 was driven by the Group's reduced equity exposures for non-linked contracts.

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. They do not allow for the effect of management actions which may mitigate the equity price decline, nor for any resultant changes, such as in policyholder behaviour, that might accompany such a fall.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Foreign currency risk

Substantial amounts of the assets and liabilities are denominated in two main currencies, United States dollar and Hong Kong dollar. The Group adopts a policy of predominately matching the assets with liabilities in the same currency, effectively reducing the foreign currency exchange rate exposure. Limits are set to ensure that the net foreign currency exposure is kept to an acceptable level. The Group uses forward exchange contracts and swaps to manage its foreign currency risk.

Credit risk

The Group's portfolio of fixed income securities, and to a lesser extent short-term and other investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The Group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place. Limits are established to manage credit quality and concentration risk. The following table presents the analysis of treasury bills, other eligible bills and debt securities within the Group's insurance.

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

	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong	Medium	Sub-standard				
2008							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	5,605	242	–	–	–	–	5,847
	5,605	242	–	–	–	–	5,847
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	34,604	42	–	–	–	–	34,646
	34,604	42	–	–	–	–	34,646
Supporting shareholders funds							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	757	–	–	–	–	–	757
	757	–	–	–	–	–	757
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	1,824	1	–	–	–	–	1,825
	1,824	1	–	–	–	–	1,825
Total							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	6,362	242	–	–	–	–	6,604
	6,362	242	–	–	–	–	6,604
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	36,428	43	–	–	–	–	36,471
	36,428	43	–	–	–	–	36,471

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2007							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	6,407	190	–	–	–	–	6,597
	6,407	190	–	–	–	–	6,597
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	17,165	529	–	–	–	–	17,694
	17,165	529	–	–	–	–	17,694
Supporting shareholders funds							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	74	–	–	–	–	–	74
	74	–	–	–	–	–	74
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	1,462	95	–	–	–	–	1,557
	1,462	95	–	–	–	–	1,557
Total							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	6,481	190	–	–	–	–	6,671
	6,481	190	–	–	–	–	6,671
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	18,627	624	–	–	–	–	19,251
	18,627	624	–	–	–	–	19,251

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

The Group also has insurance and other receivable amounts subject to credit risk. The most significant of these are reinsurance recoveries. To mitigate the risk of the counterparties not paying the amounts due, the Group has established certain business and financial guidelines for reinsurer approval, incorporating ratings by major agencies and considering currently available market information. The Group also periodically reviews the financial stability of reinsurers and the settlement trend of amount due from reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries was as follows:

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2008							
Linked insurance contracts	–	–	–	–	–	–	–
Non-linked insurance contracts	63	2	–	–	–	–	65
Total	63	2	–	–	–	–	65
Reinsurance Debtors	8	1	–	12	–	–	21
2007							
Linked insurance contracts	–	–	–	–	–	–	–
Non-linked insurance contracts	49	1	–	–	–	–	50
Total	49	1	–	–	–	–	50
Reinsurance Debtors	14	2	–	7	–	–	23

Liquidity risk

The Group has to meet daily calls on its cash resources, notably from claims arising on its insurance and investment contracts and early surrender of policies for surrender value. There is therefore a risk that cash will not be available to settle liabilities when due at a reasonable cost. The Group manages this risk by monitoring and setting an appropriate level of operating funds to settle these liabilities. Investment portfolios are also structured with regard to the liquidity requirement of each underlying fund, and early surrender penalties and market adjustment clauses are used to defray costs of unexpected cash requirements.

The following table shows the expected maturity of insurance contract liabilities at 31 December 2008:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year	1-5 years	5-15 years	Over 15 years	Total
2008					
Non-life insurance	258	147	25	–	430
Life insurance (non-linked)	3,352	21,382	52,519	26,818	104,071
Life insurance (linked)	27	234	332	1,059	1,652
	3,637	21,763	52,876	27,877	106,153
2007					
Non-life insurance	246	137	25	–	408
Life insurance (non-linked)	2,291	14,897	47,796	21,167	86,151
Life insurance (linked)	30	258	334	979	1,601
	2,567	15,292	48,155	22,146	88,160

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			
	Linked investment contracts	Non-linked investment contracts	Investment contracts with DPF	Total
2008				
Remaining contractual maturity:				
– due within 1 year	2	1	–	3
– due between 1 and 5 years	–	–	–	–
– due between 5 and 10 years	–	–	–	–
– due after 10 years	83	327	–	410
– undated	–	–	–	–
	85	328	–	413
2007				
Remaining contractual maturity:				
– due within 1 year	2	38	–	40
– due between 1 and 5 years	–	–	–	–
– due between 5 and 10 years	–	–	–	–
– due after 10 years	123	346	–	469
– undated	–	–	–	–
	125	384	–	509

Present value of in-force long-term insurance business ("PVIF")

The Group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2008 was HK$2,707 million (2007: HK$2,324 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2008 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF as at 31 December 2008 of reasonably possible changes in the main economic and business assumptions:

	2008	2007
+ 100 basis points shift in risk-free rate	504	696
– 100 basis points shift in risk-free rate	(331)	(760)
+ 100 basis points shift in risk discount rate	(153)	(104)
– 100 basis points shift in risk discount rate	172	116
+ 100 basis points shift in expenses inflation	(12)	(11)
– 100 basis points shift in expenses inflation	11	10
+ 100 basis points shift in lapse rate	793	542
– 100 basis points shift in lapse rate	(771)	(573)

The effects on PVIF shown above are illustrative only and employ simplified scenarios. The effects are calculated with taking into account the sharing of investment returns with policyholders through the discretionary participation feature. Other than that, they do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Non-economic assumptions

The sensitivity of profit for the year and net assets to reasonably possible changes in assumptions used in respect of insurance businesses at 31 December 2008 is as follows:

	Impact on 2008 results		Impact on 2007 results	
	Profit for the year	**Net assets**	Profit for the year	Net assets
20 per cent increase in claims costs	**(26)**	**(26)**	(24)	(24)
20 per cent decrease in claims costs	**26**	**26**	24	24
10 per cent increase in mortality and/or morbidity rates	**(25)**	**(25)**	(34)	(34)
10 per cent decrease in mortality and/or morbidity rates	**26**	**26**	34	34
50 per cent increase in lapse rates	**505**	**505**	396	396
50 per cent decrease in lapse rates	**(516)**	**(516)**	(413)	(413)
10 per cent increase in expense rates	**(33)**	**(33)**	(26)	(26)
10 per cent decrease in expense rates	**33**	**33**	26	26

(e) Operational risk

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

The Group manages its operational risk through a controls-based environment in which the processes and controls are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by periodic independent review of the internal control systems by internal audit, and by monitoring external operational risk events, which ensure that the Group stays in line with industry best practice and takes account of lessons learned from publicised operational failures within the financial services industry.

The Group has codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance. This explains how the Group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The standard covers the following:

– operational risk management responsibility is assigned to senior management within the business operation;

– information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;

– assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;

– operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the Group’s Audit Committee; and

– risk mitigation, including insurance is considered where this is cost-effective.

The Group maintains and tests contingency facilities to support operations in the event of disasters.

Additional reviews and tests are conducted in the event that any Group’s office is affected by a business disruption event, to incorporate lessons learned in the operational recovery from those circumstances. Plans have been prepared for the continued operation of the Group’s business, with reduced staffing levels, should a flu pandemic occur.

Operational risk is mitigated by adequate insurance coverage on assets and business losses. To reduce the impact and interruptions to business activities caused by system failure or natural disaster, back-up systems and contingency business resumption plans are in place for all business and critical operations functions. Operational risk management is coordinated by the Chief Operating Officer and monitored by the Operational Risk Management Committee.

62. FINANCIAL RISK MANAGEMENT (continued)

(f) Capital management

The Group's objective for managing capital is to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times. The Group recognises the impact on shareholder returns of the level of equity capital employed within the Group and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on equity possible with greater leverage.

An annual Group capital plan is prepared and approved by the Board with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The Group manages its own capital within the context of the approved annual Group capital plan, which determines levels of risk-weighted asset growth and the optimal amount and mix of capital required to support planned business growth. As part of the Group's capital management policy, subsidiary with capital generated in excess of planned requirement will return to the Bank, normally by way of dividends. The Group also raised its subordinated debt in accordance with HSBC Group's guidelines regarding market and investor concentration, cost, market conditions, timing and maturity profile.

The Bank is primarily a provider of equity capital to its subsidiaries. These investments are substantially funded by the Bank's own capital issuance and profit retentions. The Bank seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

The principal forms of capital are included in the following balances on the consolidated balance sheet: called up share capital, retained profits, other reserves and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances and the regulatory reserve.

Externally imposed capital requirements:

The Hong Kong Monetary Authority supervises the Group on a consolidated and solo-consolidated basis and, as such, receives information on the capital adequacy of, and set capital requirements for, the Group as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. Certain non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

The Basel Committee on Banking Supervision has published a new capital adequacy framework, known as "Basel II", for calculating minimum capital requirements. With effect from 1 January 2007, the Hong Kong Monetary Authority adopted Basel II as set out in the Banking (Capital) Rules made under the Banking Ordinances. The new Rules, which replace the Third Schedule to the Banking Ordinance, stipulate the calculation methodology for capital adequacy ratio. Basel II is structured around three "pillars": minimum capital requirements, supervisory review process and market discipline. The supervisory objectives for Basel II are to promote safety and soundness in the financial system and maintain at least the current overall level of capital in the system; enhance competitive equality; constitute a more comprehensive approach to addressing risks; and focus on internationally active bank.

With respect to Pillar One minimum capital requirements, Basel II provides three approaches, of increasing sophistication, to the calculation of credit risk regulatory capital. The most basic, the Standardised Approach, requires banks to use external credit ratings to determine risk weightings applied to rated counterparties, and groups other counterparties into broad categories and applies standardised risk weightings to these categories. In the next level, the Foundation Internal Ratings-based Approach, allows banks to calculate their credit risk regulatory capital requirement on the basis of their internal assessment of the probability that a counterparty will default ("PD"), but with quantification of exposure at default ("EAD") and loss given default estimates ("LGD") being subject to standard supervisory parameters. Finally, the Advanced Internal Ratings-based Approach, will allow banks to use their own internal assessment of not only the probability of default but also the quantification of exposure at default and loss given default.

Expected losses are calculated by multiplying EAD by PD and LGD. The capital resources requirement under the IRB approaches is intended to cover unexpected losses and is derived from a formula specified in the regulatory rules, which incorporates these factors and other variables such as maturity and correlation.

For credit risk, with the HKMA approval, the Group has adopted the Foundation Internal Ratings-based Approach for the majority of its business with effect from 1 January 2008, with the remainder on Standardised Approach. A rollout plan is in place to extend coverage of the IRB over the next three years, leaving a small residue of exposures on the Standardised Approach. The Group has also obtained approval from the Hong Kong Monetary Authority to adopt the Advanced Internal Ratings-based Approach to calculate the risk-weighted assets for credit risk effective 1 January 2009.

62. FINANCIAL RISK MANAGEMENT (continued)

(f) Capital management (continued)

Basel II also introduces capital requirements for operational risk and, again, contains three levels of sophistication. The capital required under the Basic Indicator Approach is a simple percentage of gross revenues, whereas under the Standardised Approach it is one of three different percentage of gross revenues allocated to each of eight defined business lines. Finally, the advanced measurement approach uses bank's own statistical analysis and modelling of operational risk data to determine capital requirements. The Group has adopted the Standardised Approach to the determination of operational risk capital requirements.

For market risk, the Group is required to use a variety of approaches to calculate its market risk capital requirement, including the internal model approach, the CAD1 model and the Standardised Approach for different risk categories.

Under Pillar Two, the Group has initiated its internal capital adequacy assessment process ("ICAAP") to comply with HKMA's requirement set out in the Supervisory Policy Manual "Supervisory Review Process". The Group will also align with HSBC Group guidance in setting up its ICAAP.

To comply with Pillar Three requirements which focuses on disclosure requirements and policies as prescribed by the Banking (Disclosure) Rules, the Group has formulated a disclosure policy which was approved by the Board with an aims of making relevant disclosures in accordance with the disclosure rules.

During the year, the Group complied with all of the externally imposed capital requirements by the Hong Kong Monetary Authority.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS

(a) Determination of fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial instruments measured at fair value on an ongoing basis include trading assets and liabilities, instruments designated at fair value, derivatives, and financial investments classified as available-for-sale (including treasury and other eligible bills, debt securities, and equity securities).

Control framework

Fair values are subject to a control framework that aims to ensure that they are either determined, or validated, by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with Finance. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) valuation models; (ii) any inputs to those models; and (iii) any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, independent price determination or validation is utilised.

Determination of fair value of financial instruments carried at fair value

Fair value are determined according to the following hierarchy:

(i) Quoted market price
Financial instruments with quoted prices for identical instruments in active markets.

(ii) Valuation technique using observable inputs
Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(iii) Valuation technique with significant non-observable inputs
Financial instruments valued using models where one or more significant inputs are not observable.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. For these instruments, the fair value derived is more judgemental. "Not observable" in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (historical data may, for example, be used).

Furthermore, the assessment of hierarchy level is based on the lowest level of input that is significant to the fair value of the financial instrument. Consequently, the level of uncertainty in the determination of the unobservable inputs will generally give rise to valuation uncertainty that is less than the fair value itself.

To assist in understanding the extent of this uncertainty, additional information is provided in respect of these instruments in the "Effect of changes in significant non-observable assumptions to reasonably possible alternatives" section below.

In certain circumstances, the Group applies the fair value option to its own debt in issue. Where available, the fair value will be based upon quoted prices in an active market for the specific instrument concerned. Where unavailable, the fair value will either be based upon quoted prices in an inactive market for the specific instrument concerned, or estimated by comparison with quoted prices in an active market for similar instruments. The fair value of these instruments therefore includes the effect of own credit spread. Gains and losses arising from changes in the credit spread of liabilities issued by Group reverse over the contractual life of the debt, provided that the debt is not repaid early.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the Group issues structured notes. These market spreads are significantly smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets.

All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer prices as appropriate. Long positions are marked at bid prices; short positions are marked at offer prices.

The fair values of large holdings of non-derivative financial instruments are based on a multiple of the value of a single instrument, and do not include block adjustments for the size of the holding.

The valuation models used where quoted market prices are not available incorporate certain assumptions that the Group anticipates would be used by a market participant to establish fair value. Where the Group believes that there are additional considerations not included within the valuation model, appropriate adjustments may be made. Examples of such adjustments are:

– Credit risk adjustment: an adjustment to reflect the credit worthiness of over-the-counter ("OTC") derivative counterparties.

– Inception profit ("day 1 P&L reserves"): for financial instruments valued at inception, on the basis of one or more significant unobservable inputs, the difference between transaction price and model value (as adjusted) at inception is not recognised in the consolidated income statement, but is deferred and any unamortised balance is included as part of the fair value.

  Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage fees and post-trade costs are included in operating expenses. The future costs of administering the OTC derivative portfolio are also not included in fair value, but are expensed as incurred.

– Debt securities, Treasury and eligible bills, and Equities

  These instruments are valued based on quoted market prices from an exchange, dealer, broker, industry group or pricing service, where available. Where unavailable, fair value is determined by reference to quoted market prices for similar instruments or, in the case of certain mortgage-backed securities and unquoted equities, valuation techniques using inputs derived from observable market data, and, where relevant, assumptions in respect of unobservable inputs.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

– Derivatives

Over-the-counter (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon "no-arbitrage" principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some discrepancy in practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historic data or other sources.

Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors.

– Private equity

The Group's private equity positions are generally classified as available-for-sale and are not traded in an active market. In the absence of an active market for the investment, fair value is estimated based upon an analysis of the investee's financial position and results, risk profile, prospects and other factors as well as reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The exercise of judgement is required because of uncertainties inherent in estimating fair value for private equity investments.

Analysis of fair value determination

The following table provides an analysis of the basis for valuing financial assets and financial liabilities measured at fair value in the consolidated financial statements:

	Group					
		Valuation techniques				
	quoted market price	using observable inputs	with significant non-observable inputs	Third party total	Amounts with HSBC entities	Total
2008						
Assets						
Trading assets	3,369	105,020	–	108,389	–	108,389
Financial assets designated at fair value	782	3,254	217	4,253	3,545	7,798
Derivative financial instruments	449	6,020	–	6,469	635	7,104
Available-for-sale financial investments	2,796	141,953	137	144,886	68	144,954
Liabilities						
Trading liabilities	3,563	42,381	2,338	48,282	–	48,282
Financial liabilities designated at fair value	–	1,407	–	1,407	–	1,407
Derivative financial instruments	35	7,485	–	7,520	7,425	14,945
2007						
Assets						
Trading assets	2,305	8,085	–	10,390	–	10,390
Financial assets designated at fair value	5,766	4,237	217	10,220	3,672	13,892
Derivative financial instruments	486	3,830	–	4,316	386	4,702
Available-for-sale financial investments	6,867	217,806	424	225,097	200	225,297
Liabilities						
Trading liabilities	4,553	39,040	4,558	48,151	–	48,151
Financial liabilities designated at fair value	–	1,491	7	1,498	–	1,498
Derivative financial instruments	120	2,790	–	2,910	1,773	4,683

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

	Bank					
	Valuation techniques					
	quoted market price	using observable inputs	with significant non-observable inputs	Third party total	Amounts with HSBC entities	Total
2008						
Assets						
Trading assets	3,369	104,406	–	107,775	–	107,775
Financial assets designated at fair value	306	524	–	830	–	830
Derivative financial instruments	447	5,776	–	6,223	687	6,910
Available-for-sale financial investments	2,762	109,136	34	111,932	68	112,000
Liabilities						
Trading liabilities	3,563	37,566	2,338	43,467	–	43,467
Financial liabilities designated at fair value	–	994	–	994	–	994
Derivative financial instruments	33	7,417	–	7,450	7,488	14,938
2007						
Assets						
Trading assets	2,305	6,599	–	8,904	–	8,904
Financial assets designated at fair value	554	684	–	1,238	–	1,238
Derivative financial instruments	475	3,586	–	4,061	350	4,411
Available-for-sale financial investments	5,569	166,509	321	172,399	200	172,599
Liabilities						
Trading liabilities	4,553	38,039	4,558	47,150	–	47,150
Financial liabilities designated at fair value	–	989	–	989	–	989
Derivative financial instruments	60	2,618	–	2,678	1,753	4,431

Effects of changes in significant non-observable assumptions to reasonably possibly alternatives

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values due to parallel movement of plus or minus 10 per cent of change in fair value to reasonably possible alternative assumptions.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

	Group			
	Reflected in profit/(loss)		Reflected in equity	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
2008				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	22	(22)	–	–
Available-for-sale financial investments	–	–	14	(14)
2007				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	22	(22)	–	–
Available-for-sale financial investments	–	–	42	(42)

	Bank			
	Reflected in profit/(loss)		Reflected in equity	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
2008				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Available-for-sale financial investments	–	–	3	(3)
2007				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Available-for-sale financial investments	–	–	32	(32)

Changes in fair value recorded in the income statement

The following table details changes in fair values recognised in profit or loss during the year, where the fair value is estimated using valuation techniques that incorporate significant assumptions that are not supported by prices from observable current market transactions in the same instrument, and are not based on observable market data:

- the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component;
- instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges.

	Group		Bank	
	2008	2007	**2008**	2007
Recorded profit/(loss):				
Derivatives/trading assets/trading liabilities	24	55	24	55
Financial assets/liabilities designated at fair value	(42)	–	–	–

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

Fair value of financial instruments not carried at fair value

The fair values of financial instruments that are not recognised at fair value on the balance sheet are calculated as described below.

The calculation of fair value incorporates the Group's estimate of the amount at which financial assets could be exchanged, or financial liabilities settled, between knowledgeable, willing parties in an arm's length transaction. It does not reflect the economic benefits and costs that the Group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available, so comparisons of fair values between entities may not be meaningful and users are advised to exercise caution when using this data.

The following types of financial instruments are measured at amortised cost unless they are held for trading or designated at fair value through profit or loss. Where assets or liabilities are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the assets or liabilities so hedged includes a fair value adjustment for the hedged risk only. Fair values at the balance sheet date of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

(i) Loans and advances to customers

The fair value of advances to customers is estimated using discounted cash flow models, using an estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans.

(ii) Financial investments

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration either the prices of, or future earnings streams of, equivalent quoted securities.

(iii) Deposits and customer accounts

The fair value of deposits and customers account is estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of deposits repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

(iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the Group as a going concern.

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held. No block discount or premium adjustments are made.

The fair values of intangible assets, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above because they are not financial instruments.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

The following table lists financial instruments whose carrying amount is a reasonable approximation of fair value because, for example, they are short-term in nature or reprice to current market rates frequently:

Assets

Cash and balances at central banks
Items in the course of collection from other banks
Endorsements and acceptances
Short-term receivables within "Other assets"
Accrued income

Liabilities

Items in the course of transmission to other banks
Endorsements and acceptances
Short-term payables within "Other liabilities"
Accruals

The methods and significant assumptions applied in determining the fair value of financial instruments are set out in note 4(n).

(b) Fair value

The following table provides an analysis of the fair value of financial instruments not measured at fair value in the balance sheet. For all other instruments the fair value is equal to the carrying value:

	Group			
	2008		2007	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	**69,579**	**69,635**	113,029	113,029
Advances to customers	**329,121**	**320,651**	308,356	310,476
Held-to-maturity debt securities	**36,205**	**39,315**	18,997	19,526
Financial Liabilities				
Current, savings and other deposit accounts	**562,183**	**562,257**	546,653	546,710
Deposits from banks	**11,556**	**11,556**	19,736	19,736
Certificates of deposit and other debt securities in issue	**2,772**	**2,838**	5,685	5,621
Subordinated liabilities	**9,309**	**7,849**	9,354	8,980

	Bank			
	2008		2007	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	**38,097**	**38,154**	86,137	86,137
Advances to customers	**280,255**	**271,787**	255,413	257,579
Financial Liabilities				
Current, savings and other deposit accounts	**547,385**	**547,459**	533,330	533,386
Deposits from banks	**8,263**	**8,263**	12,593	12,593
Certificates of deposit and other debt securities in issue	**2,772**	**2,838**	7,203	7,169
Subordinated liabilities	**9,309**	**7,849**	9,354	8,980

64. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with the current year's presentation. For details, please refer to note 62(c).

65. 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.

66. APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 2 March 2009.