



HANG SENG BANK



TAKING THE LEAD

2010

ANNUAL REPORT

TAKING THE LEAD

In a competitive operating environment, Hang Seng Bank strives for top-level performance as we pursue long-term growth.

Our objective is to serve our stakeholders by becoming the leading personal and private bank for middle-class and affluent customers in Hong Kong and on the Mainland, and the leading trade bank in Greater China.

This year's theme – Taking The Lead – reflects our determination to reinforce our market leadership in traditional banking and build a strong position in new areas of financial services to achieve our goals.

2010 Asian Games –
Table Tennis, Silver Medal

Jiang Huajun

STRATEGY



PASSION

STRENGTH





2006 Asian Games –
Table Tennis, Gold Medal

Li Ching



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



CORPORATE PROFILE

Established in 1933, Hang Seng Bank is one of Hong Kong's largest listed companies and among the 50 largest listed banks in the world in terms of market capitalisation (HK\$244.3bn as at the end of December 2010).

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

Established in 2007 and headquartered in Shanghai, wholly owned mainland China subsidiary Hang Seng Bank (China) Limited operates a network of 38 outlets in Beijing, Shanghai, Guangzhou, Shenzhen, Dongguan, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming, Foshan and Zhongshan.

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



RESULTS IN BRIEF

| | 2010 | 2009 | Change |
|---|----------------|---------|--------|
| For the year | HK\$m | HK\$m | % |
| Operating profit excluding loan impairment charges and other credit risk provisions | 14,475 | 14,026 | 3 |
| Operating profit | 14,085 | 13,214 | 7 |
| Profit before tax | 17,345 | 15,400 | 13 |
| Profit attributable to shareholders | 14,917 | 13,138 | 14 |
| | HK\$ | HK\$ | % |
| Earnings per share | 7.80 | 6.87 | 13.5 |
| Dividends per share | 5.20 | 5.20 | – |
| At year-end | HK\$m | HK\$m | % |
| Shareholders' funds | 70,012 | 62,148 | 13 |
| Total assets | 916,911 | 830,668 | 10 |
| Ratios | % | % | |
| <i>For the year</i> | | | |
| Return on average shareholders' funds | 22.8 | 22.9 | |
| Cost efficiency ratio | 33.7 | 32.6 | |
| Average liquidity ratio | 38.1 | 48.1 | |
| <i>At year-end</i> | | | |
| Capital adequacy ratio* | 13.6 | 15.8 | |
| Core capital ratio* | 10.8 | 12.8 | |

* Capital ratios at 31 December 2010 were compiled in accordance with the Banking (Capital) Rules (the "Capital Rules") issued by the Hong Kong Monetary Authority ("HKMA") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II. Having obtained approval from the HKMA to adopt the advanced internal ratings-based approach ("AIRB") to calculate the risk-weighted assets for credit risk from 1 January 2009, the Bank used the AIRB approach to calculate its credit risk exposure. The standardised (operational risk) approach and internal models approach were used to calculate its operational risk and market risk respectively.

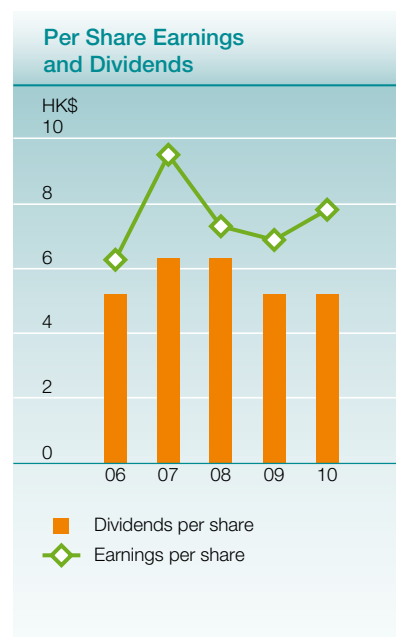
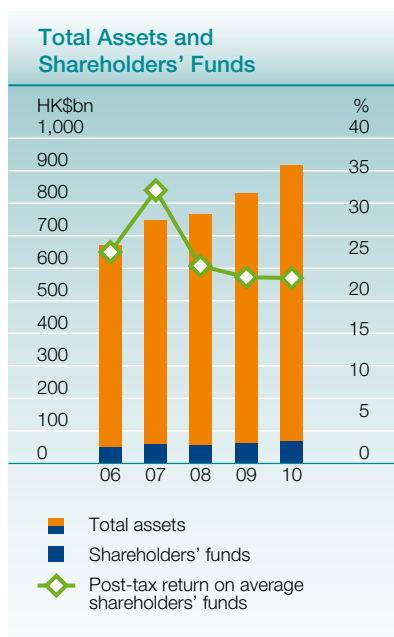
The basis of consolidation for calculation of capital ratios under the Capital Rules follows the basis of consolidation for financial reporting with the exclusion of subsidiaries which are "regulated financial entities" (e.g. insurance and securities companies) as defined by the Capital Rules. Accordingly,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

FIVE-YEAR FINANCIAL SUMMARY

| | 2006 (restated) | 2007 (restated) | 2008 (restated) | 2009 (restated) | 2010 |
|--|--------------------|--------------------|--------------------|--------------------|---------------|
| For the year | HK\$bn | HK\$bn | HK\$bn | HK\$bn | HK\$bn |
| Operating profit | 12.5 | 17.7 | 13.6 | 13.2 | 14.1 |
| Profit before tax | 14.3 | 21.4 | 15.7 | 15.4 | 17.3 |
| Profit attributable to shareholders | 12.0 | 18.1 | 13.9 | 13.1 | 14.9 |
| At year-end | HK\$bn | HK\$bn | HK\$bn | HK\$bn | HK\$bn |
| Shareholders' funds | 49.2 | 59.2 | 55.0 | 62.1 | 70.0 |
| Issued and paid up capital | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 |
| Total assets | 671.8 | 749.4 | 766.0 | 830.7 | 916.9 |
| Total liabilities | 622.6 | 690.2 | 711.0 | 768.6 | 846.9 |
| Per share | HK\$ | HK\$ | HK\$ | HK\$ | HK\$ |
| Earnings per share | 6.26 | 9.49 | 7.29 | 6.87 | 7.80 |
| Dividends per share | 5.20 | 6.30 | 6.30 | 5.20 | 5.20 |
| Ratios | % | % | % | % | % |
| Post-tax return on average shareholders' funds | 26.0 | 33.6 | 24.3 | 22.9 | 22.8 |
| Post-tax return on average total assets | 1.9 | 2.6 | 1.8 | 1.7 | 1.7 |
| Capital adequacy ratio* | 13.6 | 11.2 | 12.5 | 15.8 | 13.6 |
| Core capital ratio* | 10.7 | 8.4 | 9.5 | 12.8 | 10.8 |
| Cost efficiency ratio | 29.3 | 26.9 | 29.6 | 32.6 | 33.7 |

* Capital ratios at 31 December 2010 were compiled in accordance with the Banking (Capital) Rules (the "Capital Rules") issued by the Hong Kong Monetary Authority ("HKMA") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II. Having obtained approval from the HKMA to adopt the advanced internal ratings-based approach ("AIRB") to calculate the risk-weighted assets for credit risk from 1 January 2009, the Bank used the AIRB approach to calculate its credit risk exposure. The standardised (operational risk) approach and internal models approach were used to calculate its operational risk and market risk respectively.

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



MAJOR MILESTONES

JANUARY - MARCH

- Hang Seng China opens first cross-location sub-branch in Foshan
- Hang Seng China launches new branding campaign
- Hang Seng becomes first bank in Hong Kong to set renminbi prime rate



APRIL - JUNE

- Hang Seng launches Hong Kong dollar China UnionPay Credit Card
- Hang Seng China opens cross-location sub-branch in Zhongshan
- Hang Seng launches securities and foreign exchange investment information iPhone application
- Hang Seng Indexes launches Hang Seng Dividend Point Index Series



JULY - SEPTEMBER

- Personal e-Banking celebrates 10th anniversary
- Hang Seng launches first-of-its-kind foreign exchange margin trading iPhone application
- Hang Seng launches Hong Kong's first renminbi certificate of deposit for retail customers
- Hang Seng Indexes launches Hang Seng Corporate Sustainability Index Series



OCTOBER - DECEMBER

- Hang Seng launches Hang Seng RMB Bond Fund
- Hang Seng lead-arranges Hong Kong's first renminbi syndicated loan
- Hang Seng China unveils new headquarters building in Shanghai



RECOGNITION



AWARDS

Best Domestic Bank in Hong Kong (for 11th consecutive year)
The Asset

Best Local Private Bank in Hong Kong
Euromoney

No. 1 for Financial Reputation (Hong Kong)
No. 3 Most Admired Company Overall (Hong Kong)
The Wall Street Journal Asia

No. 1 for Most Committed to a Strong Dividend Policy
(China and Hong Kong)
FinanceAsia

Achievement Award for Cash Management in Hong Kong
The Asian Banker

Best Risk Management Bank in Asia
21st Century Business Herald

Wealth Management Company of the Year
Best-in-Class: Innovation of the Year – Investment
Management; Online Capabilities; Training and Development
Benchmark

Best in Hong Kong
Structured Products

Best Investor Relations by Sector – Banks & Financial
(Greater China)
Best Investor Relations by a CFO (Hong Kong)
Best Governance and Disclosure (Hong Kong)
IR Magazine

Best Fund (two funds managed by Hang Seng)
Lipper Fund Awards Hong Kong

SME's Best Partner Award
Hong Kong Chamber of Small and Medium Business

Trusted Brands Gold Award – Bank
Trusted Brands Gold Award – Credit Card Issuing Bank
Reader's Digest

Best Foreign Bank (Hang Seng China)
National Business Daily

No. 1 for Wealth Management Products' Investment Return
(Hang Seng China)
China Benefit


2010 Top Ten Best Wealth Management Products in China
(Hang Seng China – Equity-linked investment product
'Pick & Win')
Money Week

Best SME Services Award (Hang Seng China)
CFO World



RATINGS

| | | | |
|---------------------------|--------------------------------|---|---------------------------------------|
| Moody's Investors Service | Hang Seng Bank | Long-term Bank Deposit (local and foreign currency) Short-term Bank Deposit (local and foreign currency) Subordinated Debt (local and foreign currency) Bank Financial Strength Outlook | Aa1 Prime-1 Aa2 B+ Stable |
| | Hang Seng Bank (China) Limited | Long-term Bank Deposit (local and foreign currency) Short-term Bank Deposit (local and foreign currency) Bank Financial Strength Outlook | A1 Prime-1 D Stable |
| Standard & Poor's | Hang Seng Bank | Long-term Counterparty Credit (local and foreign currency) Short-term Counterparty Credit (local and foreign currency) Bank Fundamental Strength Outlook | AA A-1+ B+ Stable |
| | Hang Seng Bank (China) Limited | Long-term Counterparty Credit (local and foreign currency) Short-term Counterparty Credit (local and foreign currency) Outlook | AA- A-1+ Stable |
| Fitch | Hang Seng Bank | Individual Rating | B |

A low-angle, dynamic shot of a cyclist on a track. The cyclist is on the right side of the frame, leaning into a turn. The track surface is light-colored with dark, curved lines. In the background, a curved concrete wall is topped with a series of tall, silver stadium light poles, each with two lamps. The sky is a clear, bright blue. The overall composition is energetic and emphasizes motion and speed.

TAKING THE LEAD

DETERMINATION

2010 Asian Games –
Cycling, Silver Medal

Jamie Wong



CHAIRMAN'S STATEMENT



Raymond Ch'ien
Chairman

Our focus on strengthening Hang Seng's platform for long-term growth produced solid results in 2010.

TAKING THE LEAD

DISTINCTIVE VISION

As the global economic recovery progressed, we took steps to maintain our leading position in traditional areas of banking and capitalise on new business opportunities, achieving increases in both net interest and non-interest revenue streams. The success of our approach saw income growth in the second half of the year outpace that in the first half despite increasingly competitive operating conditions.

As economic confidence returned, we used our time-to-market strength to capture the shift in investment sentiment, driving good growth in both personal and corporate wealth management business.

We leveraged our strong balance sheet, excellent market knowledge and effective credit risk management system to expand lending portfolios, underpinning the rise in net interest income.

We continued to support local industry through active participation in government-sponsored lending schemes as well as efforts to enhance service access and delivery for SME customers.

Assisted by our comprehensive cross-border capabilities, our rapid response to the further opening up of renminbi banking in Hong Kong strengthened our status as a preferred partner for trade-related financial services.



Hang Seng Bank (China) Limited purchased headquarters premises in Shanghai and achieved increases in its customer and deposit bases, further improving its springboard for long-term business growth. We continued to collaborate with our strategic mainland China partners – Industrial Bank and Yantai Bank – to good effect. In the first half of the year, we took up our full entitlement under a rights share issue by Industrial Bank.

FINANCIAL PERFORMANCE

Operating profit excluding loan impairment charges and other credit risk provisions rose by 3% to HK\$14,475m. Operating profit grew by 7% to HK\$14,085m, with the stabilisation in economic conditions and our good management of credit risk driving a 52% improvement in loan impairment charges and other credit risk provisions to HK\$390m.

Profit before tax was up 13% at HK\$17,345m. Profit attributable to shareholders rose by 14% to HK\$14,917m. Earnings per share were up 13.5% at HK\$7.80.

We built good business momentum during the year to record increases of 11% in operating profit excluding loan impairment charges and 14% in attributable profit in the second half of the year compared with the first half.

Higher performance-related pay as well as more investment in marketing to support future growth saw operating expenses rise by 8% to HK\$7,355m. Our cost efficiency ratio for 2010 was 33.7%.

Return on average shareholders' funds was 22.8%, compared with 22.9% in 2009. Return on average total assets was 1.7% – the same as a year earlier.

At 31 December 2010, our capital adequacy ratio was 13.6%, compared with 15.8% at the end of 2009. The decline mainly reflects our participation in Industrial Bank's rights issue and the rise in risk-weighted assets. Our core capital ratio was down 2 percentage points at 10.8%.

The Directors have declared a fourth interim dividend of HK\$1.90 per share, payable on 30 March 2011. This brings the total distribution for 2010 to HK\$5.20 per share.

Our strong stakeholder relationships are a vital element in our success as we work to contribute to and share in the long-term prosperity of the markets in which we operate.

I wish to express sincere appreciation to our customers and shareholders for continuing to place great confidence in Hang Seng. Your support provides encouragement that we have an excellent strategy for business growth, and inspiration for the development of new products and services. While global markets have staged a recovery from the international financial crisis in the past year, its effects will continue to reverberate. In good economic times and bad, we will work hard to provide the service and value that have become synonymous with the Hang Seng brand.

Our close partnerships with customers – old and new – are built and maintained by our dedicated and professional team. I wish to thank staff at all levels for their enthusiasm and commitment in executing our vision for service excellence and long-term growth. Their invaluable efforts will ensure we continue to strengthen our position as a leading provider of financial services in Greater China.

OUTLOOK

Large-scale fiscal and monetary stimulus initiatives launched in the wake of the international financial crisis supported a rebound in the global economy in 2010. However, the recovery has occurred on two distinct tracks, with fast growth in emerging economies but slower progress in advanced economies.

The resurgence in export activity and robust domestic consumption underpinned GDP growth in Hong Kong and on the Mainland, although the pace began to moderate in the second half of the year.

With many stimulus programmes now being phased out, challenges remain. The US Federal Reserve's announcement in November of another round of quantitative easing underlines the continuing fragility of the US economy, while many countries in Europe have instituted austerity measures as they attempt to restore fiscal discipline and address unprecedented levels of sovereign debt.

These developments may dampen export demand in 2011. In addition, the persistence of low interest rates and excess market liquidity in Hong Kong are fuelling concerns over inflation and asset price bubbles. However, unemployment remains low and overall market sentiment is upbeat. Along with the major boost to construction provided by several large government-led infrastructure projects, this should support domestic consumption, helping to cushion the effects of a slowdown in the external sector.

Despite recent measures to curb rising inflation and property prices on the Mainland, steady income growth and the government's efforts to promote private consumption through its 12th five-year plan should sustain strong domestic demand, which will be the primary driver of GDP growth in the short term.

In uncertain market conditions, our competitive strengths will ensure we maintain our leadership in areas such as mortgages, credit cards and commercial lending. We will use our trusted brand, time-to-market capabilities and extensive range of service delivery channels to capture new business opportunities. We will also continue to build on the good progress we have made in strongly positioning ourselves to achieve sustainable growth.



Raymond Ch'ien

Chairman

Hong Kong, 28 February 2011

CHIEF EXECUTIVE'S REPORT

Margaret Leung
Vice-Chairman and Chief Executive



The operating environment was very competitive in 2010 as banks sought to capitalise on improved investment sentiment and the upturn in economic activity.

TAKING THE LEAD

UNRIVALLED PASSION

Backed by our trusted brand and strong financial fundamentals, our timely actions to meet changing customer needs reinforced our leadership in traditional bank services and strengthened our position in new areas of business – supporting good growth in the customer bases, revenue and profit of our core business lines.

Low interest rates had an adverse effect on deposit spreads and returns from Treasury's balance sheet management portfolio. While remaining vigilant in managing credit risk, we redeployed the commercial surplus to expand lending, outperforming the market for growth in customer advances and increasing our share in the competitive credit card and residential mortgage sectors.

We achieved year-on-year growth in net interest income, building good momentum during the year to record increases in net interest income and net interest margin in the second half compared with the first half.

With our strong wealth management and cross-border trade-related capabilities, we also achieved a second-half growth trend in net fee income – supporting a solid rise in fee-related revenue for the year.



We launched new mainland China-focused investment products and increased our retail investment fund market share, reaffirming our reputation as a leading fund manager and distributor in Hong Kong.

Innovative initiatives to support business customers with operations in Hong Kong and on the Mainland established us as a market leader for renminbi financial services. We are now well positioned to capture a growing share of this rapidly expanding sector.

A new iPhone application for foreign exchange margin trading and the expansion of services on our online banking platforms helped customers take timely advantage of investment opportunities. At 31 December 2010, our Personal e-Banking and Business e-Banking customer bases were up 10% and 19% respectively compared with a year earlier.

CUSTOMER GROUPS

Personal Financial Services recorded an 8% increase in profit before tax to HK\$7,872m. Operating profit excluding loan impairment charges grew by 5% to HK\$7,865m. Operating profit was up 9%.

Despite downward pressure on mortgage pricing and deposit spreads, we achieved a 4% rise in net interest income to HK\$8,485m by expanding our loan portfolios.

Unsecured lending recorded a 52% rise in profit before tax compared with 2009, attributable to good business momentum and improved loan quality. Our new Hong Kong dollar China UnionPay credit card helped support an 11% increase in the card base, which passed the major milestone of 2 million cards in circulation. Card spending and receivables rose by 18% and 14% respectively. Personal loans grew by 29%. Impairment charges for unsecured lending fell by 46%.

We reinforced our strong position in the residential mortgage sector. We outperformed the market in terms of the number of new mortgage registrations and increased our share of mortgage business.

We used our time-to-market strength and extensive distribution network to capitalise on the improvement in investor outlook during the year, achieving a 9% increase in wealth management income. Wealth management revenue in the second half of 2010 rose by 4% compared with the first half.

Investment income was up 10%. Timely new products, including the Hang Seng RMB Bond Fund, supported a 181% increase in retail investment fund sales and an 85% rise in investment fund fee revenue. Funds under management (including private banking) exceeded HK\$150bn for the first time. With a diverse investment product suite and an emphasis on customised wealth management solutions, private banking achieved a 25% increase in service fee income.

Our enhanced online securities services and innovative iPhone application for foreign exchange margin trading drove increases in the number of securities and margin trading accounts.

We strengthened our position as a prominent provider of retirement planning solutions and insurance coverage for different life stages by launching new products and enhancing protection under existing plans. Life insurance income rose by 10%. Total life insurance policies in-force and annualised premiums grew by 9% and 13% respectively.

We were named 'Company of the Year' in *Benchmark's* Wealth Management Awards 2010 and 'Best Local Private Bank in Hong Kong' by *Euromoney* for the second consecutive year.

Commercial Banking took good advantage of the global economic recovery and the further opening up of renminbi financial services in Hong Kong. Profit before tax rose by 42% to HK\$3,748m, reflecting broad-based income growth as well as a 36% improvement in loan impairment charges. Operating profit excluding loan impairment charges was up 34% at HK\$2,671m. Operating profit rose by 46%.

We took steps to facilitate commercial activity. Our cross-border and renminbi offerings helped companies capitalise on new business opportunities while managing risk, driving a 225% increase in trade finance. Our financial support for SMEs through government-initiated lending schemes topped HK\$18.4bn by the end of 2010. We used technology to reduce turnaround times for new and renewed lending and credit facility decisions. These efforts helped drive a 102% increase in customer advances, with a 58% rise in related net interest income.

Customer deposits rose by 14%, but pressure on spreads resulted in a 19% fall in deposit net interest income.

We established a leadership position for renminbi commercial banking services that will provide an excellent springboard for future growth. Among other initiatives, we became the first bank in Hong Kong to establish a prime rate and lead-arrange a syndicated loan denominated in renminbi.

Close collaboration between commercial banking teams in Hong Kong and on the Mainland and new strategic alliances with Mainland partners enhanced our cross-border service proposition and proved a valuable source of referral business. At the end of 2010, we had over 58,000 renminbi commercial accounts and our renminbi cross-border trade-related business exceeded RMB35bn.

Net fee income rose by 9%, supported in part by an enriched portfolio of corporate wealth management products and enhanced online investment services.

Corporate wealth management income rose by 27%, representing 13% of Commercial Banking's net operating income before loan impairment charges.

Stronger Internet-based business banking platforms helped drive continued customer migration to online channels. At 31 December 2010, the number of Business e-Banking customers had reached over 92,000. The number of online business transactions in 2010 grew by 19% compared with 2009.

Corporate Banking recorded a 38% increase in profit before tax to HK\$1,266m. Operating profit excluding loan impairment charges was up 29% at HK\$1,264m. Operating profit rose by 40%.

Total operating income rose by 25% on the back of a 24% increase in net interest income.

“ We reaffirmed our reputation as a leading fund manager and distributor in Hong Kong. ”

Tighter regulations in the Hong Kong and Mainland property markets and intensifying competition among lenders created new challenges for traditional drivers of Corporate Banking growth. We took steps to further diversify the revenue base, leveraging our strong customer relationships and good market knowledge to capture business in a broader range of industry sectors and explore opportunities created by the growing demand for cross-border financial services. Customer advances and deposits grew by 32% and 34% respectively.

Treasury's profit before tax fell by HK\$32m, or 1%, to HK\$3,361m. With increased loan demand from business customers, a substantial proportion of the commercial surplus was redeployed to support commercial lending. Good growth in trading income, a disposal gain and an increase in share of profits from associates was more than offset by the effects of continuing low global interest rates on net interest income, which dropped by 35%. Operating profit fell by 24%.

We made prudent use of gapping opportunities and took steps to enhance the investment mix under the balance sheet management portfolio by disposing of selected instruments and investing in high-quality debt securities, resulting in a HK\$95m disposal gain. These actions led to a 30% increase in net interest income in the second half of 2010 compared with the first half despite the challenging market conditions.

Closer collaboration with business banking colleagues and efforts to meet the growing demand for renminbi-denominated products drove the 10% increase in trading income.

“ We became the first bank in Hong Kong to establish a prime rate and lead-arrange a syndicated loan denominated in renminbi. ”

MAINLAND BUSINESS

Hang Seng Bank (China) Limited moved forward with its strategy for long-term development with the RMB510m purchase of headquarters premises in Shanghai. With the opening of two cross-location sub-branches under CEPA VI in 2010, Hang Seng China now has 38 outlets across 13 Mainland cities.

An enhanced customer referral mechanism, good cross-border commercial banking capabilities and a diverse portfolio of products proved valuable in attracting new business and building a broader platform to sustain growth in deposits. The Mainland personal and commercial banking customer bases increased by 15% and 14% respectively year on year.

The expansion of wealth management offerings to better meet the needs of customers at different life stages underpinned a 17% rise in the number of Prestige Banking accounts. Along with enhancements to services for commercial customers, this rise helped drive a 76% year-on-year increase in deposits – improving balance sheet strength. With continuing emphasis on credit quality over portfolio size, advances to customers increased by 28%.

Hang Seng China's profit before tax recorded solid growth, with the 24% rise in total operating income outweighing increases in loan impairment charges and operating expenses.

Collaboration with Hang Seng's strategic Mainland partners, Industrial Bank and Yantai Bank, continued to extend our reach in regions with good economic growth potential.

FINANCIAL HIGHLIGHTS

Total assets rose by HK\$86.2bn, or 10%, to HK\$916.9bn. Our efforts to facilitate the upswing in commercial trade and capitalise on robust consumer demand underpinned the 37% increase in customer advances. Customer deposits, including certificates of deposit and other debt securities in issue, were up 7%, driven partly by good growth in renminbi deposits. With the emphasis on using surplus funds to support loan growth, financial investments and trading assets were down 17% and 61% respectively.

Net interest income rose by 2% to HK\$14,300m. The 9% increase in average interest-earning assets, improved loan spreads and returns from the life insurance funds investment portfolio outweighed reduced contributions from deposits and the Treasury balance sheet management portfolio. In challenging operating conditions, we achieved a 13% rise in net interest income and a 3 basis points improvement in net interest margin in the second half of 2010 compared with the first half. Net interest margin for the year was down 12 basis points on 2009 at 1.78%.

We recorded a 13% increase in net fee income to HK\$4,897m, largely reflecting the 72% rise in investment fund fee income. Fees from trade services, remittances and credit facilities grew by 19%, 19% and 44% respectively. Successful credit card customer acquisition and card utilisation campaigns supported a 3% rise in fee income from card services. As investor confidence improved, our diverse range of wealth management products and service excellence supported a 35% increase in insurance agency fees and a 24% rise in private banking service fee income. Net fee income in the second half of 2010 was up 7% compared with the first half.

Trading income grew by 7% to HK\$2,059m. Income from securities, derivatives and other trading activities rose by HK\$160m, or 122%, reflecting an improvement in derivatives trading. Foreign exchange income fell by HK\$24m, or 1%, due mainly to a fall in net interest income from funding swaps and increased losses on the revaluation of Hang Seng China's US dollar capital against the renminbi.

While continuing to carefully monitor costs, we invested in staff and marketing to recognise good performance and support future growth. Rental expenses increased with higher rents in Hong Kong and new outlets on the Mainland.

Our cost efficiency ratio for 2010 was 33.7%.

“ Our long-term goals are to be the leading personal and private bank for affluent and middle-class customers in Hong Kong and on the Mainland, and the leading trade bank in Greater China. ”

The combined impact of the improved economic climate and our effective actions to manage credit risk saw loan impairment charges and other credit risk provisions fall by HK\$422m, or 52%, to HK\$390m.

Total loan impairment allowances as a percentage of gross advances to customers was 0.39% compared with 0.56% a year earlier. Gross impaired advances as a percentage of gross advances to customers improved by 30 basis points to 0.40%.

A WINNING STRATEGY

The economic rebound boosted international trade and investment markets in 2010, but the outlook for 2011 remains uncertain. With stimulus initiatives winding down, many of the world's advanced economies are still grappling with major monetary and fiscal issues, which may subdue export demand.

Although upbeat consumer and business sentiment should continue to support domestic demand, a slowdown in the external sector would create new challenges for Hong Kong. Despite recent measures to curb economic overheating, domestic consumption on the Mainland looks set to remain robust, underpinning continued growth – albeit at a more moderate pace.

Our long-term goals are to be the leading personal and private bank for affluent and middle-class customers in Hong Kong and on the Mainland, and the leading trade bank in Greater China.

To achieve these objectives, we have identified business priorities that capitalise on our competitive strengths and support sustainable growth.

Hang Seng's strengths are its unique market positioning, comprehensive wealth management capabilities and extensive business referral network.

The rapidly growing middle and affluent classes on the Mainland are seeking new investment opportunities at home and in Hong Kong. With our good cross-border reach and trusted brand, we are strongly positioned to meet their needs.

In support of achieving our goals, we will maintain our excellent service level. We will make further investments in technology and launch service innovations to facilitate transactions and capture more business, particularly in the Prestige Banking segment and among young people. We will develop new applications for personal mobile devices to provide convenient access to account and market information. We will work to drive continuing good growth in deposits in Hong Kong and on the Mainland, providing a solid foundation for business expansion.

We have placed ourselves at the leading edge of the wealth management and offshore renminbi financial services markets. We will continue to make good use of our product development strength and well-established service platforms to become the preferred bank in these rapidly growing sectors.

Our strong cross-border banking proposition is proving an important tool as we work to become the leading trade bank in Greater China.

Treasury will continue to develop effective hedging solutions and new renminbi-related products, and Commercial Banking has enhanced online banking services to support renminbi account enquiries and transaction instructions. We will remain close to customers and to Mainland regulators to ensure we stay ahead of the game.

Enduring characteristics of Hang Seng's success are a willingness to aim high in setting our business objectives and our focus on serving customers well by providing financial solutions that are tailored to their needs. We have a winning strategy for maintaining a strong position in traditional business lines and for taking the lead in key areas of new banking business to deliver long-term growth.



Margaret Leung

Vice-Chairman and Chief Executive
Hong Kong, 28 February 2011



TAKING THE LEAD

DEDICATION

COMMUNITY

EDUCATION

EMPLOYEES

ENVIRONMENT



As a leading corporate citizen in Hong Kong, our commitment to excellence extends beyond the provision of financial services.

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

We take steps to raise awareness of social and environmental issues among our staff and the general public. We also provide financial and volunteer support for a variety of community development projects.

In 2010, we marked our 10th year as a member of the FTSE4Good Global Index, which tracks the performance of companies that meet internationally recognised standards of corporate responsibility. We have been named a Caring Company by the Hong Kong Council of Social Service every year since 2003.

In May, we received the Gold Award in the Financial, Insurance and Accounting Institutions Sector of the Hong Kong Awards for Environmental Excellence in recognition of our environmental initiatives.



Our annual corporate responsibility report, available online via our website since 2005, gives more details of our principles and activities as regards our interactions with stakeholders and provides a crucial benchmark for tracking our social and environmental performance.

DEEP COMMUNITY ROOTS

Over the past decade, we have provided more than HK\$207m in donations and community sponsorships – including about HK\$30m in 2010 – to support various educational, environmental, social welfare and sports development programmes.

We also give back through volunteer service, with members of staff and their family members collectively spending about 20,000 hours to serve the community in 2010. The Bank organised more than 100 volunteer activities – including craft and cooking workshops for underprivileged children, festive lunches for the elderly, and environmental and conservation activities.

We are a long-term supporter of The Community Chest of Hong Kong, which provides funding for 148 charities in Hong Kong, making more than HK\$28m in donations over the past decade. Matching staff contributions on a dollar-for-dollar basis, we raised about HK\$1.2m for The Chest's annual Dress Special Day campaign in 2010.

Our e-Donation channel makes it easier for customers to offer financial support to those in need, with about HK\$2.4m in donations reaching 60 charitable organisations in Hong Kong via this online service in 2010. More than HK\$19m has been donated to deserving causes since the service was launched in December 2001.

Bank staff and their families gave about 20,000 hours in volunteer service.



LEADERSHIP THROUGH EDUCATION

With our desire to contribute to a better future for our communities, we place a strong emphasis on youth development programmes. In 2010, we allocated over HK\$6m to educational initiatives.

Since 1995, we have given out more than HK\$54m under various scholarship schemes, providing financial support for about 1,500 outstanding students from Hong Kong and mainland China – including 190 in 2010.

We worked with the Hong Kong Federation of Youth Groups to produce the 'Hang Seng Bank Leaders to Leaders Lecture Series', which gives secondary school children the chance to engage in direct dialogue with prominent community and business leaders. With the theme of 'Hong Kong Today – Pass on the Wonders of Hong Kong', over 300 students took part in each of the 10 lectures organised under the series.

Designed to help raise awareness about crime-related issues and reduce criminal activity among young people, the biennial 'Hang Seng Bank – Help the Police Fight Youth Crime Competition' received a record 140,000 entries in 2010.

We continued to sponsor the Ming Pao Student Reporter Programme, which uses media training activities to improve participants' critical thinking and language skills as well as promote a better understanding of current affairs.

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

HK\$ 11 MILLION

awarded under Hang Seng Athlete Incentive Awards Scheme

In partnership with the Regeneration Society, we promoted the importance of positive life values and attitudes through the Hang Seng Bank Regeneration Society Top Ten Regeneration Warriors Competition, which highlighted the stories of 10 'Regeneration Warriors' who had overcome chronic illness to live rewarding lives.

The arts enrich communities by providing a variety of channels through which to express and exchange different social, cultural and philosophical ideas. Since 2007, our sponsorship of various student ticket schemes has helped open up access to artistic performances for more than 45,000 young people.

PROVIDING SPORTING INSPIRATION

Through the Hang Seng Athlete Incentive Awards Scheme (Scheme), a joint initiative with the Hong Kong Sports Institute, we provide financial support for top local athletes, who not only bring honour to Hong Kong but also offer lessons about the importance of commitment, determination and teamwork.

Having extended our sponsorship of the Scheme to include local medalists at the 2010 Asian Games and Asian Para Games held in Guangzhou, we were proud to award about HK\$11m to 82 athletes and 25 parathletes who returned home triumphant from these Games and serve as role models for future generations of sportsmen and sportswomen. Since 1996, the Scheme has given over HK\$26.6m to outstanding athletes.

We help hone the talents of rising young stars of table tennis, providing a total of HK\$31m since 1991 to fund training and development programmes for players and coaches. The Hang Seng Table Tennis Academy – which will celebrate its 10th anniversary in 2011 – gave over 22,000 individuals the opportunity to participate in a wide range of table tennis activities in 2010. With the objective of using participation in sport to build confidence and self-esteem, we invited more than 300 underprivileged children to participate in two table tennis fun days held at our Penthouse and hosted by Bank volunteers.

We strive to promote the importance of a good work-life balance among our staff by offering a wide range of sporting and recreational activities. To foster a strong team spirit and reinforce the importance of good communication and cooperation among colleagues, we organised four sporting tournaments – ten-pin bowling, table tennis, basketball and football – under the Hang Seng Cup, which attracted the participation of over 700 members of staff.



Over 22,000 people participated in Hang Seng Table Tennis Academy activities.



We allocated over HK\$6 million to educational initiatives.



A GREEN BANK

We operate our business in an environmentally responsible manner. We are working to reduce the negative environmental impacts of our own operations and participate in activities that positively influence the environmental practices of our staff, customers and the wider community.

Our Environmental Management Committee implements and monitors our environmental system. We achieved ISO 14001 compliance at our headquarters building in 2005 – making us the first local financial institution in Hong Kong to receive such accreditation – and have since attained certification for our Hang Seng Tower and MegaBox offices and all our street-level bank branches. We have been carbon neutral since 2007.

In October, staff volunteers travelled to Yunnan province to inspect a Bank-sponsored project organised by The Conservancy Association, under which 600 biogas toilets are providing renewable energy to about 2,400 people in local villages – saving approximately 1,500 tonnes of firewood per year (equivalent to about 375 acres of forest) and cutting annual carbon dioxide emissions by 7,500 tons. The Bank has now sponsored the construction of 1,100 biogas toilets in Yunnan, benefitting more than 4,600 people.

Launched jointly with the Federation of Hong Kong Industries, the Hang Seng Pearl River Delta Environmental Awards (Awards) are part of our commitment to working with the business community on environmental issues. By recognising the green achievements of participants, the Awards encourage manufacturing companies in Hong Kong and the Pearl River Delta region to enhance their environmental performance. The 144 companies that took part in the 2009/10 Awards submitted a total of 555 environmental projects – a 40% increase on the previous year. The collective impact of the projects includes reducing waste by about 140,000 tons and cutting electricity consumption by over 97 million kWh.

Other ways in which we are working with stakeholders to reduce the consumption of resources is through our e-Statement and e-InvestAdvice services, under which customers can choose to receive account statements and various investment notices in electronic rather than paper format. By the end of 2010, subscribers to the e-Statement service were up 30.3% compared with a year earlier at over 435,000 and customers using the e-InvestAdvice service had increased by 42.8% to more than 90,000 – collectively saving over 24 million sheets of paper a year.

As part of a three-year partnership with Friends of the Earth (HK), we planted 10,000 trees in Tuen Mun in 2010 and are helping to maintain the reforestation site. During The Conservancy Association's Tree-Caring Day, staff volunteers and their families helped tidy up a Bank-sponsored reforestation site in Ma On Shan. Since 1999, we have facilitated the planting of 70,000 trees in country parks in Hong Kong.

We are playing our part in helping to conserve biodiversity. We comply with the sustainability principles set out in the WWF Hong Kong's *Seafood Guide*. We stopped serving shark's fin at Bank functions in 2003, and have since extended this policy to include endangered reef fish species and black moss.

We recycled more than 15,200 toner cartridges and over 2,800 items of computer equipment in 2010. We promoted green messages to staff through various channels, including talks, training, newsletters and in-house broadcasts, and environmentally themed outings. We continued our tradition of making a donation to charity in lieu of sending Christmas cards.

Social and environmental considerations are an important element of our financing decisions. We include environmental factors in our credit assessments and support the Equator Principles, which address sustainability risks in project financing. We also follow sector-specific guidelines for financing activities in ecologically sensitive industry sectors. We are a participant in the Carbon Disclosure Project, which provides a forum for the world's largest institutional investors to collectively consider the business implications of climate change.



Hang Seng Volunteer Team
恒生義工隊
We organised more than 100 volunteer activities.

ENVIRONMENTAL PERFORMANCE

| | 2010 | 2009 | 2008 | 2007 | 2006 | 2010 vs 2009 (%) | 2010 vs 2008 (%) |
|---|--------------------------|-------|-------|-------|-------|------------------|------------------|
| Greenhouse gas emissions per person* (tons CO ₂ /FTE) | 3.01 | 3.13 | 3.28 | 3.30 | 3.30 | -3.76% | -8.16% |
| Greenhouse gas emissions per m ² * (tons CO ₂ /m ²) | 0.17 | 0.17 | 0.20 | 0.20 | 0.20 | -1.50% | -16.28% |
| Greenhouse gas emissions* (kilotons CO ₂) | 23.97 | 24.52 | 27.40 | 26.70 | 25.30 | -2.26% | -12.54% |
| Electricity consumption (GWh) | 35.32 | 36.50 | 38.10 | 35.90 | 34.10 | -3.24% | -7.30% |
| Gas consumption (GWh) | 0.39 | 0.40 | 0.42 | 0.70 | 0.82 | -1.36% | -6.06% |
| Water consumption (000 m ³) | 71.16[#] | 55.85 | 50.80 | 54.10 | 70.40 | 27.40% | 40.07% |
| IT/electrical waste recycled (tons) | 50.84 | 85.03 | 64.90 | 59.00 | 41.70 | -40.21% | -21.66% |

Data coverage: Hang Seng Bank's Hong Kong operations

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

[#] The rise is largely due to the installation of water-cooled chillers for the air-conditioning system at the Bank's headquarters building, which has led to a reduction in electricity consumption.

Key:

FTE: Full-time equivalent m²: Square metres m³: Cubic metres CO₂: Carbon dioxide GWh: Gigawatt hours

CORPORATE GOVERNANCE AND OTHER INFORMATION

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

BOARD OF DIRECTORS

The Board has collective responsibility for leadership and control of, and for promoting the success of, the Bank by directing and supervising the Bank’s affairs.

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

- five-year strategic plan;
- annual operating plans and performance targets;
- annual and interim results;
- risk appetite;
- internal control and risk management framework;
- specified senior appointments;
- acquisitions and disposals above predetermined thresholds; and
- substantial changes to balance sheet management policies.

Chairman and Chief Executive

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

Board Composition

As at the date of this Annual Report, the Board comprises 15 Directors, of whom two are Executive Directors and 13 are Non-executive Directors. Of the 13 Non-executive Directors, eight are Independent Non-executive Directors. There is a strong independent element on the Board, to ensure the independence and objectivity of the Board’s decision-making process as well as the thoroughness and impartiality of the Board’s oversight of the Management.

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

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

Board Process

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

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

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

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

During 2010, the important matters discussed at the Board meetings included:

- acquisition of headquarters premises in Shanghai by Hang Seng Bank (China) Limited;
- the Bank's internal capital adequacy assessment process;
- review of the Bank's remuneration policy and remuneration system;
- the Bank's strategy for RMB business;
- the Bank's strategy for recruitment, retention and development of talents;
- capital management plan;
- appointments of Directors and senior management; and
- pay review for 2010 and variable incentive pool for 2009.

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

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

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

Appointment, Re-election and Removal

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

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

Four new Directors have been appointed since 2010 Annual General Meeting, namely, Ms L Y Chiang, Ms Sarah C Legg, Mr Mark S McCombe and Mr Michael W K Wu. The aforesaid Directors will all stand for election by the Bank's shareholders at the Bank's Annual General Meeting to be held on 13 May 2011.

Responsibilities of Directors

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

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

- the Bank's business operations in Hong Kong, including personal financial services, corporate and commercial banking, treasury and investment services;
- the Bank's business operations on the Mainland; and
- the Bank's financial control, risk management, internal audit, compliance, information technology and support, and human resources.

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

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

CORPORATE GOVERNANCE AND OTHER INFORMATION

The Bank has adopted a Code for Securities Transactions by Directors on terms no less exacting than the required standards as set out in the Model Code for Securities Transactions by Directors of Listed Issuers (as set out in Appendix 10 to the Listing Rules). Specific enquiries have been made with all Directors who have confirmed that they have complied with the Bank's Code for Securities Transactions by Directors throughout the year of 2010.

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

The interests in Group securities, including securities relating to HSBC Holdings plc and the Bank, held by the Directors as at

31 December 2010 are disclosed in the Report of the Directors as set out in this Annual Report.

DELEGATION BY THE BOARD

Board Committees

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

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

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

Executive Committee

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

To further enhance the Bank's risk management framework and in line with best practices, the Bank has set up a Risk Management Committee to centralise the risk management oversight function of the Bank and its subsidiaries. The Risk

Management Committee reports directly to the Executive Committee. Its main functions are to review, analyse, evaluate, recognise and manage various risks of the Bank, including all the eight types of risks stipulated in the Supervisory Policy Manual of HKMA, namely, credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal and compliance risk, reputation risk and strategic risk. In addition, the Risk Management Committee also covers insurance risk, pension risk and sustainability risk, and is responsible for approval of all risk management related policies.

Audit Committee

The Audit Committee meets at least four times a year, with the Bank's senior executives (including, but not limited to, the Chief Financial Officer, the Chief Risk Officer, the Chief Credit Officer, the Chief Compliance Officer and the Head of Audit)

and representatives of the external auditor, to consider, among other things, the Bank's financial reporting, the nature and scope of audit reviews, and the effectiveness of the systems of internal control and compliance. It is also responsible for the appointment, reappointment, removal and remuneration of the Bank's external auditor. Further, given the importance of risk management to the business and operations of a financial institution, the scope of responsibilities of the Audit Committee has recently been expanded to cover risk management oversight. As such, the Audit Committee will also review the Bank's risk appetite, tolerance and strategy, and the effectiveness of the Bank's risk management framework.

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

The Audit Committee held five meetings in 2010. The major work performed by the Committee during 2010 included:

- reviewing the Bank's financial statements for the year ended 31 December 2009 and the related documents, and the management letter and audit issues noted by the Bank's external auditor;
- reviewing the Bank's interim financial statements for the six months ended 30 June 2010 and the related documents, and the issues noted by the Bank's external auditor;
- reviewing essential matters or reports relating to financial control, internal audit, credit, compliance and internal control, and discussing the same with the Management;
- reviewing risk-related matters including the Bank's risk management framework, risk maps, and balance sheet management position;
- reviewing regulatory review reports and internal audit reports, and discussing the same with the Management and Head of Audit;
- reviewing the revised accounting standards and prospective changes to accounting standards, and the impact on the Bank's financial reporting;
- reviewing the internal audit plan for 2011 and monitoring the staffing and resources of the Bank's internal audit function;
- reviewing the remuneration and engagement letters of the Bank's external auditor, and its objectivity and independence;

- reviewing the adequacy of resources, qualifications and experience of the staff of the accounting and financial reporting function of the Bank, and their training programme and budget;
- reviewing the implementation progress of Sarbanes-Oxley Act;
- reviewing the implementation and effectiveness of the Policy for the Reporting of Improperities;
- reviewing the terms of reference of the Audit Committee for the purpose of expanding its role and responsibilities to cover risk management oversight; and
- exercising oversight over the audit committees of the Bank's principal subsidiaries.

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

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

Remuneration Committee

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

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

CORPORATE GOVERNANCE AND OTHER INFORMATION

The Remuneration Committee held two meetings in 2010. The major work performed by the Committee during 2010 included:

- reviewing the fees payable to the Directors and Board Committee Chairmen/members of the Bank and its subsidiaries;
- reviewing the remuneration packages of the Executive Directors and senior management of the Bank; and the Chief Executive of Hang Seng Bank (China) Limited;
- reviewing the proposed variable incentive pool for 2009;
- reviewing the pay review proposal for 2010;
- determining the proposed revisions of certain senior executives' remuneration packages of the Bank; and
- conducting independent review of the Bank's remuneration system.

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

Attendance Records

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

| | Meetings held in 2010 | | | | |
|---|-----------------------|-------|---------------------|-----------------|------------------------|
| | 2010 AGM | Board | Executive Committee | Audit Committee | Remuneration Committee |
| Number of Meetings | 1 | 7 | 12 | 5 | 2 |
| Directors | | | | | |
| Dr Raymond K F Ch'ien* (Chairman) ^{Note 1} | 1/1 | 7/7 | | | N/A |
| Mrs Margaret Leung (Vice-Chairman and Chief Executive) | 1/1 | 7/7 | 12/12 | | |
| Dr John C C Chan* | 1/1 | 7/7 | | | 2/2 |
| Dr Marvin K T Cheung* | 1/1 | 6/7 | | 5/5 | |
| Ms L Y Chiang* ^{Note 2} | N/A | 1/1 | | | |
| Mr Alexander A Flockhart# ^{Note 3} | 0/1 | 4/7 | | | |
| Mr Jenkin Hui* | 1/1 | 7/7 | | | 2/2 |
| Ms Sarah C Legg# ^{Note 4} | N/A | N/A | | | |
| Mr William W Leung | 1/1 | 7/7 | 11/12 | | |
| Dr Eric K C Li* | 1/1 | 5/7 | | 5/5 | |
| Dr Vincent H S Lo# | 1/1 | 6/7 | | | |
| Mr Iain J Mackay# ^{Note 3} | 1/1 | 6/7 | | | |
| Mr Mark S McCombe# ^{Note 4} | N/A | N/A | | | |
| Mrs Dorothy K Y P Sit# | 1/1 | 7/7 | | | |
| Mr Richard Y S Tang* | 1/1 | 7/7 | | 5/5 | |
| Mr Peter T S Wong# | 1/1 | 5/7 | | | |
| Mr Michael W K Wu* ^{Note 2} | N/A | 1/1 | | | |
| Senior Executives | | | | | |
| Mr Andrew H C Fung | | | 12/12 | | |
| Mr Nixon L S Chan | | | 11/12 | | |
| Mr Christopher H N Ho | | | 11/12 | | |
| Mr Andrew W L Leung | | | 12/12 | | |
| Mr David W H Tam | | | 8/12 | | |
| Average Attendance Rate | 92% | 90% | 92% | 100% | 100% |

* Independent Non-executive Directors

Non-executive Directors

^{Note 1} Dr Raymond K F Ch'ien was appointed as a member of the Remuneration Committee with effect from 5 November 2010.

^{Note 2} Ms L Y Chiang and Mr Michael W K Wu were appointed as Independent Non-executive Directors with effect from 20 September 2010.

^{Note 3} Mr Alexander A Flockhart and Mr Iain J Mackay resigned from the Board with effect from 31 December 2010.

^{Note 4} Ms Sarah C Legg and Mr Mark S McCombe were appointed as Non-executive Directors with effect from 14 February 2011.

REMUNERATION OF DIRECTORS, SENIOR MANAGEMENT AND KEY PERSONNEL

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

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

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

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

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

The scales of Director's fees, and additional fees for Chairmen and members of the Audit Committee and Remuneration Committee for 2010 and 2011 respectively, are outlined below:

| | Fees for 2010 | Fees/Proposed fees for 2011 |
|-------------------------------|-------------------------------|--------------------------------------|
| Board of Directors | | |
| Chairman | HK\$360,000 | HK\$440,000 ^{Note 6} |
| Vice-Chairman | Nil ^{Note 5} | Nil ^{Note 5} |
| Other Directors | HK\$280,000 ^{Note 5} | HK\$340,000 ^{Notes 5 and 6} |
| Audit Committee | | |
| Chairman | HK\$120,000 | HK\$260,000 ^{Note 7} |
| Other Members | HK\$80,000 | HK\$160,000 ^{Note 7} |
| Remuneration Committee | | |
| Chairman | HK\$60,000 | HK\$90,000 ^{Note 7} |
| Other Members | HK\$40,000 | HK\$60,000 ^{Note 7} |

^{Note 5} In line with the remuneration policy of HSBC Group, no Directors' fees are paid to those Directors who are full time employees of the Bank or its subsidiaries.

^{Note 6} Having regard to the latest market trend, and the ever demanding regulatory requirements and industry best practices applicable to the Bank which have significantly expanded the responsibilities and commitments of the Chairman and the Non-executive Directors, a resolution will be proposed for approval by the Bank's shareholders at the 2011 AGM to increase the fees payable by the Bank to the Chairman and the Non-executive Directors to HKD440,000 per annum and HKD340,000 per annum respectively. If approved by the shareholders, the proposed fees will become effective retrospectively as from 1 January 2011. More information on the proposed fees to the Chairman and the Non-executive Directors is set out in the Circular in relation to the 2011 AGM to be issued in March 2011.

^{Note 7} Having regard to the latest market trend, and the workload and commitments required, the Board has approved the increase in the fees payable to the Chairmen and Members of Audit Committee and Remuneration Committee, which became effective as from 1 January 2011.

Information relating to the remuneration of each Director for 2010 is set out in Note 19 to the Bank's 2010 Financial Statements.

Aggregate quantitative information on the remuneration for the Bank's senior management and key personnel is set out below:

- (i) Amount of remuneration for the financial year 2010, split into fixed and variable remuneration, and number of beneficiaries;

| | |
|-----------------------------|------------|
| Fixed Remuneration (HKD) | 34,760,000 |
| Variable Remuneration (HKD) | 29,283,000 |
| Number of beneficiaries | 12 |

CORPORATE GOVERNANCE AND OTHER INFORMATION

- (ii) Amounts and form of variable remuneration for the financial year 2010, split into cash, shares and share-linked instruments and other instruments (if any);

| | |
|---|------------|
| Variable Remuneration in Cash (HKD) (a) | 16,170,000 |
| Variable Remuneration in Shares (HKD) (b) | 13,113,000 |
| Variable Remuneration (HKD) (a) + (b) | 29,283,000 |

- (iii) Amount of deferred remuneration during the financial year 2010 was HKD13,113,000. The aforesaid relates to share awards (variable remuneration) granted and unvested in 2010. According to the terms of the share scheme, the shares awarded have a vesting period of three years, commencing from the first anniversary of the date of award;
- (iv) As mentioned in item (iii) above, the share awards were unvested in the financial year 2010. Accordingly, there was no deferred remuneration awarded during 2010 being paid out or reduced through performance adjustment; and
- (v) No senior management or key personnel has been awarded with new sign-on or severance payment during the financial year 2010.

ACCOUNTABILITY AND AUDIT

Financial Reporting

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

Strategic planning cycles are generally from three to five years. The Bank's strategic plan for 2008 to 2012, following an interim review and adjustments, was reviewed by the Board in December 2009. Progress on the implementation of the strategic plan was reported to and reviewed by the Board on a regular basis.

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

The Directors acknowledge their responsibilities for preparing the accounts of the Bank. As at 31 December 2010, the Directors were not aware of any material uncertainties relating to events or conditions which may cast significant doubt upon the Bank's ability to continue as a going concern. Accordingly, the Directors have prepared the financial statements of the Bank on a going-concern basis.

The responsibilities of the external auditor with respect to financial reporting are set out in the Independent Auditor's Report attached to the Bank's 2010 Financial Statements.

Internal Controls

System and Procedures

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

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

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

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

Management Committee, Risk Management Committee, Executive Committee and Audit Committee, and ultimately to the Board for monitoring the respective types of risk. The Bank's risk management policies and major control limits are approved by the Board or its delegated committees, and are monitored and reviewed regularly according to established procedures of the Bank.

More detailed discussions on the policies and procedures for management of each of the major types of risk the Bank faces, including credit, market, liquidity and operational risks, are included in the risk management section of the "Financial Review" under the Bank's 2010 Annual Report, and in Note 61 to the Bank's 2010 Financial Statements.

Annual Assessment

A review of the effectiveness of the Bank's internal control system covering all controls, including financial, operational and compliance, and risk management controls, is conducted annually. The review at the end of 2010 was conducted with reference to the COSO (The Committee of Sponsoring Organisations of the Treadway Commission) internal control framework, which assesses the Bank's internal control system against the five elements of control environment, risk assessment, control activities, communication and monitoring. The Bank has also conducted an annual review to assess the adequacy of resources, qualifications and experience of staff of the Bank's accounting and financial reporting function, and their training programmes and budget. The approach, findings, analysis and results of these annual reviews have been reported to the Audit Committee and the Board.

Framework for Disclosure of Price Sensitive Information

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

Internal Audit

The internal audit function plays an important role in the Bank's internal control framework. It monitors the effectiveness of internal control procedures and compliance with policies and standards across all business and functional units. All management letters from external auditor and reports from regulatory authorities will be reviewed by the Audit Committee and all recommendations will be implemented. The Management is required to provide the internal audit function with an annual written confirmation that it has acted fully on all recommendations made by external auditor and regulatory authorities. The internal audit function also advises the Management on operational efficiency and other risk management issues. The work of the internal audit function is focused on areas of greatest risk to the Bank as determined by risk assessment. The Bank's Head of Audit reports to the Chairman and the Audit Committee.

External Auditor

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

During 2010, fees paid to the Bank's external auditor for audit services amounted to HK\$13.3m, compared with HK\$13.4m in 2009. For non-audit services, the fees paid to the Bank's external auditor amounted to HK\$5.8m, compared with HK\$5.6m in 2009. In 2010, the significant non-audit service assignments covered by these fees include the following:

| Nature of service | Fees paid (HK\$m) |
|--------------------------|-------------------|
| Other assurance services | 5.7 |
| Tax services | 0.1 |
| | <u>5.8</u> |

Audit Committee

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

COMMUNICATION WITH SHAREHOLDERS

Effective Communication

The Bank attaches great importance to communication with shareholders. To this end, a number of means are used to promote greater understanding and dialogue with the investment community. The Bank holds group meetings with analysts in connection with the Bank's annual and interim results. The results announcements are also broadcast live via webcast. Apart from the above, designated senior executives maintain regular dialogue with institutional investors and analysts to keep them abreast of the Bank's development, subject to compliance with the applicable laws and regulations. Including the two results announcements, a total of 95 meetings with 308 analysts and fund managers from 222 companies were held in 2010. In addition, the Bank's Vice-Chairman and Chief Executive; and Chief Financial Officer also made presentations and held group meetings with investors at investor forums in Hong Kong and overseas.

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

The Annual General Meeting provides a useful forum for shareholders to exchange views with the Board. The Bank's Chairman, Executive Directors, Chairmen of the Board Committees and Non-executive Directors are available at the Annual General Meeting to answer questions from shareholders. Separate resolutions are proposed at general meetings for each substantial issue, including the re-election and election (as the case may be) of individual Directors. An explanation of the detailed procedures of conducting a poll will be provided to shareholders at the commencement of the Annual General Meeting, to ensure that shareholders are familiar with such procedures.

The Bank's last Annual General Meeting was held on Friday, 14 May 2010 at Hang Seng Bank Headquarters, 83 Des Voeux Road Central, Hong Kong. All the resolutions proposed at that meeting were approved by the shareholders by poll voting. Details of the poll results are available under the investor relations section of the Bank's website at www.hangseng.com.

The next Annual General Meeting will be held on Friday, 13 May 2011, the notice of which will be sent to shareholders at least 20 clear business days before the said meeting. Shareholders may refer to the section "Corporate Information and Calendar" in this Annual Report for information on other important dates for shareholders in year 2011.

OTHER INFORMATION

The Annual and Interim Reports contain comprehensive information on business strategies and developments. Discussions and analyses of the Bank's performance during 2010 and the material factors underlying its results and financial position can be found in the sections "Business in Hong Kong", "Business on the Mainland" and "Financial Review" in this Annual Report.

Material Related Party Transactions and Contracts of Significance

The Bank's material related party transactions are set out in Note 60 to the 2010 Financial Statements. These transactions include those that the Bank has entered into with its immediate holding company and fellow subsidiary companies in the ordinary course of its interbank activities, including the acceptance and placement of interbank deposits, corresponding banking transactions, off-balance sheet transactions, and the provision of other banking and financial services.

The Bank uses the information technology services of, and shares an automated teller machine network with, The Hongkong and Shanghai Banking Corporation Limited, its immediate holding company. The Bank also shares information technology and certain processing services with fellow subsidiaries on a cost recovery basis. In 2010, the Bank's share of the costs includes HK\$164m for system development, HK\$214m for data processing, and HK\$168m for administrative services.

The Bank maintains a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. As part of its ordinary course of business with other financial institutions, the Bank also markets Mandatory Provident Fund products and distributes retail investment funds for fellow subsidiaries, with a fee income of HK\$209m and HK\$81m respectively in 2010. Hang Seng Investment Management Limited, a wholly owned subsidiary of the Bank, manages in the ordinary course of its business a fund administered by a fellow subsidiary, to which management fee rebates were made. The rebate for 2010 amounted to HK\$137m.

These transactions were entered into by the Bank in the ordinary and usual course of business on normal commercial terms, and in relation to those which constituted connected transactions under the Listing Rules, they also complied with applicable requirements under the Listing Rules. The Bank regards its usage of the information technology services of The Hongkong and Shanghai Banking Corporation Limited (amount of information technology services cost incurred for 2010: HK\$478m) as contracts of significance for 2010.

Connected Transaction and Continuing Connected Transactions

Connected Transaction

On 20 May 2010, Hang Seng Bank (China) Limited (“HACN”), a wholly-owned subsidiary of the Bank, entered into a sale and purchase agreement with HSBC Bank (China) Company Limited (“HBCN”) and Shanghai Senmao International Real Estate Company Limited. Pursuant to the aforesaid agreement, HACN conditionally agreed to acquire (the “Acquisition”) from HBCN, Unit 101 and the whole of 34th, 35th and 36th Floors (the “Property”) of HSBC Tower (now renamed as Hang Seng Bank Tower) (the “Building”) at 1000 Lujiazui Ring Road, Shanghai, the People’s Republic of China, together with the right to the exclusive use of certain car parking spaces, and the naming right in respect of the Building and the right to put up signages on certain designated places of the Building (collectively the “Naming and Signage Rights”), at a total consideration of RMB510m.

Following the completion of all conditions precedent, the Acquisition was completed on 16 September 2010. The consideration was funded by internal resources of the Group.

HACN would relocate its headquarters to the Property for its long term development and achievement of the China strategies of the Group. The acquisition of the Naming and Signage Rights would serve the dual purposes of enhancing the Group’s corporate profile and image on the Mainland, and signifying its commitment to the mainland market.

The Directors (including the Independent Non-executive Directors) consider that the Acquisition is in the ordinary and usual course of business of the Bank and the terms of the Acquisition are on normal commercial terms, fair and reasonable and in the interests of the Bank and its shareholders as a whole.

HBCN is a wholly-owned subsidiary of HSBC Holdings plc (“HSBC”), the controlling shareholder of the Bank and therefore a connected person of the Bank. Accordingly, the Acquisition constituted a connected transaction for the Bank under the Listing Rules. An announcement relating to the aforesaid was issued by the Bank on 20 May 2010. The Bank has complied with the disclosure requirements in accordance with Chapter 14A of the Listing Rules.

Continuing Connected Transactions

- (a) On 22 June 2007, Hang Seng Life Limited (“HSL”) entered into the following agreements, which expired on 21 June 2010:
- (i) A management services agreement (“Previous Management Services Agreement”) for a term of three years with HSBC Life (International) Limited (“INH”), pursuant to which INH would continue to provide certain management services, being services relating to risk management, back office processing and administration, development and pricing for selected products, information technology and business recovery, financial control and actuarial services (the “Management Services”), to HSL to enable HSL to conduct its life insurance business.

INH charged HSL for the provision of the services on a fully absorbed cost basis plus a mark-up of 5%. These charges were determined following negotiation on an arm’s length basis and in accordance with the policy of HSBC Group, which took into account the transfer pricing guidelines of UK and the Organisation for Economic Co-operation and Development (“OECD”).

CORPORATE GOVERNANCE AND OTHER INFORMATION

- (ii) An investment management agreement (“Previous Investment Management Agreement”) for a term of three years with HSBC Global Asset Management (Hong Kong) Limited (formerly known as HSBC Investments (Hong Kong) Limited) (“ISHK”), pursuant to which ISHK would continue to act as investment manager in respect of certain of HSSL’s assets held from time to time to maintain business continuity of HSSL.

HSSL paid to ISHK a fee of between 0.17% and 0.375% per annum of the mean value of the assets under management, which was determined on an arm’s length basis.

HSSL has become a wholly-owned subsidiary of Hang Seng Insurance Company Limited (“HSIC”), which in turn is a wholly-owned subsidiary of the Bank, since September 2007. As part of the plan of the Bank to rationalise its insurance business structure, HSSL’s long term insurance business has been integrated into that of HSIC. Accordingly, all rights and obligations under the agreements entered into between HSSL and the third parties have then been novated to HSIC. These agreements include, among others, the Previous Management Services Agreement and the Previous Investment Management Agreement.

Details of the terms of and the annual caps under the Previous Management Services Agreement and the Previous Investment Management Agreement for the years 2007, 2008 and 2009 were announced by the Bank on 22 June 2007. The Bank has also set the caps under each of the aforesaid agreements for the period from 1 January to 22 June 2010, details of which were announced by the Bank on 18 December 2009.

- (b) On 22 June 2010, HSIC entered into the following new agreements:

- (i) a new management services agreement (“New Management Services Agreement”) with INHK for a term of three years commencing from 22 June 2010, pursuant to which INHK, directly or through one or more of its affiliates, would provide the Management Services to HSIC.

INHK will charge HSIC for the provision of the services on a fully absorbed cost basis plus a mark-up of 5%, which is the same as that under the Previous Management Services Agreement. These charges have been determined following negotiation on an arm’s length basis and in accordance with the policy of the HSBC Group, which takes into account UK and OECD transfer pricing guidelines.

- (ii) a new investment management agreement (“New Investment Management Agreement”) with ISHK for a term of three years commencing from 22 June 2010, pursuant to which ISHK would act as investment manager in respect of certain of HSIC’s assets held from time to time.

HSIC will pay, on a quarterly basis, to ISHK a fee of between 0.17% and 0.375% per annum of the mean value of the assets under management, which is equal to the fee payable under the Previous Investment Management Agreement and has been determined on an arm’s length basis.

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

The Directors believed that the New Management Services Agreement would enable HSIC to run at a reasonably low cost structure by leveraging on the shared infrastructure and expertise of INHK. The resulting cost efficiency has contributed to increased competitiveness of HSIC’s manufactured products in the market, which the Directors considered to be essential to the future business growth of HSIC.

The New Investment Management Agreement was based on the commercial terms set out in the Previous Investment Management Agreement and the Directors (including the Independent Non-executive Directors) believed that these terms should remain in place.

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

For the year ended 31 December 2010, the aggregate amount paid under the Previous and the New Management Services Agreements was HK\$97m, whereas the aggregate amount paid under the Previous and the New Investment Management Agreements was HK\$52m.

In respect of the agreements mentioned in paragraphs (a) and (b) above which constituted the Bank's continuing connected transactions, all the Independent Non-executive Directors of the Bank have reviewed the said transactions and confirmed that the said transactions have been entered into:

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

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

Human Resources

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

Employee Statistics

As at 31 December 2010, the Bank's total headcount was 9,642, representing an increase by 300, or 3.2%, compared with a year earlier. The total headcount comprised 1,251 executives, 3,896 officers and 4,495 clerical and non-clerical staff.

Grading Structure

To simplify the Bank's job grade structure and to facilitate the implementation of a market pay strategy, "Broadbanding" is introduced to replace the Bank's existing grading structure with effect from 1 January 2011.

The broad-banded structure allows for greater ease of movement by enabling career and/or salary progression without the prerequisite of changing job grade. It also provides flexibility to match internal pay levels to market trends and to differentiate rewards based on performance and potential.

The implementation of Broadbanding will facilitate the Bank in adopting a market-led strategy which helps to attract, develop and motivate the best employees which should ultimately result in improved productivity and achievement of business objectives.

Employee Remuneration

The Bank has adopted the Total Reward Approach which focuses on staff's total compensation with fixed pay based on individual market pay position and variable pay differentiated by performance. To facilitate the implementation of the Bank's performance-based reward strategy, individual and business performances are assessed systemically against pre-determined business, compliance and risk management objectives in guiding reward decisions. In determining the total remuneration for employees, the Bank will take into account the seniority, responsibility, remuneration package and risk profile to ensure an appropriate balance between the fixed pay and variable pay.

CORPORATE GOVERNANCE AND OTHER INFORMATION

Fixed pays take into account levels and composition of pay in the markets in which the Bank operates. Salaries are reviewed in the context of individual and business performance, market practice, internal relativities, risk management requirements and competitiveness compared to peers.

Under appropriate circumstances, performance-related variable pay is provided as an incentive for those eligible staff members under performance-based remuneration strategy. In determining the size and allocation of variable pay budget, the Bank will take into consideration the Bank's performance over the longer term, the economic outlook, market practices, risk appetite, capital and liquidity position as well as other non-financial factors. Variable pays for individual employees are differentiated with their responsibilities, performance, potential, and contributions. According to specific variable pay award criteria, a portion of variable pay of senior staff is deferred in the share award so as to tie them to the future performance of the Group and ensure effective alignment of incentive reward to effective risk management. The deferred share award has a vesting period of three years; with gradual vesting on a pro-rata basis commencing from the first anniversary of the date of award. The vesting of share award is also subject to the employee's continued employment.

In addition, the Bank has participated in the HSBC Holdings Savings-related Share Option Plan ("Sharesave"), under which staff members can make monthly savings for the purchase of shares of HSBC Holdings plc after a specified period. For Sharesave 2010, 2,349 staff members have subscribed to the plan.

Employee Involvement

Communication with staff is a key aspect of the Bank's policies. Information relating to employment matters, the Bank's business direction and strategies, and factors affecting the Bank's performance are conveyed to staff via different channels, including an intranet site, in-house magazines, morning broadcasts and training programmes.

The fourth bankwide Global People Survey was conducted in June 2010 as a continuous initiative to measure staff engagement level. The results were very positive as the employee engagement index was among the best in class. Communication sessions to staff were organised to share the survey results and collect feedback for continual enhancement.

Staff Development

In order to fully develop staff capability and potential, the Bank offers a wide range of training and development programmes that help the staff fulfill their personal career goals and professional requirements, including those for regulated businesses and activities, and equip them to meet future challenges.

New staff joining the Bank will participate in a comprehensive induction programme that provides them with an understanding of the Bank's history, culture, values and corporate governance. Sustainable development of staff is enabled through multiple learning channels, including instructor-led training courses and web-based learning via an intranet platform. Staff members are also encouraged to pursue professional or academic qualifications through the Bank's Professional Qualifications and Education Award Scheme.

A talent strategy has been in place with the aim to provide a ready, good quality internal pipeline to fill critical positions, and to build talents to feed leadership roles across the Bank. Identified talents are populated into the succession plans to critical positions and are provided with a mix of development interventions to accelerate their growth.

On average, our staff members received six days of training in 2010.

Recruitment and Retention

The employment market was very active especially in the second half of 2010. Vigorous recruitment activities continued to meet business needs and for replacement of staff turnover, especially for front-line sales positions, experienced professionals and specialists.

There were also conscious efforts on retention of talents and key staff. As part of the Bank's staff retention strategies, remuneration packages and career paths for certain job positions have been reviewed to increase career advancement opportunities and ensure market competitiveness. Further, trainee programmes have been provided for jobs in selected functional areas in order to build pipeline for succession.

Business principles and values

The Bank has adopted HSBC Group's business principles and values requiring staff to keep the highest personal standards of integrity at all levels, to commit to truth, fair dealing, quality and competence as well as to comply with the spirit and letter of all laws and regulations when conducting business. "Commitment to integrity and ethics" is also one of the expectations on its staff. Staff members are required to adhere strongly to high professional ethics and demonstrate an honest and credible character in work as well as in the relationship with the Bank's customers.

Code of Conduct

To ensure the Bank operates according to the highest standards of ethical conduct and professional competence, all staff are required to strictly follow the Code of Conduct contained in the Bank's Staff Handbook. With reference to the applicable regulatory guidelines and other industry best practices, the Code sets out ethical standards and values to which all the Bank's staff are required to adhere and covers various legal, regulatory and ethical issues. These include topics such as prevention of bribery, dealing in securities, personal benefits, outside employment and anti-discrimination policies.

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

Health and Safety

The Bank acknowledges and accepts its responsibilities for securing the health, safety and welfare of all its employees, of contractors working at premises over which it has control, and

of visiting members of the public. By successfully implementing the certified BS OHSAS 18001:2007-compliant Safety Management System, the Bank marks its achievement to be the first bank world-wide to conform to this internationally acclaimed best practice aiming at reducing the exposure of the Bank's staff and customers to occupational safety and health risks associated with its business activities.

The Bank provides a range of training and promotional activities to enhance the knowledge of its staff in occupational safety and health, fire safety, manual handling, and office safety.

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

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

Corporate Governance Recognition

In recognition of the Bank's continuous excellence in and reputation for its leading approach to good corporate governance, it was named No.3 in the Best Corporate Governance Awards in Hong Kong by Euromoney, a leading financial sector publication, in 2010. The Euromoney's award, which was based on a survey of market analysts at leading banks and research institutes in Asia, affirmed the Bank's adherence to the highest standards of business ethics and corporate governance.

TAKING THE LEAD

DRIVE



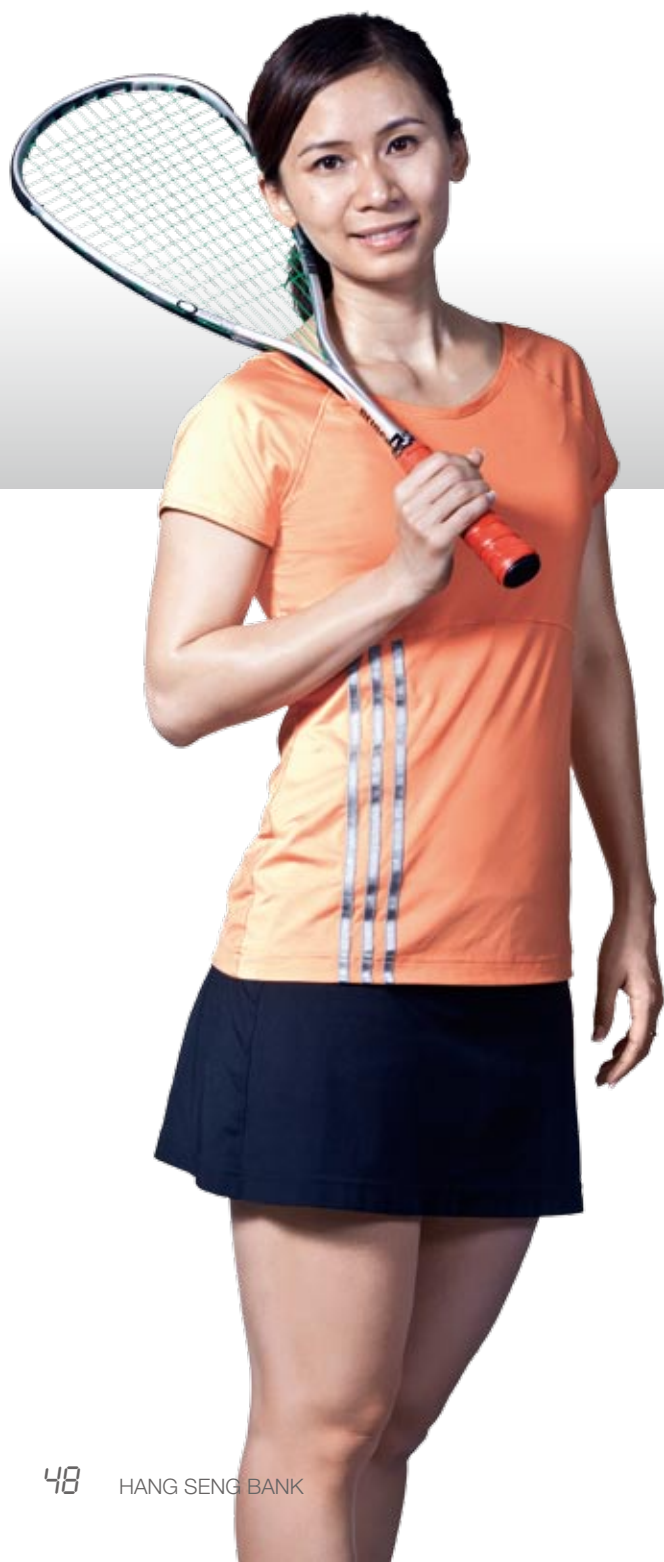


2010 Asian Games –
Squash, Silver Medal

Rebecca Chiu

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS IN HONG KONG



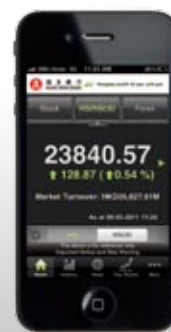
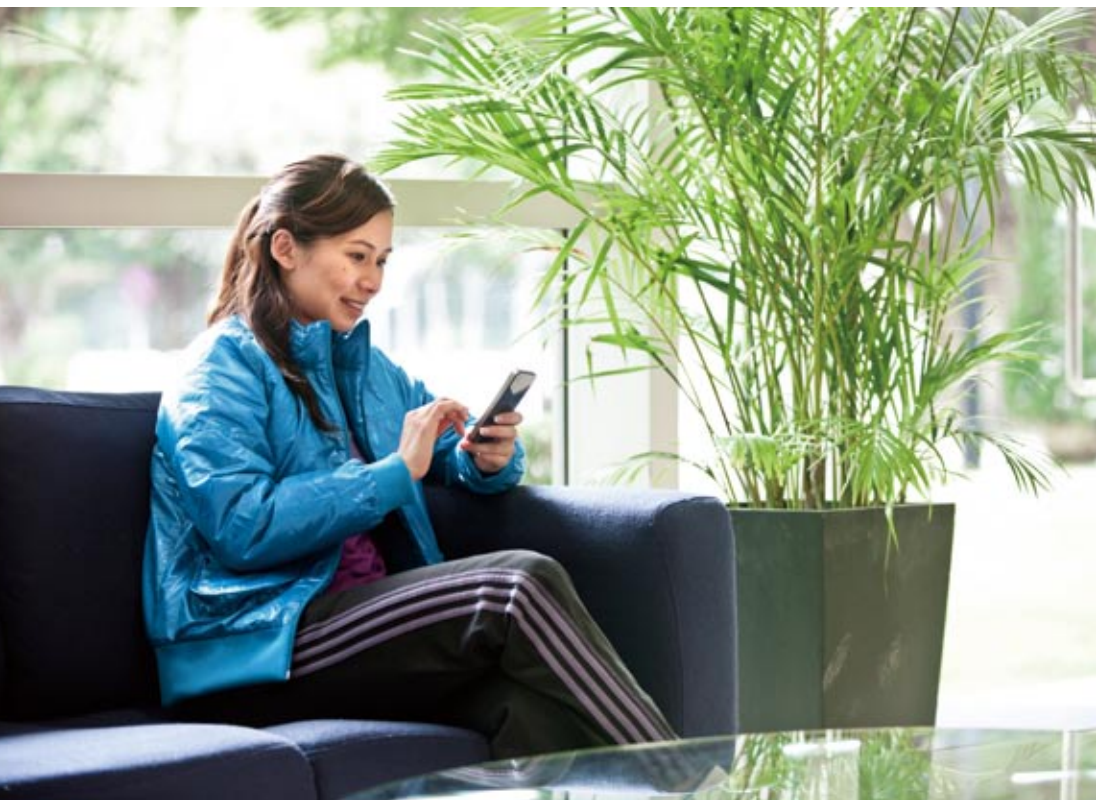
Hang Seng's trusted brand, diverse portfolio of financial products and extensive network of service channels reinforced our leading position in key areas of banking during 2010.

Our swift response to the opening up of new avenues of business strengthened our foothold in sectors with good potential for future growth.

With increased demand for loans, we leveraged our balance sheet strength to achieve a 36.9% increase in gross advances to customers to HK\$474.5bn. Customer deposits, including certificates of deposit and other debt securities in issue, rose by HK\$46.7bn, or 7.0%, to HK\$710.3bn, driven in part by good growth in renminbi deposits.

PERSONAL FINANCIAL SERVICES

Personal Financial Services' operating profit excluding loan impairment charges rose by 5.5% to HK\$7,865m, reflecting increases in lending and fee-related business. Operating profit was up 9.3% at HK\$7,656m, driven by a 54% improvement in loan impairment charges. Profit before tax grew by 8.5% to HK\$7,872m.



We launched a first-of-its-kind foreign exchange margin trading iPhone application.

Net interest income increased by 3.5% to HK\$8,485m, with good growth in credit card business and personal loans more than offsetting the adverse effects of downward pressure on deposit spreads and mortgage loan pricing.

Net fee income rose by 14.1%. We used our wealth management strength to help customers pursue their financial goals against a backdrop of changing market conditions – recording significant increases in investment fund and insurance agency fees. The upturn in investment sentiment and our emphasis on personalised service supported a 24.9% rise in service fee income from private banking.

We continued to invest in technology to provide our customers with fast, convenient and secure access to financial services. Personal e-Banking passed two major milestones in 2010 – registering its 1 millionth customer in the first half of the year and celebrating its 10th anniversary in August.



We made good use of the popular mobile platform, reaching out to younger and tech-savvy customers with the launch of two iPhone applications. Our first application, which provides on-the-move access to securities and foreign exchange investment information, recorded about 40,000 registrations in its first month. In August, we built on this success with the launch of a first-of-its-kind foreign exchange margin trading application, helping drive growth in the retail margin trading account base.

At the end of 2010, the number of Personal e-Banking customers was up 10.2% at 1.1 million compared with a year earlier. The percentage of total personal banking transactions conducted via Personal e-Banking was up 0.7 percentage points at 52.2%.

Wealth Management

Wealth management income rose by 9% to HK\$5,092m. We maintained a steady growth trend during the year to record a 4.1% increase in revenue in the second half of 2010 compared with the first half.

Against the backdrop of a tighter regulatory environment, we achieved a 9.8% rise in investment services income to HK\$2,786m – driven largely by the 85.1% growth in fee revenue from investment fund business. Enhancements to our life insurance proposition and increased returns from the life insurance investment funds portfolio generated a 9.7% rise in life insurance income to HK\$2,121m.

+180.8%

retail investment funds sales

Improving economic conditions and continuing low interest rates generated renewed customer interest in investment opportunities offering enhanced yields. Our trusted reputation for wealth management services and time-to-market competitive strength helped us capitalise on the increase in investor activity. We also established a new customer referral mechanism to capture more business from affluent mainland Chinese individuals looking for wealth management services in Hong Kong.

Riding on the robust Mainland economy and growing demand for investment exposure to the renminbi, we developed new China-related funds. In November, we became the first non-Mainland fund manager to offer a renminbi bond investment fund in Hong Kong with the launch of the Hang Seng RMB Bond Fund – which was fully subscribed in four days. Our Hang Seng A Share Focus Fund that was authorised earlier in the year also enjoyed a good response from customers. These new products helped drive strong growth of 180.8% in retail investment fund sales and we increased our investment fund market share – further reinforcing our reputation for Hong Kong and Mainland-focused product development expertise.

Our innovative foreign exchange margin trading iPhone application was a primary driver of the 54.5% increase in new margin trading accounts in the second half of the year compared with the first half. The margin trading account base increased by 3.8% year on year.

We worked to establish ourselves as a market leader in providing renminbi-related retail investment opportunities. In addition to our RMB Bond Fund, we offered a renminbi-denominated floating rate bond and equity-linked note. We were also the first bank in Hong Kong to launch renminbi certificates of deposit for retail investors.

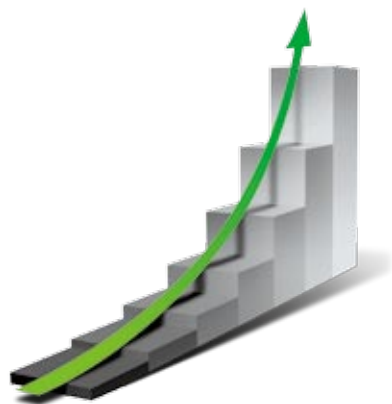
With strong market competition in securities services, we launched customer acquisition and service utilisation promotions, and enhanced our Internet-based securities platform with convenient new functions such as online submission of corporate events instructions, supporting a 16.2% increase in income from stockbroking and related services in the second half of 2010 compared with the first half.



We worked to establish ourselves as a market leader for renminbi-related retail investment opportunities.

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS IN HONG KONG



Our credit card base passed the 2 million cards in circulation milestone.

We continued to strengthen our position as a prominent provider of retirement planning and life insurance solutions. We further diversified our insurance offerings with new products and improved protection under existing plans to meet the needs of customers at different life stages. We enhanced the capacity of our telemarketing channel to increase our market penetration of the younger customer segment. We also launched strategic promotional offers to expand relationships with existing insurance customers. This proved effective in driving sales, with life insurance policies in-force and annualised premiums growing by 8.6% and 13.3% respectively. Insurance agency fee income rose by 34.7%.

Effective management of the life insurance funds investment portfolio generated a HK\$270m increase in investment gains and an 18.4% rise in related net interest income and fee income for the year.

Consumer Finance

Lending to individuals grew by 8.8% to HK\$185.3bn.

We capitalised on the positive outlook of consumers and robust domestic demand with card utilisation incentive offers. In June, we launched the Hang Seng Hong Kong dollar China UnionPay (CUP) credit card which offers cardholders access to the extensive CUP merchant network in Hong Kong and on the Mainland, as well as in many countries overseas. This new card enjoyed strong uptake, with over 100,000 issued by the end of 2010, helping to drive the 11.2% rise in the card base to over 2 million cards in circulation. We gained market share and maintained our number two ranking for card advances and cardholder spending, which grew by 13.9% and 18.4% respectively.

Excluding Government Home Ownership Scheme mortgages, residential mortgage lending to individuals increased by 11.1% to HK\$134.7bn. Amid intense market competition and government measures to cool speculation in the property sector, our multi-platform mortgage services helped us outperform the market in terms of new mortgage registrations and grow our overall market share.

+224.8%

Commercial Banking trade finance



COMMERCIAL BANKING

Commercial Banking leveraged its competitive strengths to capitalise on improved commercial and trade activity in 2010, recording a 34.3% increase in operating profit excluding loan impairment charges to HK\$2,671m. Operating profit rose by 45.7% to HK\$2,493m, reflecting the positive impact of the economic recovery and effective credit risk management on loan impairment charges, which fell by 36%. Profit before tax was up 42.1% at HK\$3,748m.

Net interest income rose by 34.7% to HK\$2,709m. Benefitting from our close customer relationships and good understanding of market trends, we moved quickly to meet the growing demand for financing, achieving a 102.1% increase in customer advances to HK\$167.5bn, with a 57.8% rise in related net interest income.

As a well-established supporter of local business, we remained an active participant in government-initiated loan schemes for SMEs, with total lending under these programmes reaching more than HK\$18.4bn by the end of 2010.

We helped customers manage risk while taking advantage of the improving economic conditions, resulting in a 224.8% increase in trade finance to HK\$62.5bn.

We took steps to enhance service access and efficiency at Business Banking Centres and strengthened customer referral mechanisms, supporting a 35.2% rise in the number of new account openings compared with 2009.

Business
Banking
商務理財

Commercial Banking achieved a 35.2% year-on-year increase new account openings.

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS IN HONG KONG



The increase in the customer base helped drive a 14.5% increase in deposits, which partly offset the adverse effects of the continuing compression of spreads. Net interest income from deposits fell by 19%.

With the widening scope of renminbi financial services in Hong Kong, we leveraged our strong internal infrastructure to establish ourselves as a market leader. We were the first bank in Hong Kong to launch a renminbi prime rate and to lead-arrange a renminbi syndicated loan, placing us in a good position to capture a growing share of business in this important new market sector. At the end of 2010, we had more than 58,000 renminbi commercial accounts and had helped settle more than RMB35bn in renminbi cross-border trade-related business.

Net fee income increased by 8.5% to HK\$1,209m, supported in part by good growth in corporate insurance business.

Trade-related fee income was up 16.1%. In addition to our comprehensive suite of renminbi products and services, our close collaboration with Hang Seng China and strategic alliances with Mainland partners reinforced the competitive strength of our cross-border capabilities and proved a valuable source of top-end customer referrals.

Our extensive Mainland correspondent bank network facilitated efficient cross-border transactions, resulting in a 22.1% increase in fee income from remittances.



Our service excellence was recognised with an 'Achievement Award for Cash Management in Hong Kong'.

We used platforms including cash management and yield enhancement to market our growing portfolio of corporate wealth management offerings. We worked to streamline insurance underwriting processes and extended the reach of our 'premium financing' programme to provide customers with a faster service and more flexibility in obtaining insurance coverage, helping us achieve good growth in sales of universal life insurance products and our Executive Retention Insurance Plan.

In the low interest rate environment, we offered customers improved-yield investment opportunities serving a variety of risk appetites, recording increases in sales of structured products and treasury instruments. Income from investment and treasury business rose by 80.6%.

Overall, income from corporate wealth management increased by 26.6%, representing 13.4% of Commercial Banking's net operating income before loan impairment charges.

Our efforts to assist customers brought us industry recognition, with an 'Achievement Award for Cash Management in Hong Kong' at *The Asian Banker* Transaction Banking Awards 2010. We received an 'SME's Best Partner Award' from the Hong Kong Chamber of Small and Medium Business for the fifth consecutive year.

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS IN HONG KONG



Our renminbi cross-border trade settlement business topped RMB35bn.



We made further enhancements to our online channel, providing a wider range of investment services and support for renminbi account services. At 31 December 2010, the number of Business e-Banking customers had risen by 19.3% compared with a year earlier to more than 92,000. The number of online business customer transactions was up 19%, with online securities transactions reaching 51.4% of total securities transactions.

CORPORATE BANKING

Corporate Banking recorded a 29.1% increase in operating profit excluding loan impairment charges to HK\$1,264m.

Net operating income before loan impairment charges was up HK\$332m, or 25.3%, at HK\$1,643m, due mainly to the 24.4% rise in net interest income to HK\$1,440m.

In a competitive operating environment, we achieved a 32.4% increase in customer advances. With property-related financing traditionally a key element of Corporate Banking lending, the tightening of property sector regulations in Hong Kong and on the Mainland during 2010 created new challenges. We leveraged our in-depth understanding of local markets to capture more business in other industry sectors. Our cross-border capabilities proved a useful tool in expanding lending to the Hong Kong-based operations of well-established large Mainland enterprises and in growing trade finance. Net interest income from advances rose by 27.5%.

+19.3%

Business e-Banking customers

Customer deposits increased by 34.5%, but the effects of continuing low interest rates saw net interest income from deposits fall by 29.4%.

We leveraged our strong customer relationships and market leadership for renminbi financial services to explore new opportunities for growing fee-based business and further diversifying income. We capitalised on rising demand for renminbi investment products to open more client investment accounts and increased corporate wealth management sales turnover. Fee income for the year grew by 29.7% to HK\$188m.

With loan impairment charges improving by 96.2%, Corporate Banking recorded an operating profit of HK\$1,261m – up 40% compared with a year earlier. Profit before tax rose by 38.4% to HK\$1,266m.

TREASURY

Treasury's operating profit fell by 24.3% to HK\$2,207m, with growth in trading income outweighed by the decline in net interest income in difficult market conditions. A 68.4% increase in the share of profits from associates and a disposal gain helped support profit before tax, which was down just 0.9% at HK\$3,361m.

Net interest income dropped by 35.1% to HK\$1,403m. Excess market liquidity and continuing uncertainty over the outlook for sustained global economic recovery kept downward pressure on interest rates, serving to limit good investment opportunities under the balance sheet management portfolio. Yield curves remained relatively flat, particularly in the first half of the year. With increased loan demand from business customers, a substantial proportion of the commercial surplus was redeployed to support commercial lending.

We continued to emphasise prudent risk management while taking steps to defend the interest margin. As market conditions changed, we disposed of selected instruments and invested in high-quality enhanced-yield assets, generating a HK\$95m disposal gain. We took advantage of gapping opportunities to capitalise on yield differentials. This effective management of the balance sheet management portfolio underpinned the 30.4% increase in net interest income to HK\$794m in the second half of the year compared with the first half.

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS IN HONG KONG



We took steps to enhance service access and efficiency for customers.



With the further liberalisation of the renminbi financial services sector in Hong Kong, we actively sourced and developed renminbi-denominated products to meet growing demand from customers, and strengthened cross-selling and customer referral mechanisms with corporate and commercial banking business units, supporting a 10.2% increase in trading income to HK\$1,162m.

HANG SENG INDEXES

Wholly owned subsidiary Hang Seng Indexes Company Limited (Hang Seng Indexes), strengthened its indexing services and expanded its global exposure in 2010 with the launch of new indexes and the overseas listing of new index-linked funds.

In March, Hang Seng Indexes restructured the Hang Seng Family of Indexes based on the findings of an extensive market consultation exercise undertaken in 2009 and, in July, deepened its coverage of the Hong Kong and Mainland markets with the launch of two new index series.

The Hang Seng Corporate Sustainability Index Series serves the increasing market interest in the development of socially responsible investment products and also aims to raise awareness about corporate sustainability issues among listed companies and the financial communities

in Hong Kong and on the Mainland. Comprised of the Hang Seng Corporate Sustainability Index, the Hang Seng (China A) Corporate Sustainability Index and the Hang Seng (Mainland and HK) Corporate Sustainability Index, the series is the first of its kind to focus exclusively on Hong Kong and the Mainland.

The Hang Seng Dividend Point Index Series – consisting of the Hang Seng Index Dividend Point Index and the Hang Seng China Enterprises Index Dividend Point Index – provides the market with indicators to track cash dividends from Hang Seng Index (HSI) constituents and Hang Seng China Enterprise Index (HSCEI) constituents respectively. In November, Hong Kong Exchanges and Clearing Limited launched dividend futures based on the index series, reflecting its value in providing benchmarks for investment products hedging dividend risks.

Hang Seng Indexes increased its profile in both Asia and Europe during 2010. In July, the exchange-traded funds (ETFs) of ComStage HSI and ComStage HSCEI were listed on the SIX Swiss Exchange. Later in the year, new funds tracking the HSCEI were listed in the Mainland and Japan – an open-ended fund on the Shenzhen Stock Exchange and an ETF on the Tokyo Stock Exchange.

Hang Seng Indexes now compiles 88 publicly available indexes – 46 real-time price indexes and 42 daily indexes – of which 34 track the Mainland segment of the market. In addition to its publicly available indexes, Hang Seng Indexes also compiles customised indexes to serve the specific indexing needs of various clients.

The total number of futures and options contracts traded on the HSI and the HSCEI in 2010 increased by 11.8% and 7.1% respectively compared with 2009. At 31 December 2010, the total size of ETFs tracking all indexes in the Hang Seng Family of Indexes was over US\$12bn.



Backed by our trusted brand, we reinforced our leading position in key areas of financial services.

88

publicly available indexes compiled by
Hang Seng Indexes Company Limited

● GUANGZHOU

● FOSHAN

● DONGGUAN

● SHENZHEN

● ZHONGSHAN

● KUNMING



● BEIJING

● TIANJIN

● NANJING

● SHANGHAI

● HANGZHOU

● NINGBO

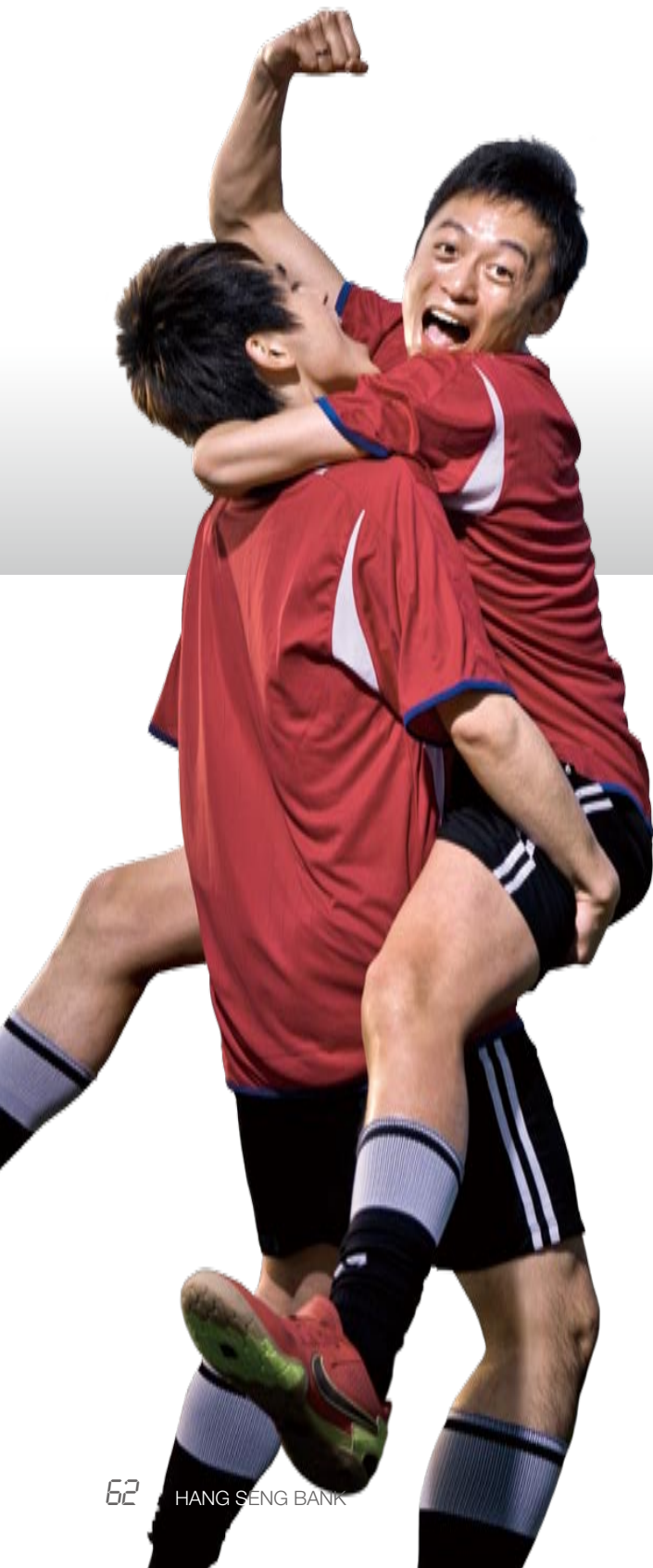
● FUZHOU

TAKING THE LEAD

DIRECTION

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS ON THE MAINLAND



Assisted by good brand building and steps to expand the breadth and depth of our financial services proposition, we made significant progress with developing our mainland China business in 2010.

Through our Mainland subsidiary bank, Hang Seng Bank (China) Limited, we further leveraged strategic alliances to offer a wider range of wealth management products and more convenient access to services. An improved business referral mechanism assisted with the acquisition of new customers and helped us deepen existing relationships. We launched initiatives to promote greater awareness of the Hang Seng China brand among key customer segments and in cities with good economic potential.

These developments drove a 15.3% increase in the customer base, providing support for the expansion of deposits to underpin long-term business growth.

Hang Seng China purchased headquarters premises in Shanghai and added two new cross-location sub-branches in the Pearl River Delta region.



Excluding exchange losses on the revaluation of US dollar capital against the renminbi, Hang Seng China's profit before tax rose by 139.8%. Total operating income grew by 24.1%, supported by increases in both net interest income and non-interest revenue, to more than offset rises in operating costs and loan impairment charges.

We achieved a 17.2% increase in the Mainland Prestige Banking account base.

Government steps to keep inflation under control amid robust economic growth led to a tighter regulatory environment, particularly for property-related lending. Market competition for deposits business remained keen. Against this backdrop, we achieved encouraging increases in customer advances and deposits, resulting in an 8.3% rise in net interest income.

We continued to emphasise credit risk management over portfolio expansion, focusing on high-quality borrowers that offered good potential for generating additional revenue through cross-selling opportunities and deposits business. At 2010 year-end, lending was up 28.4% compared with a year earlier. Residential mortgage lending fell by 3%, reflecting the impact of government measures to cool activity in the property market.

Customer deposits rose by 76.1%, leading to further improvement in our advances-to-deposits ratio.

Leveraging our growing Mainland wealth management and renminbi trade settlement capabilities, we took successful steps to further diversify our revenue base, resulting in a 106.3% rise in non-interest income.

MANAGEMENT DISCUSSION AND ANALYSIS

BUSINESS ON THE MAINLAND



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

Including the share of profit from Hang Seng's Mainland strategic partners, Industrial Bank and Yantai Bank, Mainland business contributed 14.9% to total profit before tax, compared with 13.3% in 2009.

SERVICES

We improved access to services and broadened our range of product offerings, with a particular emphasis on attracting new business in key customer segments.

We deepened existing customer relationships by promoting total wealth management financial solutions and establishing a new structure to boost cross-referrals and resource sharing among Mainland business divisions.

Our wealth management strength in Hong Kong proved an effective tool in the development and launch of new investment products, helping to reinforce Hang Seng China's growing reputation as a market leader among foreign banks. We focused on products designed to attract and retain deposits, particularly those denominated in renminbi. We stepped up collaboration with Mainland insurance companies to offer a broader range of insurance options for customers.

+76.1%

Hang Seng China customer deposits

Our efforts to exceed customer service expectations helped us win a number of awards in 2010, including 'Best Foreign Bank' from *National Business Daily* and *CFO World*'s 'Best SME Services Award'. We were ranked number 1 for investment returns in *China Benefit*'s 'Wealth Management Survey' and our Pick & Win equity-linked investment product was one of *Money Week*'s 'Top Ten Best Wealth Management Products in 2010'.

With our growing appeal among the mass-affluent and affluent customer segments, we achieved a 17.2% increase in the Mainland Prestige Banking account base – supporting an 89% rise in Mainland Personal Financial Services' deposits. The overall personal customer base grew by 15.3% year on year.

New insurance offerings enriched our trade-related financial services proposition for Mainland commercial customers. We partnered with China Export and Credit Insurance Corporation (Sinasure) to extend our factoring business from foreign trade to domestic trade. We also launched a domestic trade forfeiting service for local banks.

We worked with China Union Merchant Service to provide merchant acquiring services, which helped us grow our operating accounts base and deposits business in the retail sector.

Facilitated by our strategically located network of outlets and close collaboration between commercial banking teams in Hong Kong and on the Mainland, we continued to be an active player in cross-border renminbi trade settlement business. Following the expansion of the pilot programme from four selected cities in Guangdong and Shanghai to 20 provinces and municipalities in mid-2010, we achieved a 13-fold increase in renminbi trade settlement transaction volume compared with that recorded between July 2009 and May 2010. Trade turnover in 2010 more than doubled compared with 2009.

The Mainland corporate and commercial banking customer base grew by 14.4% year on year. Corporate and commercial customer advances and deposits were up 33.1% and 58.4% respectively.

Market competition and a tighter regulatory environment put pressure on interest-based revenue business in the second half of the year. We worked to strengthen non-interest revenue streams, including successful efforts to grow treasury business by promoting our trading capabilities and leveraging an enhanced cross-referral mechanism to boost corporate treasury sales.



We launched new initiatives to achieve greater awareness of the Hang Seng China brand.



NETWORK

Hang Seng China opened two cross-location sub-branches – one each in Foshan and Zhongshan – under CEPA VI, which allows Hong Kong banks with branches in Guangdong to apply to establish cross-location sub-branches in the province.

With 17 outlets in the Pearl River Delta region, we are in a good position to capture a growing share of commercial business flows and take advantage of new opportunities under the cross-border renminbi trade settlement programme.

Including the two cross-location sub-branches, Hang Seng China now has 38 outlets across 13 Mainland cities.

In a further demonstration of our long-term commitment to the Mainland market, Hang Seng China completed the RMB510m purchase of headquarters premises in Shanghai's financial district, Lujiazui.

In addition to acquiring over 7,000 square metres of office and retail space, the transaction included naming and signage rights to the building – providing a strong boost to our brand-building efforts. We gained further valuable exposure by securing the naming rights to the building that houses our Foshan sub-branch.

Improvements in service delivery included upgrading and expanding our online platform to provide a better customer experience and support greater sales via self-guided channels.

In addition to using Hang Seng China's 67 ATMs across the Mainland, our customers can access their accounts through HSBC China's Mainland ATM network. Hang Seng China debit cards can be used on the China UnionPay (CUP) network at home and overseas. CUP cardholders can use their cards at Hang Seng China ATMs, providing another important opportunity for brand exposure.

We extended our counter services agreement with Industrial Bank – under which our customers can enjoy renminbi deposit services at the Mainland bank – from its outlets in Shanghai to all its outlets on the Mainland.

To support growth and strengthen relationships with customers, Hang Seng China increased its number of full-time staff by 12.5% to 1,614 in 2010. With customer service as our key competitive strength, we continued to invest in our people through training and career development programmes.

STRATEGIC ALLIANCES

We have built strategic partnerships that complement our organic growth through Hang Seng China.

Our partnership with Industrial Bank continues to yield good returns, both in financial terms and in areas such as service delivery and business referrals. We took up our full entitlement under a rights share issue by the Mainland bank during the first half of 2010 – raising our equity interest from 12.78% to 12.80% and underscoring our commitment to this valuable alliance.

Our holding in Yantai Bank extends our brand reach in the strategically significant Bohai Economic Rim region. We continued to leverage our strengths in working with Yantai to enhance its internal infrastructure and build a deeper foundation for future growth in key areas of business.

FUTURE GROWTH

Looking ahead, we will use our competitive advantages to attract more customers in target segments. The acquisition of deposits, particularly renminbi deposits, remains key to the sustainable expansion of our business – helping to strengthen our balance sheet and providing liquidity to prudently grow our loans portfolio.

We will reach out to customers through the extended network provided by Hang Seng China's outlets and our strategic alliances.

We will reinforce our reputation as a leader in wealth management and commercial banking services among foreign banks, and further diversify our income base by expanding fee-based business. With support provided by Hang Seng's business strengths in Hong Kong, we will launch innovative new products and services. We will continue to capitalise on opportunities provided under CEPA VI and the further opening up of the cross-border renminbi trade settlement programme.

We will explore new avenues of cooperation with our strategic partners to strengthen our platform for long-term business growth.



We focused on products designed to attract and retain deposits.

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL REVIEW

FINANCIAL PERFORMANCE

Income Statement

Summary of Financial Performance

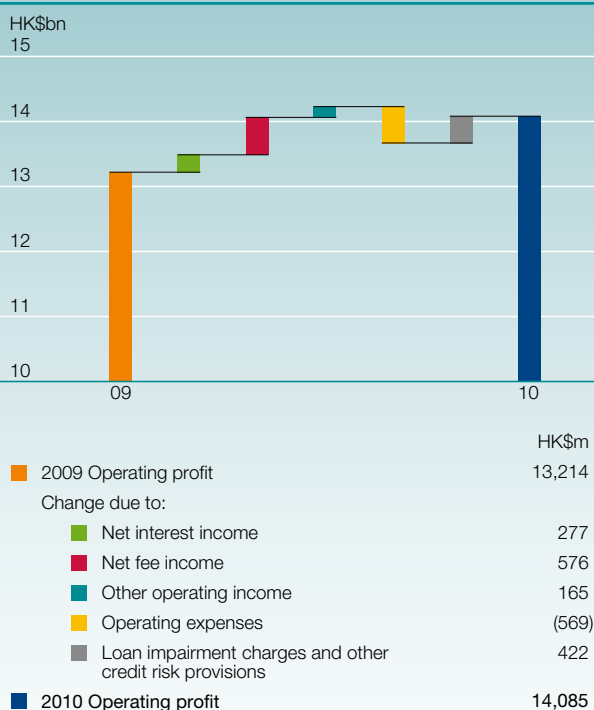
| Figures in HK\$m | 2010 | 2009 (restated) |
|---|---------------|--------------------|
| Total operating income | 34,417 | 32,816 |
| Total operating expenses | 7,355 | 6,786 |
| Operating profit after loan impairment charges and other credit risk provisions | 14,085 | 13,214 |
| Profit before tax | 17,345 | 15,400 |
| Profit attributable to shareholders | 14,917 | 13,138 |
| Earnings per share (in HK\$) | 7.80 | 6.87 |

Hang Seng Bank Limited (“the Bank”) and its subsidiaries (“the Group”) reported an audited profit attributable to shareholders of HK\$14,917m for 2010, up 13.5% compared with 2009. Earnings per share were HK\$7.80, up HK\$0.93 from 2009. Profit attributable to shareholders for the second half of 2010 increased by HK\$989m, or 14.2%, when compared with the first half.

Operating profit excluding loan impairment charges and other credit risk provisions grew by HK\$449m, or 3.2%, to HK\$14,475m.

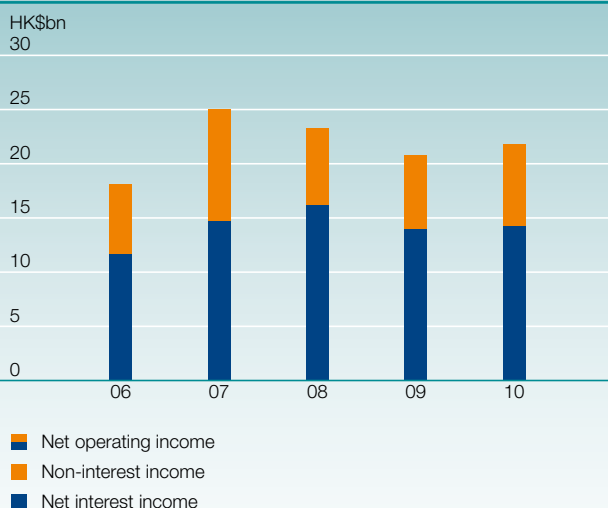
Although Hong Kong’s economy improved solidly on the back of the strong rebound in exports, the operating environment for banks remained challenging with the persistence of low interest rates and intensifying market competition. Net interest income registered an increase of 2.0%, underpinned by strong loan growth. Supported by the improvement in investment sentiment, non-interest income grew by 10.9%. While continuing to carefully manage costs, investment for future growth led to an 8.4% rise in operating expenses compared with 2009. The Bank built encouraging business momentum, resulting in an 11.3% increase in operating profit excluding loan impairment charges and other credit risk provisions in the second half of the year compared with the first half.

Operating Profit Analysis



Net Operating Income

(Before loan impairment charges and other credit risk provisions)



Net interest income rose by HK\$277m, or 2.0%, with an 8.9% increase in average interest-earning assets.

| Figures in HK\$m | 2010 | 2009 |
|---|----------------|---------------|
| Net interest income/ (expense) arising from: | | |
| – financial assets and liabilities that are not at fair value through profit and loss | 14,459 | 14,151 |
| – trading assets and liabilities | (238) | (234) |
| – financial instruments designated at fair value | 79 | 106 |
| | 14,300 | 14,023 |
| Average interest-earning assets | 802,464 | 736,953 |
| Net interest spread | 1.72% | 1.84% |
| Net interest margin | 1.78% | 1.90% |

The increase in net interest income was largely contributed by strong growth in customer advances, which more than offset the adverse effects of the repricing of assets at lower market interest rates and the continuing compression of deposit spread.

Net interest margin narrowed by 12 basis points to 1.78% compared with 2009, and net interest spread fell by 12 basis points to 1.72%. Liability spread continued to be constrained by the low interest rate environment. Treasury's balance sheet management portfolio was negatively affected by the repricing of assets at lower interest rates and the flattening of yield curves, although increased contributions from the credit card business, personal loans and corporate lending provided a partial buffer. The Bank achieved volume growth in the average balance of mortgage lending, but intense market competition continued to drive down mortgage pricing. The contribution from debt securities under the life insurance funds investment portfolio grew, with a 17.7% rise in related net interest income. The contribution from net free funds remained the same as in 2009 at 6 basis points.

Net interest income in the second half of 2010 grew by HK\$874m, or 13.0%, compared with the first half, due mainly to fewer days in the first half of the year and a 9.3% increase in average interest-earning assets. Net interest margin in the second half was 1.80% – up 3 basis points on the first half of the year.

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

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

| Figures in HK\$m | 2010 | 2009 |
|---------------------------------|----------------|---------|
| Net interest income | 14,456 | 14,137 |
| Average interest-earning assets | 756,110 | 670,321 |
| Net interest spread | 1.86% | 2.06% |
| Net interest margin | 1.91% | 2.11% |

Net fee income increased by HK\$576m, or 13.3%, to HK\$4,897m compared with 2009.

Leveraging its strong wealth management platform and improved investment market sentiment, income from retail investment funds rose by 72.0%. Income from stockbroking and related services fell by 6.3%, reflecting keen market pricing competition and a decline in stock market trading turnover. Insurance agency fee income rose by 34.7%, due mainly to strong sales of a life protection with return insurance product. In improved market conditions, private banking leveraged its core strengths of a diverse suite of investment products and client service excellence to grow private banking service fee income by 24.0%.

Card services income increased by 3.5%. The Bank grew the card base by 11.2% to over two million and gained market share in terms of card receivables and card spending, supporting a 13.9% increase in receivables and 18.4% rise in spending. Credit facilities fee income grew by 44.4%, due mainly to higher fees from increased corporate lending.

The upturn in trade activity together with the expansion of the cross-border renminbi trade settlement scheme boosted remittances and trade-related fee income by 19.4% and 19.3% respectively.

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL REVIEW

Compared with the first half of 2010, net fee income in the second half grew by HK\$159m, or 6.7%, mainly reflecting increases in income from stockbroking and related services and the sales of retail investment funds. Fee income from private banking services, trade-related business and remittances also registered solid growth in the second half of the year.

Trading income rose by HK\$136m, or 7.1%, to HK\$2,059m.

Trading income rose by HK\$136m, or 7.1%, to HK\$2,059m. Foreign exchange income fell by HK\$24m, or 1.3%, attributable partly to reduced net interest income from funding swaps* and lower customer demand for foreign exchange-linked structured products. The reduction was also affected by increased losses on the revaluation of certain US dollar capital funds – maintained in the Bank's mainland subsidiary bank and subject to regulatory controls – against the renminbi. Excluding the above items, foreign exchange trading grew by HK\$72m, or 4.7%.

Income from securities, derivatives and other trading activities increased by HK\$160m, or 122.1%, reflecting an improvement in derivatives trading.

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

Net income from financial instruments designated at fair value reported a revaluation gain of HK\$282m, compared with a revaluation loss of HK\$75m in 2009.

This was mainly due to the improvement in financial markets in 2010. The gain is due mainly to changes in the fair value of assets supporting the linked insurance contracts and reported in "net income/(loss) from financial instruments designated at fair value" with offsetting movements in the value of these contracts reported under "net insurance claims incurred and movement in policyholders' liabilities".

Net earned insurance premiums fell by HK\$212m, or 1.8%. Net insurance claims incurred and movement in policyholders' liabilities rose by HK\$583m, or 4.9%.

Analysis of income from wealth management business

| Figures in HK\$m | 2010 | 2009 |
|-------------------------------------|-------|-------|
| Investment income: | | |
| – retail investment funds | 1,039 | 604 |
| – structured investment products* | 448 | 473 |
| – private banking service fee** | 196 | 158 |
| – stockbroking and related services | 1,468 | 1,566 |
| – margin trading and others | 129 | 141 |
| | 3,280 | 2,942 |
| Insurance income: | | |
| – life insurance | 2,282 | 2,070 |
| – general insurance and others | 342 | 337 |
| | 2,624 | 2,407 |
| Total | 5,904 | 5,349 |

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

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

Wealth management business maintained good growth momentum in 2010, achieving a 10.4% increase in income compared with 2009. Investment and insurance income rose by 11.5% and 9.0% respectively.

Leveraging the open architecture of its wealth management platform, the Bank promoted a comprehensive range of yield enhancement investment products to suit the various risk appetites of customers in the low interest rate environment. Benefiting from the improvement in equity markets and investor sentiment, the Bank achieved strong growth of 72.0% in income from retail investment funds. Stockbroking and related services income fell by 6.3% as a result of lower stock market turnover activity recorded by the Bank and keen market pricing competition.

Private banking service income grew by 24.1%, supported by the improvement in investment sentiment.

The Bank continued to enhance its leading position in providing retirement savings and life insurance protection to customers. Total policies in-force increased by 8.6%. Net interest income and fee income from the life insurance funds investment portfolio rose by 18.4%, due mainly to growth in the size of the life insurance investment portfolio, which held bond investments as its major assets.

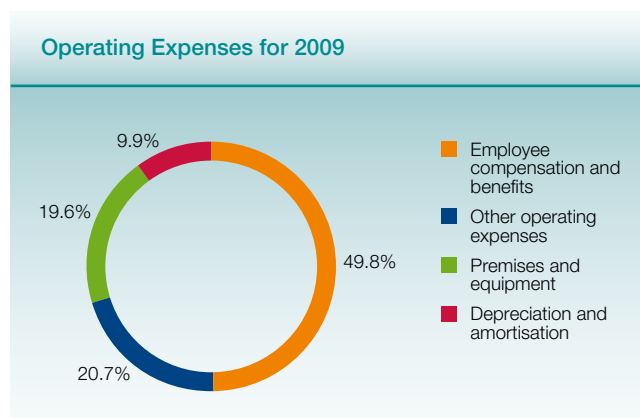
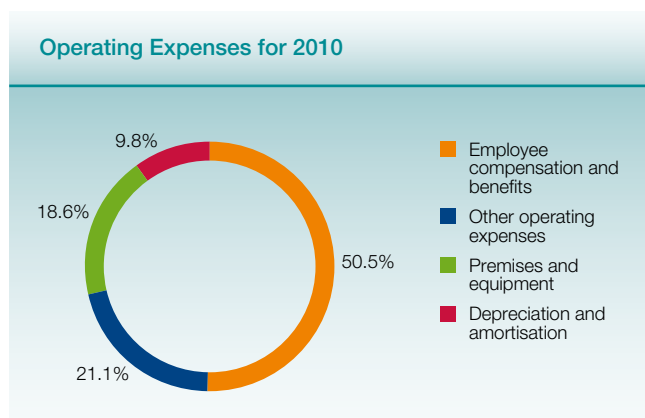
Investment return on life insurance investment funds improved by HK\$270m. The gain mainly reflects changes in the fair value of assets supporting linked insurance contracts and reported under "net income/(loss) from financial instruments designated at fair value", with offsetting movements in policyholders' liabilities. Movement in the present value of in-force insurance business increased strongly, due mainly to the growth in volume and profitability of new business written during 2010.

General insurance income increased by 1.5% to HK\$342m.

| Figures in HK\$m | 2010 | 2009 |
|---|----------|----------|
| Life insurance: | | |
| – net interest income and fee income | 2,382 | 2,012 |
| – investment returns on life insurance funds | 287 | 17 |
| – net earned insurance premiums | 10,966 | 11,193 |
| – net insurance claims incurred and movement in policyholders' liabilities* | (12,479) | (11,912) |
| – movement in present value of in-force long-term insurance business | 1,126 | 760 |
| | 2,282 | 2,070 |
| General insurance and others | 342 | 337 |
| Total | 2,624 | 2,407 |

* Including premium and investment reserves

Operating expenses rose by HK\$569m, or 8.4%, to HK\$7,355m.



While carefully managing costs, the Bank continued to make investments in support of long-term business growth. Excluding mainland business, operating expenses rose by 7.1%.

Employee compensation and benefits increased by HK\$339m, or 10.0%. Salaries and other related costs increased by 11.5%, reflecting the annual salary increment and higher average headcounts as well as an increase in performance-related pay expenses. General and administrative expenses were up 6.7%. Rental expenses rose as a result of increased rents for branches in Hong Kong and new branches on the Mainland. Depreciation charges rose by 4.7%, mainly reflecting increases

in depreciation on the Bank's headquarters building in Hong Kong. Marketing and advertising expenses increased by 23.0% to support business growth.

Staff numbers* by region

| | 2010 | 2009 |
|-----------|-------|-------|
| Hong Kong | 7,960 | 7,834 |
| Mainland | 1,623 | 1,449 |
| Others | 59 | 59 |
| Total | 9,642 | 9,342 |

* Full-time equivalent

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL REVIEW

At 31 December 2010, the Group's number of full-time equivalent staff was up by 300 compared with the end of 2009.

With the increase in operating expenses outpacing the growth in net operating income before impairment charges and other credit risk provisions, the cost efficiency ratio rose by 1.1 percentage points compared with 2009 to 33.7%.

Loan impairment charges and other credit risk provisions fell by HK\$422m, or 52.0%, to HK\$390m compared with a year earlier, reflecting an overall improvement in the credit environment.

| Figures in HK\$m | 2010 | 2009 |
|--|--------------|---------|
| Loan impairment charges: | | |
| – individually assessed | (186) | (310) |
| – collectively assessed | (204) | (502) |
| | (390) | (812) |
| of which: | | |
| – new and additional | (609) | (1,104) |
| – releases | 157 | 230 |
| – recoveries | 62 | 62 |
| | (390) | (812) |
| Other credit risk provisions | – | – |
| Loan impairment charges and other credit risk provisions | (390) | (812) |

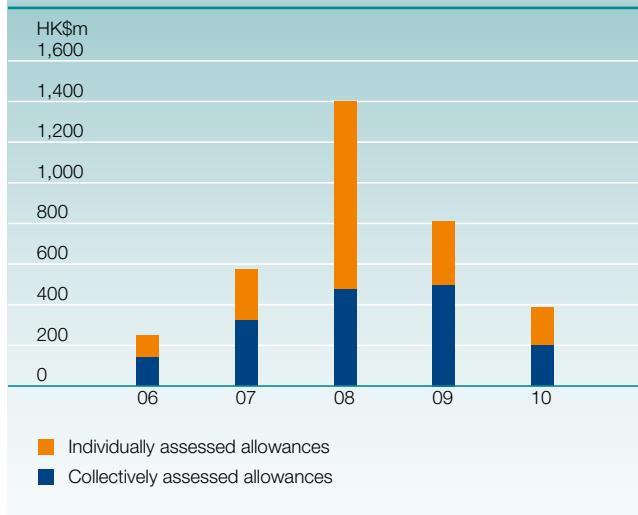
Individually assessed provisions were down HK\$124m, with lower impairment charges made for Commercial Banking customers as economic conditions continued to improve.

Collectively assessed provisions were down HK\$298m, attributable to lower charges on credit card and personal loans portfolios as a result of fewer delinquencies and the falling bankruptcy trend. Impairment allowances for loans not individually identified as impaired also fell due to lower historical loss rates with the improvement in global credit markets.

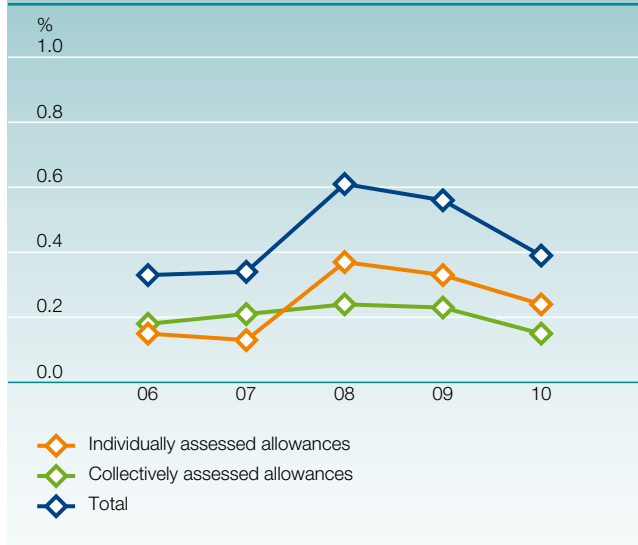
Total loan impairment allowances as a percentage of gross advances to customers are as follows:

| | 2010 % | 2009 % |
|----------------------------------|-------------|-----------|
| Loan impairment allowances: | | |
| – individually assessed | 0.24 | 0.33 |
| – collectively assessed | 0.15 | 0.23 |
| Total loan impairment allowances | 0.39 | 0.56 |

Net Charges for Loan Impairment Allowances



Loans Impairment Allowances as a Percentage of Gross Advances to Customers



Operating profit rose by HK\$871m, or 6.6%, at HK\$14,085m.

Profit before tax increased by 12.6% to HK\$17,345m, after taking into account a 39.8% (or HK\$74m) fall in **gains less losses from financial investments and fixed assets**; a 93.3% (or HK\$235m) increase in **net surplus on property revaluation** and a 52.2% (or HK\$913m) increase in **share of profits from associates**, mainly from Industrial Bank Co., Ltd. ("Industrial Bank").

Gains less losses from financial investments and fixed assets amounted to HK\$112m, a decrease of 39.8% when compared with 2009.

Net gains from the disposal of available-for-sale equity securities fell by HK\$151m, or 93.8%, attributable to the profit realised from the disposal of Visa Inc. shares in 2009. The Bank realised a HK\$95m gain from the disposal of available-for-sale debt securities – reflecting profit realised primarily from the disposal of government-guaranteed debt securities – compared with a loss of HK\$152m on the disposal of certain debt securities in the previous year. The net gain on the disposal of assets held for sale in 2010 was HK\$12m, compared with HK\$187m for 2009 which included a significant disposal profit from the sale of a property.

Net surplus on property revaluation rose by 93.3% to HK\$487m.

| Figures in HK\$m | 2010 | 2009 (restated) |
|---|------------|--------------------|
| Surplus of revaluation on investment properties | 474 | 250 |
| Surplus of revaluation on assets held for sale | 10 | – |
| Reversal of revaluation deficit on premises | 3 | 2 |
| | 487 | 252 |

The Group's premises and investment properties were revalued at 30 November 2010 and updated for any material changes at 31 December 2010 by DTZ Debenham Tie Leung Limited. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use and the basis of valuation for investment properties was open market value. The net revaluation surplus for Group premises amounted to HK\$2,105m of which HK\$2,102m was credited to premises revaluation reserve and HK\$3m was credited to the income statement. Revaluation gains of HK\$474m on investment properties were recognised through the income statement. The related deferred tax provisions for Group premises and investment properties were HK\$345m and HK\$78m respectively.

The revaluation exercise also covered business premises/investment properties reclassified as properties held for sale. In accordance with HKFRS 5, the revaluation gain of HK\$10m was recognised through the income statement.

Customer Group Performance

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

| Figures in HK\$m | Personal Financial Services | Commercial Banking | Corporate Banking | Treasury | Other | Total reportable segments |
|---|-----------------------------|--------------------|-------------------|----------|-------|---------------------------|
| Year ended 31 December 2010 | | | | | | |
| Profit before tax | 7,872 | 3,748 | 1,266 | 3,361 | 1,098 | 17,345 |
| Share of profit before tax | 45.4% | 21.6% | 7.3% | 19.4% | 6.3% | 100.0% |
| Year ended 31 December 2009 (restated) | | | | | | |
| Profit before tax | 7,258 | 2,637 | 915 | 3,393 | 1,197 | 15,400 |
| Share of profit before tax | 47.1% | 17.1% | 5.9% | 22.0% | 7.9% | 100.0% |

MANAGEMENT DISCUSSION AND ANALYSIS

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Personal Financial Services (“PFS”) recorded a profit before tax of HK\$7,872m for 2010, up 8.5% compared with 2009. Operating profit excluding loan impairment charges rose by 5.5% to HK\$7,865m.

Net interest income grew by 3.5% over 2009, with the expansion in deposits and lending portfolios more than compensating for the squeeze on the net interest margin and severe price competition.

Unsecured lending grew strongly to achieve a 51.9% rise in profit before tax when compared with a year earlier, attributable to the impressive business momentum and improved loan quality. PFS took successful steps to increase the credit card base, which surpassed the two million mark, supporting year-on-year increases in card spending and receivables of 18.4% and 13.9% respectively. Personal loans grew by 29.1% to HK\$4.6bn. Overall loan impairment charges dropped by 46.1% in 2010.

Against a backdrop of intense market competition and new government measures to cool property speculation, the residential mortgage business achieved good growth in 2010 to remain a top three mortgage lender and sustain its market share.

With new regulations governing investment business, PFS implemented the physical segregation of banking and investment services and reconfigured the investment sales process to maintain business momentum under the new operational structure. New products were launched to capture the shift in investor appetite in the changing market conditions. Wealth management income grew by 9.0% year-on-year and by 4.1% in the second half of the year compared with the first half.

Investment-related income increased by 9.8%, driven in part by an 85.1% rise in revenue from investment funds business. Timely new products, including the Hang Seng RMB Bond Fund, supported growth of 180.8% in retail investment fund sales as well as a significant increase in the Bank’s investment fund market share. Stockbroking and related services fee income grew by 16.2% in the second half of 2010 compared with the first half.

New life insurance plans offering improved protection propositions proved effective in driving sales. Income from the life insurance business grew by 9.7% compared with 2009. Total life insurance policies in-force and annualised premiums rose by 8.6% and 13.3% respectively.

Hang Seng continued to be recognised as the leading wealth management bank in Hong Kong, receiving awards including “Best Domestic Bank in Hong Kong” from The Asset for the 11th consecutive year, “Company of the Year” in Benchmark’s 2010 Wealth Management Awards and “Best Local Private Bank in Hong Kong” from *Euromoney* for the second year in a row.

Personal e-Banking grew its registered customer base by 10.2% compared with the end of 2009 to reach 1.1 million. PFS continued to implement service innovations, including the development and launch in August 2010 of a first-of-its-kind iPhone application to support foreign exchange margin trading. As of December over 435,000 customers had added their support to the Bank’s environmental efforts by registering to receive electronic rather than paper statements through the e-Statement service – a 30.3% increase compared with a year earlier.

Commercial Banking (“CMB”) achieved a 42.1% increase in profit before tax to HK\$3,748m. CMB’s contribution to the Bank’s total profit before tax increased to 21.6%, up 4.5 percentage points from 2009. Operating profit excluding loan impairment charges was up by 34.3% to HK\$2,671m, due mainly to increases in net interest income from advances and net fee income. With improving market conditions and a continuing emphasis on risk management, loan impairment charges fell by 36.0%.

Against a backdrop of economic recovery and the rebound in exports, CMB’s swift response to the increase in demand for financing saw customer advances increase by 102.1%, underpinning a 57.8% rise in net interest income from lending. The influx of liquidity into the region drove a 14.5% rise in customer deposits. However, with continuing pressure on spreads, deposit-related net interest income fell by 19.0%.

Supported by a comprehensive business development plan and the Bank’s strong internal infrastructure, CMB was quick to respond to the further relaxation of the scope of renminbi business in Hong Kong in early 2010, rolling out a comprehensive range of renminbi commercial banking services and establishing the Bank as a pioneer in this expanding area of business. Hang Seng was the first bank in Hong Kong to set up a renminbi prime rate and to sign a renminbi syndicated loan. CMB has developed a full suite of renminbi commercial banking products including, but not limited to, renminbi commercial finance, renminbi savings and current accounts, and renminbi factoring and solutions. At the end of 2010, we had more than 58,000 renminbi commercial accounts and had helped settle more than RMB35bn in renminbi cross-border trade-related business.

To assist commercial customers in growing their cross-border business and to establish a dynamic customer referral channel, CMB closely collaborated with Hang Seng China and several strategic partners on the Mainland, including Industrial Bank and China Export and Credit Insurance Corporation (SINOSURE). This collaboration has enhanced CMB's ability to offer one-stop commercial banking solutions and capture an increasing share of cross-border business flows.

CMB worked to provide timely, competitive corporate wealth management products to its customers, focusing particularly on those in the top-end segment. Enhanced corporate insurance products were marketed on various platforms, including wealth management and yield enhancement. Underwriting procedures were streamlined to improve service efficiency.

Income from corporate wealth management business increased by 26.6% and contributed 13.4% to CMB's total net operating income before loan impairment charges in 2010.

With strong roots in its local communities, CMB continued to be an active player in government-backed schemes to support small and medium-sized enterprises. Since late 2008, the Bank has approved about 6,800 applications with a total loan amount of more than HK\$18.4bn under the government-backed SME Loan Guarantee and Special Loan Guarantee schemes, with market shares of 25% and 15% respectively at the end of 2010.

CMB customers continued to migrate to online and automated banking channels. At 31 December 2010, over 92,000 customers had registered for the Bank's Business e-Banking service, up 19.3% compared with a year earlier. The number of online business transactions grew by 19.0%.

Corporate Banking ("CIB") experienced an intensification of market competition in 2010. With the uneven pace of global economic recovery, many banks turned their attention to Asia, leading to growing competition among lenders. Property-related financing has traditionally been an important element of CIB's business. With tighter government regulation in the property sector both in Hong Kong and on the Mainland, CIB took steps to diversify its revenue base, leveraging its strong customer relationships and good industry sector knowledge to capitalise on new business opportunities created by the growing demand for cross-border financial services.

CIB's advances to customers and customer deposits grew by 32.4% and 34.5% respectively compared with a year earlier.

Operating profit excluding loan impairment charges was HK\$1,264m, an increase of HK\$285m, or 29.1%. Operating profit was up 40.0% at HK\$1,261m.

Treasury ("TRY") recorded a profit before tax of HK\$3,361m, in line with 2009. With increased loan demand from business customers, a substantial proportion of the commercial surplus was redeployed to support commercial lending. Operating profit was down 24.3% at HK\$2,207m.

Trading income increased 10.2% to HK\$1,162m and disposal gains rose by 162.5% to HK\$95m, but these increases were more than offset by the 35.1% decline in net interest income to HK\$1,403m.

With abundant market liquidity and the fragile nature of the global economic recovery, interest rates remained at low levels. Yield curves were also relatively flat, particularly in the first half of the year. Net interest income fell to HK\$609m in the first half of the year, but TRY's active management of the balance sheet management portfolio saw net interest income rebound by 30.4% to HK\$794m in the second half of the year.

TRY placed more emphasis on high-quality debt securities, particularly government-guaranteed papers and high-quality corporate debt securities, and capitalised on market opportunities to dispose of selected securities. These actions helped improve the investment mix of the balance sheet management portfolio and generated a disposal gain of HK\$95m, while remaining in line with the Bank's prudent risk management strategy.

Trading income increased by HK\$108m, or 10.2%, to HK\$1,162m, mainly contributed by the improvement in foreign exchange income and derivatives trading, boosted in part by strong demand for renminbi-denominated products and derivatives following the further liberalisation of renminbi business in Hong Kong.

Mainland Business

Hang Seng Bank (China) Limited ("Hang Seng China") opened two cross-location sub-branches under CEPA VI during the year, bringing its mainland network to 38 outlets across Beijing, Shanghai, Guangzhou, Dongguan, Shenzhen, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming, Foshan and Zhongshan. The Bank also has a branch in Shenzhen for foreign currency wholesale business and a representative office in Xiamen.

MANAGEMENT DISCUSSION AND ANALYSIS

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Hang Seng China continued to further enrich and diversify its wealth management product offerings and enhance its Commercial Banking capabilities to capture good growth opportunities. Close collaboration between Commercial Banking teams on the Mainland and in Hong Kong helped to support solid growth in both the personal and commercial customer bases – which increased by 15.3% and 14.4% respectively compared with a year earlier.

Customer advances recorded growth of 28.4% to HK\$36.4bn compared with 2009 year-end. Customer deposits grew by 76.1%, underpinned by the increase in the mainland customer base.

Hang Seng China's profit before tax (excluding exchange losses on US dollar capital funds) recorded a growth of 139.8% compared with 2009, with growth in both net interest income and non-interest income offsetting increases in operating expenses and loan impairment charges.

The purchase of headquarters premises in Shanghai in 2010 demonstrated the Group's long-term commitment to the

mainland market and is supporting the continued development of Hang Seng China.

The Bank's strategic alliance with Industrial Bank continued to generate good results. The Bank took up its full share entitlement under a rights issue by Industrial Bank and increased its equity interest in the mainland bank from 12.78% to 12.80% at 31 December 2010.

Economic Profit

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

For the year 2010, economic profit was HK\$9,408m, an increase of HK\$1,036m, or 12.4%, compared with 2009. Return on invested capital (post-tax profit, adjusted for the property revaluation surplus net of deferred tax, depreciation attributable to the revaluation and impairment of purchased goodwill), rose by HK\$1,541m.

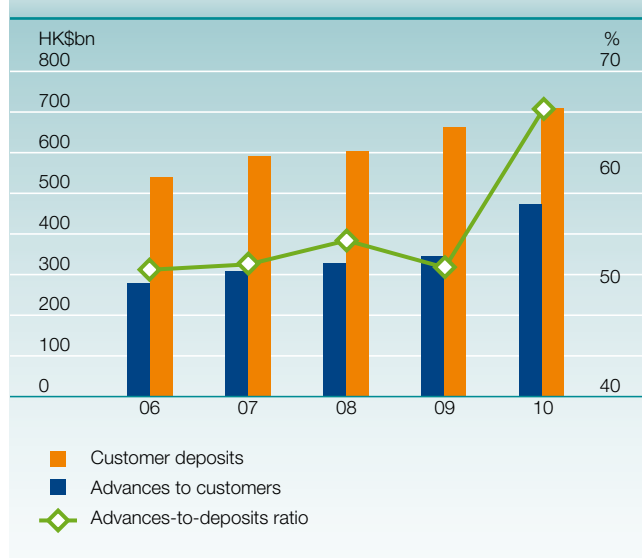
| | 2010 | | 2009 | |
|-----------------------------|----------------|--------------|---------|-------|
| | HK\$m | % | HK\$m | % |
| Average invested capital | 57,616 | | 52,937 | |
| Return on invested capital* | 14,690 | 25.5 | 13,149 | 24.8 |
| Cost of capital | (5,282) | (9.2) | (4,777) | (9.0) |
| Economic profit | 9,408 | 16.3 | 8,372 | 15.8 |

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

Balance Sheet

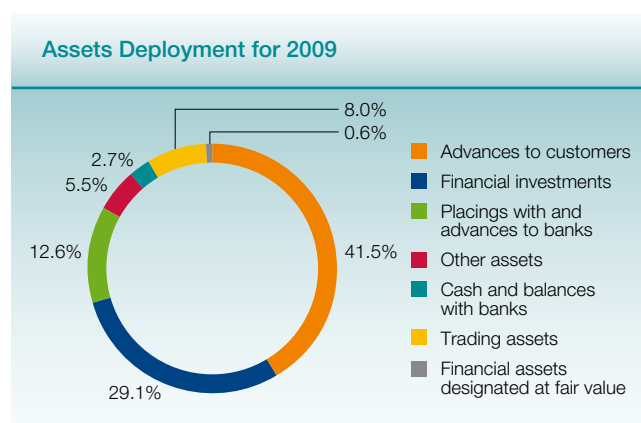
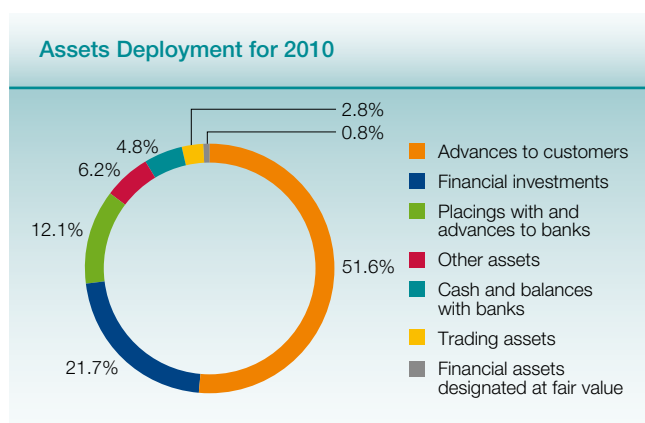
Total assets rose by HK\$86.2bn, or 10.4%, to HK\$916.9bn. Customer advances increased by HK\$128.0bn, or 37.1%, with strong growth in trade financing, corporate and retail lending and mainland loans. Despite the keen market competition, the Bank's residential mortgage business continued to record good growth and sustained its market share in terms of total mortgage lending. Customer deposits and certificates of deposit and other debt securities in issue increased by HK\$46.7bn, or 7.0%, to HK\$710.3bn, driven in part by strong growth in renminbi deposits. At 31 December 2010, the advances-to-deposits ratio was 66.5%, compared with 51.9% at 31 December 2009, reflecting the faster pace of loan growth in 2010. Financial investments and trading assets decreased by 17.5% and 60.9% respectively, attributable primarily to the redeployment of the commercial surplus to support loan growth.

Advances to Customers and Customer Deposits



Assets Deployment

| Figures in HK\$m | 2010 | % | 2009 (restated) | % |
|--|----------------|--------------|--------------------|--------------|
| Cash and balances with banks and other financial institutions | 44,411 | 4.8 | 22,086 | 2.7 |
| Placings with and advances to banks and other financial institutions | 110,564 | 12.1 | 104,551 | 12.6 |
| Trading assets | 26,055 | 2.8 | 66,597 | 8.0 |
| Financial assets designated at fair value | 7,114 | 0.8 | 5,450 | 0.6 |
| Advances to customers | 472,637 | 51.6 | 344,621 | 41.5 |
| Financial investments | 199,359 | 21.7 | 241,502 | 29.1 |
| Other assets | 56,771 | 6.2 | 45,861 | 5.5 |
| Total assets | 916,911 | 100.0 | 830,668 | 100.0 |



Advances to Customers

At 31 December 2010, gross advances to customers were up HK\$127.9bn, or 36.9%, at HK\$474.5bn compared with the previous year-end. Riding on the improved economic conditions and the increased scope of renminbi business in Hong Kong, the Bank leveraged its balance sheet strength to record encouraging lending growth in all core market sectors.

Loans for use in Hong Kong increased by HK\$76.2bn, or 26.2%. Riding in part on the buoyancy of property and investment markets, the Bank achieved strong growth in lending to the property development and property investment sectors. The Bank continued to actively participate in the Hong Kong government's SME Loan Guarantee and Special Loan Guarantee schemes. Lending to customers in the manufacturing and wholesale and retail trade sectors grew by 40.6% and 46.4% respectively. The increase in lending to transport and transport equipment and information technology sectors was mainly due to new drawdowns by a number of large Commercial Banking customers. Growth in lending to "Other" was attributable to new working capital financing for several large corporations.

Lending to individuals rose by HK\$19.7bn, or 14.3%. Residential mortgage lending to individuals grew by 16.3% and the Bank maintained its position as one of the leading providers of residential mortgages in Hong Kong amid intense market competition.

Against a backdrop of robust domestic consumption, card advances grew by 13.9%, supported by an 11.2% rise in the number of cards in issue and an 18.4% increase in cardholder spending. Lending to the "Other" sector, including mainly personal loans and overdrafts, rose by 15.2%, due in part to a series of successful promotional initiatives.

Commercial Banking strengthened its cross-border service proposition to offer a full range of renminbi commercial banking services and serve the growing demand from customers for renminbi-related financial solutions. This largely underpinned the 231.3% growth in trade financing.

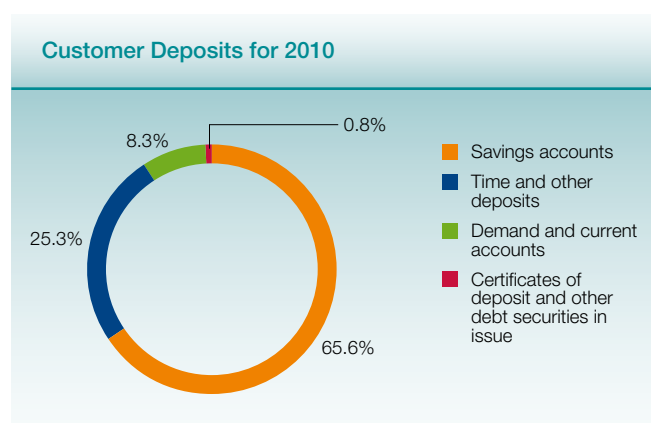
Loans for use outside Hong Kong increased by 20.0%, due largely to the 28.4% expansion in the mainland loan portfolio, which stood at HK\$36.4bn at 2010 year-end. The Group remained vigilant in assessing credit risk in increasing lending on the Mainland.

MANAGEMENT DISCUSSION AND ANALYSIS

FINANCIAL REVIEW

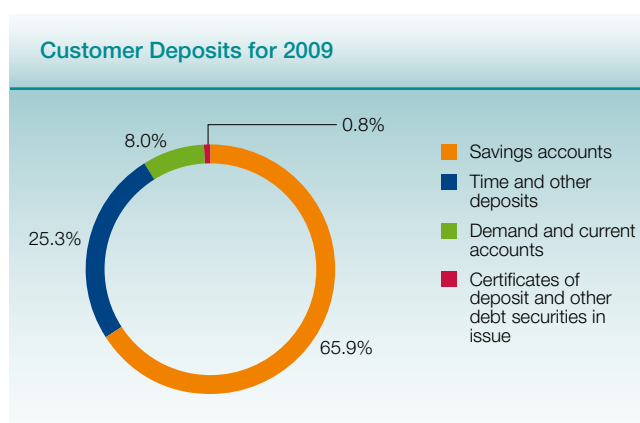
Customer Deposits

Customer deposits and certificates of deposit and other debt securities in issue stood at HK\$710.3bn at 31 December 2010, an increase of 7.0% over the end of 2009. Growth was recorded in savings and current account balances. The increase in time and other deposits mainly reflects the 76.1% growth in customer deposits with Hang Seng China.



Subordinated Liabilities

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



Shareholders' funds

| Figures in HK\$m | 2010 | 2009 (restated) |
|---------------------------------------|--------|--------------------|
| Share capital | 9,559 | 9,559 |
| Retained profits | 42,966 | 37,752 |
| Premises revaluation reserve | 9,426 | 7,885 |
| Cash flow hedging reserve | 72 | 174 |
| Available-for-sale investment reserve | | |
| – on debt securities | (25) | (496) |
| – on equity securities | 227 | 239 |
| Capital redemption reserve | 99 | 99 |
| Other reserves | 4,055 | 3,303 |
| Total reserves | 56,820 | 48,956 |
| | 66,379 | 58,515 |
| Proposed dividends | 3,633 | 3,633 |
| Shareholders' funds | 70,012 | 62,148 |
| | 22.8% | 22.9% |
| Return on average shareholders' funds | | |

Shareholders' funds (excluding proposed dividends) grew by HK\$7,864m, or 13.4%, to HK\$66,379m at 31 December 2010. Retained profits rose by HK\$5,214m, mainly reflecting the growth in 2010 profit after the appropriation of interim dividends. The premises revaluation reserve increased by HK\$1,541m, or 19.5%, compared with 2009, boosted by the robust property market. The premises revaluation reserve for 2010 and 2009 includes leasehold land held under a long lease for the Bank's headquarters building after adopting the amendments to HKAS 17 "Leases" in 2010.

The available-for-sale investment reserve for debt securities recorded a deficit of HK\$25m compared with a deficit of HK\$496m at 2009 year-end, reflecting the improvement in global credit markets and the disposal of high-risk assets under the Bank's prudent risk management strategy. The Group assessed that there were no impaired debt securities during the year, and accordingly, no impairment loss has been recognised.

The return on average shareholders' funds was 22.8%, compared with 22.9% for 2009.

Excluding the redemption of all the (1) Series A – HK\$1,000m 4.125% subordinated notes due 2015 and (2) Series B – HK\$1,500m floating rate subordinated notes due 2015, both at par on 24 June 2010, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities during 2010.

RISK MANAGEMENT

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

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

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

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

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

BIOGRAPHICAL DETAILS OF DIRECTORS



* Dr Raymond CH'EN Kuo Fung GBS, CBE, JP

Chairman

Aged 59

Joined the Board since August 2007

Other position held within Hang Seng Group

- ^ Hang Seng Bank Limited – Member of the Remuneration Committee (Note 1)

Other major appointments

- ^ CDC Corporation – Chairman
- ^ CDC Software Corporation – Director
- ^ China.com Inc – Chairman
- ^ China Resources Power Holdings Company Limited – INED
- ^ Convenience Retail Asia Limited – INED
- Federation of Hong Kong Industries – Honorary President
- Hong Kong Mercantile Exchange Limited – INED
- ^ MTR Corporation Limited – Non-executive Chairman
- ^ Swiss Reinsurance Company Limited – INED
- The Hongkong and Shanghai Banking Corporation Limited – INED
- The Hong Kong/European Union Business Cooperation Committee – Chairman
- The Tianjin Municipal Committee of the Chinese People's Political Consultative Conference – Member of Standing Committee
- ^ The Wharf (Holdings) Limited – INED
- University of Pennsylvania, USA – Trustee

Past major appointments

- The APEC Business Advisory Council – Hong Kong Member (2004-2009)
- ^ Inchcape plc – INED (1997-2009)
- ^ HSBC Holdings plc – INED (1998-2007)
- HSBC Private Equity (Asia) Limited – Chairman (1997-2010) (Note 1)
- Independent Commission Against Corruption – Chairman of Advisory Committee on Corruption (1998-2006)
- Executive Council of HKSAR Government – Member (1997-2002)
- Executive Council of Hong Kong, then under British Administration – Member (1992-1997)

Qualification

Doctoral Degree in Economics – University of Pennsylvania, USA

Major awards

Chevalier de l'Ordre du Merite Agricole of France (2008)
Gold Bauhinia Star (1999)
Commander in the Most Excellent Order of the British Empire (1994)
Justice of the Peace (1993)

Mrs Margaret LEUNG KO May Yee JP

Vice-Chairman and Chief Executive

Aged 58

Joined the Board since April 2009

Other positions held within Hang Seng Group

- ^ Hang Seng Bank Limited – Chairman of Executive Committee
- Hang Seng Bank (China) Limited – Chairman
- Hang Seng Indexes Company Limited – Chairman of Hang Seng Index Advisory Committee
- Hang Seng Insurance Company Limited – Chairman
- Chairman of other subsidiaries in Hang Seng Group

Other major appointments

- Chinese Bankers Club, Hong Kong – Honorary President (Note 1)
- Hang Seng Management College Limited – Chairman of the Board of Governors
- Hang Seng School of Commerce – Chairman of the Board; Supervisor
- HKSAR Commission on Strategic Development – Member
- Ho Leung Ho Lee Foundation – Member of Board of Trustees
- Hong Kong Baptist University – Member of the Court
- Hong Kong University Alumni Association – Honorary Vice-President
- ^ HSBC Holdings plc – Group General Manager
- ^ Hutchison Whampoa Limited – INED
- Securities and Futures Commission – Member of Advisory Committee
- ^ Swire Pacific Limited – INED



The Community Chest of Hong Kong – Board Member;
Second Vice President; Chairman of Campaign Committee
The Guangzhou Municipal Committee of the Chinese People's
Political Consultative Conference – Member
The Henan Provincial Committee of the Chinese People's Political
Consultative Conference – Member of Standing Committee
The Hongkong and Shanghai Banking Corporation Limited –
Director
The University of Hong Kong – Member of the Council

Past major appointments

Hong Kong Export Credit Insurance Corporation –
Member of Advisory Board (2005-2010) (Note 1)
HSBC Group – Global Co-Head Commercial Banking
(2003-2009)
Wells Fargo HSBC Trade Bank, NA – Director
(2007 – February 2010)

Qualification

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

Major award

Justice of the Peace (2009)

* Dr John CHAN Cho Chak

GBS, JP

Director

Aged 67

Joined the Board since August 1995

Other position held within Hang Seng Group

^ Hang Seng Bank Limited – Chairman of
Remuneration Committee

Other major appointments

^ Guangdong Investment Limited – INED
Long Win Bus Company Limited – NED
^ RoadShow Holdings Limited – Chairman and NED
Swire Properties Limited – INED
Sir Edward Youde Memorial Fund – Chairman of the Council
The Community Chest of Hong Kong – Vice Patron
The Hong Kong Monetary Authority – Member of The Exchange
Fund Advisory Committee

The Hong Kong University of Science and Technology –
Chairman of the Court

The Kowloon Motor Bus Company (1933) Limited – NED

^ Transport International Holdings Limited – NED

Past major appointments

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

^ Hong Kong Exchanges and Clearing Limited – INED
(2000-2003)

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

The Hong Kong Jockey Club – Chairman (2006-2010) (Note 1)

Qualifications

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

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

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

Major awards

Gold Bauhinia Star (1999)

Justice of the Peace (1994)

* Dr Marvin CHEUNG Kin Tung

GBS, OBE, JP

Director

Aged 63

Joined the Board since May 2004

Other position held within Hang Seng Group

^ Hang Seng Bank Limited – Member of Audit Committee

Other major appointments

Airport Authority Hong Kong – Chairman

Barristers Disciplinary Tribunal – Member

Executive Council of HKSAR Government – Non-official Member

^ HKR International Limited – INED

BIOGRAPHICAL DETAILS OF DIRECTORS

- ^ Hong Kong Exchanges and Clearing Limited – INED
Hong Kong University of Science and Technology –
Chairman of the Council
- ^ HSBC Holdings plc – INED; Audit Committee member
The Tracker Fund of Hong Kong – Chairman of the
Supervisory Committee

Past major appointments

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

Qualifications

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

Major awards

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

* Ms CHIANG Lai Yuen

Director

Aged 45

Joined the Board since September 2010

Other major appointments

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

Past major appointment

Disciplined Services Salaries and Conditions of Service of
HKSAR Government – Member of Standing Committee
(retired in December 2010) (Note 1)

Qualification

Bachelor Degree of Arts – Wellesley College, USA

Major award

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

* Mr Jenkin HUI

Director

Aged 67

Joined the Board since August 1994

Other position held within Hang Seng Group

- ^ Hang Seng Bank Limited – Member of Remuneration Committee

Other major appointments

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

Ms Sarah Catherine LEGG

Director

Aged 43

Joined the Board since February 2011

Other major appointments

The Hongkong and Shanghai Banking Corporation Limited –
Chief Financial Officer
HSBC Bank Bahamas Limited – President (subject to approval of
The Central Bank of Bahamas)
HSBC Markets (Bahamas) Limited – President
HSBC Securities Investments (Asia) Limited – Director
The Hong Kong Society for Rehabilitation – Honorary Treasurer
Director of other subsidiaries in HSBC Group

Past major appointments

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

Qualifications

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

Mr William LEUNG Wing Cheung

BBS, JP

Executive Director and Head of Personal Banking

Aged 56

Joined the Board since August 2009

Other positions held within Hang Seng Group

- ^ Hang Seng Bank Limited – Head of Personal Banking (responsible
for the Bank's branch network and all businesses and services
for personal accounts); member of Executive Committee
 - Hang Seng General Insurance (Hong Kong) Company Limited –
Chairman
 - Hang Seng Insurance Company Limited – Director
Chairman or Director of other subsidiaries in Hang Seng Group
- ### Other major appointments
- EPS Company (Hong Kong) Limited – Director
 - Hang Seng Management College Limited – Member of the Board
of Governors
 - Hang Seng School of Commerce – Director
 - Hong Kong Academy for Performing Arts – Chairman of
the Council
 - Hong Kong Baptist University – Treasurer of the Council and
the Court; Chairman of Finance Committee
 - Hong Kong Creative Arts Centre Limited – Chairman
 - HSBC Global Asset Management (Hong Kong) Limited – Director
 - ^ Industrial Bank Co., Ltd. – Member of Management Committee of
Credit Card Centre

MasterCard Asia/Pacific, Middle East & Africa Regional Advisory Board – Director
TransUnion Limited – Director
West Kowloon Cultural District Authority – Member of Consultation Panel
Yantai Bank Co., Ltd. – Director

Past major appointments

- ^ Hang Seng Bank Limited
 - General Manager, Personal Financial Services and Wealth Management (2005-2009)
 - General Manager and Head of Wealth Management (2005)
 - Deputy General Manager and Deputy Head of Commercial Banking (2003-2005)
 - Deputy General Manager and Deputy Head of Retail Banking (2000-2003)
 - Assistant General Manager and Head of Credit Card Centre (1994-2000)
- Hong Kong Baptist University – Honorary Associate of School of Business (2005-2010) (*Note 1*)
- Securities and Futures Commission – Member of Investor Education Advisory Committee (2008-2010)

Qualification

Diploma of Arts in English Language and Literature – Hong Kong Baptist College

Major awards

Bronze Bauhinia Star (2009)
Justice of the Peace (2005)

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

Director
Aged 57

Joined the Board since February 2000

Other position held within Hang Seng Group

- ^ Hang Seng Bank Limited – Chairman of Audit Committee
- Other major appointments**
- ^ Bank of Communications Co., Ltd. – INED; Chairman of Audit Committee
- ^ China Resources Enterprise, Limited – INED; Chairman of Audit Committee
- HKSAR Commission on Strategic Development – Member
- Hong Kong Monetary Authority – Chairman of Process Review Committee
- Li, Tang, Chen & Co, Certified Public Accountants – Senior Partner
- Long Win Bus Company Limited – INED
- ^ RoadShow Holdings Limited – INED; Chairman of Audit Committee
- ^ SmarTone Telecommunications Holdings Limited – INED; Chairman of Audit Committee
- ^ Sun Hung Kai Properties Limited – INED; Chairman of the Audit Committee
- The Financial Reporting Council – Convenor of Financial Reporting Review Committee
- The Hong Kong Jockey Club – Steward (*Note 1*)
- The Hong Kong Institute of Education – Treasurer of the Council
- The Kowloon Motor Bus Company (1933) Limited – INED; Chairman of Audit Committee
- The Eleventh National Committee of the Chinese People's Political Consultative Conference – Member

^ Transport International Holdings Limited – INED; Chairman of Audit Committee

^ Wong's International (Holdings) Limited – INED; Chairman of Audit Committee

Past major appointments

The International Federation of Accountants – Board Member (2004-2006)
The Legislative Council of Hong Kong – Member (1991-2004); Chairman of Public Accounts Committee (1995-2004)
Meadville Holdings Limited – INED; Chairman of Remuneration Committee (2007-2010)

Qualifications

BA (Economics) Honours Degree – University of Manchester, UK
Fellow – Hong Kong Institute of Certified Public Accountants (Practising)

Hon Doctor of Laws – University of Manchester, UK

Hon Doctor of Social Sciences – Hong Kong Baptist University

Hon Fellow – The Chinese University of Hong Kong

Hon Fellow – The Hong Kong Polytechnic University

Major awards

Gold Bauhinia Star (2003)

Officer of the Most Excellent Order of the British Empire (1996)

Justice of the Peace (1991)

Dr Vincent LO Hong Sui **GBS, JP**

Director

Aged 62

Joined the Board since February 1999

Other major appointments

- APEC Business Advisory Council – Hong Kong's Representative Business and Professionals Federation of Hong Kong – Honorary Life President
- Chongqing Municipal Government – Economic Adviser
- ^ Great Eagle Holdings Limited – NED
- Shanghai-Hong Kong Council for the Promotion and Development of Yangtze – President
- Shanghai Tongji University; Shanghai University – Advisory Professorship
- ^ Shui On Construction and Materials Limited – Chairman
- Shui On Group – Chairman
- ^ Shui On Land Limited – Chairman and Chief Executive Officer
- The Eleventh National Committee of the Chinese People's Political Consultative Conference – Member
- The Hong Kong University of Science and Technology – Honorary Court Chairman

Past major appointments

^ China Telecom Corporation Limited – INED (retired in 2008)

^ New World China Land Limited – NED (retired in 2004)

Qualification

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

Major awards

"Ernst & Young Entrepreneur Of The Year 2009" in the China Real Estate Category (2009)

"Ernst & Young Entrepreneur Of The Year 2009 China" country award winner (2009)

Chevalier des Arts et des Lettres by the French Government (2005)

BIOGRAPHICAL DETAILS OF DIRECTORS

Director of the Year in the category of Listed Company Executive Directors by The Hong Kong Institute of Directors in 2002 (2002)

Businessman of the Year award in the Hong Kong Business Awards 2001 (2001)

Justice of the Peace (1999)

Gold Bauhinia Star (1998)

Mr Mark Seumas MCCOMBE OBE

Director

Aged 44

Joined the Board since February 2011

Other major appointments

- ^ HSBC Holdings plc – Group General Manager
- The Hongkong and Shanghai Banking Corporation Limited – Chief Executive Officer, Hong Kong
- HSBC Global Asset Management (Hong Kong) Limited – Chairman and Director
- HSBC Insurance (Asia) Limited – Director
- HSBC Jintrust Fund Management Company Limited – Vice-Chairman and Director
- HSBC Life (International) Limited – Director
- HKICL Services Limited – Chairman and Director
- Hong Kong Association of Banks – Member of the Committee
- ^ Hong Kong Exchanges and Clearing Limited – Member of the Risk Management Committee
- Hong Kong Interbank Clearing Limited – Chairman and Director
- Hong Kong Monetary Authority – Member of Banking Advisory Committee

Past major appointments

- HSBC Trinkaus & Burkhardt AG – Director and Audit Committee Member (2009-2010)
- HSBC Global Asset Management – Global Chief Executive Officer (2007-2010)
- HSBC Private Bank, UK, Channel Islands and Luxembourg – Chief Executive Officer (2006-2007)
- HSBC Private Bank (UK) Limited – Chief Executive (2005-2006)
- HSBC Turkey – Deputy Chief Executive Officer (2003-2005)
- HSBC Republic Bank, France – Chief Executive Officer (2000-2003)

Qualification

Master of Arts – Aberdeen University

Major award

Officer of the Most Excellent Order of the British Empire (2006)

Mrs Dorothy SIT KWAN Yin Ping

Director

Aged 59

Joined the Board since August 2009

Other positions held within Hang Seng Group

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

Past major appointments

The Banking Industry Training Advisory Committee – Member (2006-2009); Ex-officio Member of its Sub-committee on Specification of Competency Standards Development (2007-2009)

- ^ Hang Seng Bank Limited – General Manager (2005-2009); Chief Operating Officer (2006-2009)

The Hongkong and Shanghai Banking Corporation Limited – Joined as management trainee and held various managerial positions in retail banking, operations and systems, mainland China project finance, internal audit, marketing, channel development and management, wealth management and retail investments (1976-2003) and was Head of Personal Financial Services, Hong Kong (2004-2005)

Bank of Shanghai – Director (2004-2005)

EPS Company (Hong Kong) Limited – Chairman (2004-2005)

Qualification

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

* Mr Richard TANG Yat Sun BBS, JP

Director

Aged 58

Joined the Board since August 1995

Other positions held within Hang Seng Group

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

Qualifications

Bachelor of Science Degree in Business Administration – Menlo College, California, USA

Master's Degree in Business Administration – University of Santa Clara, California, USA

Major awards

Bronze Bauhinia Star (2000)

Justice of the Peace (1997)

Mr Peter WONG Tung Shun JP

Director

Aged 59

Joined the Board since May 2005

Other major appointments

- ^ Bank of Communications Co., Ltd. – NED
- ^ Cathay Pacific Airways Limited – INED
- Greater Pearl River Delta Business Council – Member
- Hong Kong General Chamber of Commerce – Director; member of General Committee
- Hong Kong Institute for Monetary Research – Member of the Board of Directors (*Note 1*)

Hong Kong Monetary Authority – Member of Exchange Fund Advisory Committee
 HSBC Bank (China) Company Limited – Deputy Chairman and NED
 HSBC Bank Malaysia Berhad – Chairman and NED
 HSBC Bank (Vietnam) Ltd – Vice-Chairman and NED
 ^ HSBC Holdings plc – Group Managing Director; member of Group Management Board
 ^ Ping An Insurance (Group) Company of China, Ltd. – NED
 The Hongkong and Shanghai Banking Corporation Limited – Chief Executive; Executive Director
 The Hong Kong Institute of Bankers – President
 The Tenth Hubei Provincial Committee of the Chinese People's Political Consultative Conference – Member

Past major appointments

- ^ Hong Kong Exchanges and Clearing Limited – Member of Risk Management Committee (2010)
- Hong Kong Monetary Authority – Member of Banking Advisory Committee (2005-2010)
- Hong Kong Trade Development Council – Chairman of Financial Services Advisory Committee (2006-2010)
- HSBC Bank Australia Limited – NED (2010-2011) (Note 1)
- The Hong Kong Association of Banks – Chairman (2009)

Qualifications

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

Major award

Justice of the Peace (2002)

* Mr Michael WU Wei Kuo

Director

Aged 40

Joined the Board since September 2010

Other major appointments

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

Qualification

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

Major Award

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

- * Independent Non-executive Directors ("INED")
- # Non-executive Directors ("NED")
- ^ The securities of these companies are listed on a securities market in Hong Kong or overseas.

Notes:

- 1 New appointments or cessation of appointments since the date of the Bank's 2010 Interim Report or (as the case may be) the date(s) of announcement(s) for the appointment of Director(s) issued by the Bank subsequent to the date of the Bank's 2010 Interim Report.
- 2 The interests of Directors in shares of the Bank, if any, within the meaning of Part XV of the Securities and Futures Ordinance ("SFO") as at 31 December 2010 are disclosed in the section "Directors' and Alternate Chief Executives' Interests" of the Report of the Directors attached to the Bank's 2010 Annual Report.
- 3 Some Directors (as disclosed in the section "Biographical Details of Directors" of the Bank's 2010 Annual Report) are also Directors of HSBC Holdings plc ("HSBC") and/or its subsidiaries. HSBC, through its wholly owned subsidiaries, has an interest in the shares of the Bank under the provisions of Divisions 2 and 3 of Part XV of the SFO, the details of which are disclosed in the section "Substantial Interests in Share Capital" of the Report of the Directors attached to the Bank's 2010 Annual Report.
- 4 Save as disclosed in the section "Biographical Details of Directors" of the Bank's 2010 Annual Report, the Directors (a) have not held any directorships in other publicly listed companies, whether in Hong Kong or overseas, during the last 3 years; (b) do not hold any other positions in the Bank and its subsidiaries; and (c) do not have any other relationships with any Directors, senior management or substantial or controlling shareholders of the Bank, except that Mr Michael W K Wu's spouse is the niece of Dr Vincent H S Lo, a Non-executive Director of the Bank.
- 5 All Directors (except those Directors who are full time employees of the Bank or its subsidiaries) will receive Directors' fees in the amounts approved from time to time by shareholders at the Annual General Meetings of the Bank. The current amounts of Directors' fees have been determined with reference to market rates, directors' workload and required commitment. A Director will also receive a fee for duties assigned to and services provided by him/her as Chairman or member of various Committees of the Bank. Such fees have been determined with reference to the remuneration policy of the Bank.
- 6 Commencing from 1 January 2008, no Directors' fees will be paid to those Directors who are full time employees of the Bank or its subsidiaries. The salary packages of such Directors have been determined with reference to the remuneration policy of the Bank. Such Directors are also entitled to discretionary bonus.
- 7 The details of the emoluments of the Directors on a named basis are disclosed in Note 19 of the Bank's Financial Statements as contained in the Bank's 2010 Annual Report.
- 8 None of the Directors, except Mr William W Leung has signed service contracts with the Bank. However, the Bank's Articles of Association provide that each Director is required to retire by rotation once every three years and that one-third (or the number nearest to one-third) of the Directors shall retire from office every year at the Bank's Annual General Meeting. A Director's specific term of appointment, therefore, cannot exceed three years. Every retiring Director shall be eligible for re-election at the Annual General Meetings of the Bank.
- 9 Biographical details of Directors of the Bank are also available on the website of the Bank (www.hangseng.com).

BIOGRAPHICAL DETAILS OF SENIOR MANAGEMENT



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

Mrs Margaret LEUNG KO May Yee JP

Vice-Chairman and Chief Executive

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

Mr William LEUNG Wing Cheung BBS, JP

Executive Director and Head of Personal Banking

(Biographical details are set out on pages 82 and 83)

Mr Andrew FUNG Hau Chung

General Manager and Head of Treasury and Investment
Aged 53
Joined the Bank since May 2006

Major positions held within Hang Seng Group

Hang Seng Bank Limited – General Manager and Head of Treasury and Investment; member of Executive Committee

Hang Seng Insurance Company Limited – Director

Hang Seng Investment Management Limited – Director and General Manager

Other major appointments

Business Facilitation Advisory Committee – Non-official member

The Federation of Hong Kong Industries – Member of General Committee

Industrial Bank Co., Ltd. – Director; member of Executive Committee; member of Remuneration and Examination Committee

Securities and Futures Commission – Member of Process Review Panel; Member of Products Advisory Committee

The Hong Kong Mortgage Corporation Limited – Director

Past major positions

Hang Seng Bank Limited

General Manager and Head of Investment and Insurance (2008-2009)

Deputy General Manager and Head of Investment and Insurance (2006-2008)

DBS Bank Limited – Managing Director, Advisory Sales, Greater China, Wholesale Banking – Global Financial Markets (2002-2006)

Qualifications

Bachelor of Arts Degree – The University of Hong Kong

Honorary Fellowship – Lingnan University

Mr Nixon CHAN Lik Sang

Head of Corporate and Commercial Banking

Aged 58

Joined the Bank since October 2009

Major positions held within Hang Seng Group

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

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

Hang Seng Insurance Company Limited – Director

Other major appointments

Hang Seng Management College Limited – Member of the Board of Governors

Hang Seng School of Commerce – Director

Small and Medium Enterprises Committee – Member

Past major positions

The Hongkong and Shanghai Banking Corporation Limited

Senior Executive, Commercial Banking (2005-2009)

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

Qualification

Bachelor Degree in Business Administration – University of Hawaii, USA

Mr Joseph CHO Tak Chi

Head of Branch Network and Direct Banking

Aged 53

Joined the Bank in June 1995 (left in 1997) and rejoined in October 2004

Major position held within Hang Seng Group

Hang Seng Bank Limited – Head of Branch Network and Direct Banking

Other major appointments

Hong Kong Deposit Protection Board – Member of Consultative Committee on Deposit Protection Scheme

The Hong Kong Association of Banks – Member of Task Force on Financial Service Delivery Channels; member of Renminbi Services Working Group

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

Past major positions

Hang Seng Bank Limited

Assistant General Manager and Head of Branch Network and Direct Banking (2006-2008)

Senior Manager and Head of Branch Network and Direct Banking (2005-2006)

Senior Manager and Head of Customer Management and Marketing (2004-2005)

Senior Retail Planning Manager (1995-1997)

Qualifications

Certified Financial Management Planner – The Hong Kong Institute of Bankers

Certified Manager of Financial Advisors and Chartered Insurance Agency Manager – LIMRA International

Certified Management Consultant – Institute of Management Consultants Hong Kong

Fellow – Financial Services Institute of Australasia, Australia

Fellow, Life Management Institute – LOMA

Graduate Diploma in Management Consulting and Change – The University of Hong Kong

Master of Science Degree in Management Sciences – University of Manchester, UK

Mr Christopher HO Hing Nin

Chief Technology and Services Officer

Aged 58

Joined the Bank since July 2009

Major positions held within Hang Seng Group

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

Hang Seng Real Estate Management Limited – Director

Hang Seng Security Management Limited – Director

Other major appointments

Urban Renewal Authority – Member of Central Oasis Community Advisory Committee

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

Past major positions

The Hongkong and Shanghai Banking Corporation Limited

Head of Service Delivery Asia Pacific (2009)

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

Qualification

MSc in Management Information Systems – Sheffield Hallam University, UK

Mr Andrew LEUNG Wing Lok

Chief Financial Officer

Aged 48

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

Major positions held within Hang Seng Group

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

Hang Seng Bank (China) Limited – Director

Hang Seng Insurance Company Limited – Director

BIOGRAPHICAL DETAILS OF SENIOR MANAGEMENT

Other major appointment

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

Past major positions

Hang Seng Bank Limited

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

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

Senior Manager of Corporate Banking (2001-2003)

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

Qualifications

Associate – The Hong Kong Institute of Chartered Secretaries

Associate – The Institute of Chartered Secretaries and Administrators

Bachelor of PRC Law – Peking University, PRC

Bachelor of Social Sciences (Major in Management) – The University of Hong Kong

Certified Member – Certified Management Accountants Society of British Columbia, Canada

Fellow – Chartered Association of Certificated Accountants

Fellow – Hong Kong Institute of Certified Public Accountants

Master of Science, Data processing – University of Ulster, UK

Master of Science in Electronic Commerce and Internet Computing – The University of Hong Kong

Mr NG Yuen Tin

Head of Corporate Banking

Aged 59

Joined the Bank since July 1971 (will retire in May 2011)

Major positions held within Hang Seng Group

Hang Seng Bank Limited – Head of Corporate Banking

Hang Seng Finance Limited – Director and Chief Executive

Hang Seng Indexes Company Limited – Director

HSI International Limited – Director

Other major appointment

The Hong Kong Institute of Bankers – Member of Executive Committee

Past major positions

Hang Seng Bank Limited

Assistant General Manager and Head of Corporate and Institutional Banking Division (1999-2000)

Assistant General Manager and Deputy Head of Corporate Banking Division (1994-1999)

Qualification

Fellow – The Hong Kong Institute of Bankers

Mr David TAM Wai Hung

Chief Risk Officer

Aged 61

Joined the Bank since March 1999

Major positions held within Hang Seng Group

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

Other major appointments

Business and Professionals Federation of Hong Kong – Vice-Chairman and Member of the Executive Committee

Hong Kong St John Ambulance – Council Member & Chairman of Finance Committee

ReSource The Counselling Centre Limited – Chairman of the Council

Past major positions

Hang Seng Bank Limited

Deputy General Manager and Head of Commercial Banking, Greater China (2007-2008)

Deputy General Manager and Head of Commercial Banking (2003-2006)

Assistant General Manager and Head of Commercial Banking (2002-2003)

Assistant General Manager, Corporate Banking – Trade Finance (1999-2002)

The Hongkong and Shanghai Banking Corporation Limited

Senior Executive, Payments and Cash Management, Asia-Pacific (1998-1999)

Senior Executive, Corporate and Institutional Banking (1997-1998)

Qualifications

Fellow – The Hong Kong Institute of Bankers

Fellow – Chartered Institute of Bankers, UK

Master of Business Administration – University of Toronto

Mr Thomas TSUI Chun Man

Head of Corporate Banking Designate

Aged 49

Joined the Bank in October 1994 (left in 1996) and re-joined in June 1997

Major positions held within Hang Seng Group

Hang Seng Bank Limited – Head of Corporate Banking Designate

Hang Seng Investment Services Limited – Director

Hang Seng Securities Limited – Director

Past major positions

Hang Seng Bank Limited

Assistant General Manager and Head of Business Banking (2002 – January 2011)

Assistant General Manager and Head of Retail Services and Sales (1999-2002)

Senior Manager and Head of Retail Sales and Services (1998-1999)

Qualifications

Associate – The Hong Kong Institute of Bankers

Member – Institute of Financial Planners of Hong Kong

Master of Business Administration – Brunel University, UK

Bachelor of Social Science – The University of Hong Kong

REPORT OF THE DIRECTORS

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2010.

PRINCIPAL ACTIVITIES

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

PROFITS

The consolidated profit of the Bank and its subsidiaries and associates for the year and the particulars of dividends which have been paid or declared are set out on pages 98 and 135 of this Annual Report respectively.

MAJOR CUSTOMERS

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

SUBSIDIARIES

Particulars of the Bank's principal subsidiaries as at 31 December 2010 are set out in note 37 to the financial statements for the year ended 31 December 2010.

SHARE CAPITAL

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

DONATIONS

Charitable donations made by the Bank and its subsidiaries during the year amounted to HK\$13.1m. For further details of the Bank's corporate social responsibility activities and expenditures, please refer to the section "Corporate Responsibility" of this Annual Report.

RESERVES

Profit attributable to shareholders, before dividends, of HK\$14,917m (2009 restated: HK\$13,138m) have been transferred to reserves. Distributable reserve of the Bank as at 31 December 2010 amounted to HK\$20,556m (2009: HK\$19,568m). Other movements in reserves are set out in the consolidated statement of changes in equity.

DIRECTORS

The Directors of the Bank who were in office as at the end of the year were Dr Raymond K F Ch'ien, Mrs Margaret Leung, Dr John C C Chan, Dr Marvin K T Cheung, Ms L Y Chiang, Mr Alexander A Flockhart, Mr Jenkin Hui, Mr William W Leung, Dr Eric K C Li, Dr Vincent H S Lo, Mr Iain J Mackay, Mrs Dorothy K Y P Sit, Mr Richard Y S Tang, Mr Peter T S Wong and Mr Michael W K Wu.

Both Mr Alexander A Flockhart and Mr Iain J Mackay resigned from the Board with effect from the close of business on 31 December 2010.

Ms L Y Chiang and Mr Michael W K Wu were appointed Directors of the Bank with effect from 20 September 2010. Mr Mark S McCombe and Ms Sarah C Legg were appointed Directors of the Bank with effect from 14 February 2011. They will retire under the provisions of the Bank's Articles of Association and, being eligible, offer themselves for election at the forthcoming Annual General Meeting ("AGM").

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Dr Raymond K F Ch'ien, Dr Marvin K T Cheung and Mr Jenkin Hui, who, being eligible, offer themselves for re-election at the forthcoming AGM.

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

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

STATUS OF INDEPENDENT NON-EXECUTIVE DIRECTORS

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

DIRECTORS' AND ALTERNATE CHIEF EXECUTIVES' INTERESTS

Interests in shares

As at 31 December 2010, the interests of the Directors and Alternate Chief Executives in the shares, underlying shares of equity derivatives and debentures of the Bank and its associated corporations (all within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) disclosed in accordance with the Listing Rules were detailed below.

| | Personal Interests (held as beneficial owner) | Family Interests (interests of spouse or child under 18) | Corporate Interests (interests of controlled corporation) | Other Interests | Total Interests | Total Interests as % of the relevant issued share capital |
|--|---|---|---|----------------------------------|--------------------|---|
| Number of Ordinary Shares of HK\$5 each in the Bank | | | | | | |
| Directors: | | | | | | |
| Mrs Margaret Leung | 21,000 | – | – | – | 21,000 | 0.00 |
| Dr John C C Chan | – | – | – | 1,000 ⁽¹⁾ | 1,000 | 0.00 |
| Number of Ordinary Shares of US\$0.50 each in HSBC Holdings plc | | | | | | |
| Directors: | | | | | | |
| Dr Raymond K F Ch'ien | 55,988 | – | – | – | 55,988 | 0.00 |
| Mrs Margaret Leung | 97,532 | – | – | 400,471 ⁽⁶⁾ | 498,003 | 0.00 |
| Dr John C C Chan | 20,234 | – | – | 4,371 ⁽¹⁾ | 24,605 | 0.00 |
| Ms L Y Chiang | 12,000 | – | 6,000 ⁽²⁾ | – | 18,000 | 0.00 |
| Mr Alexander A Flockhart | – | – | – | 1,231,453 ^{(3)&(6)} | 1,231,453 | 0.00 |
| Mr Jenkin Hui | 17,574 | – | 1,947,315 ⁽⁴⁾ | – | 1,964,889 | 0.01 |
| Mr William W Leung | 37,845 | – | – | 32,935 ⁽⁶⁾ | 70,780 | 0.00 |
| Dr Eric K C Li | – | 39,490 | – | – | 39,490 | 0.00 |
| Mr Iain J Mackay | 34,217 | – | – | 255,033 ⁽⁶⁾ | 289,250 | 0.00 |
| Mrs Dorothy K Y P Sit | 41,585 ⁽⁵⁾ | 1,031 | – | 48,420 ⁽⁶⁾ | 91,036 | 0.00 |
| Mr Peter T S Wong | 249,925 | 17,599 | – | 308,025 ⁽⁶⁾ | 575,549 | 0.00 |
| Alternate Chief Executives: | | | | | | |
| Mr Nixon L S Chan | 10,961 | – | – | 34,496 ⁽⁶⁾ | 45,457 | 0.00 |
| Mr Andrew H C Fung | 4,064 | – | – | 42,973 ⁽⁶⁾ | 47,037 | 0.00 |
| Mr Christopher H N Ho | 75,367 | 42,653 | – | 14,114 ⁽⁶⁾ | 132,134 | 0.00 |
| Mr Andrew W L Leung | 4,428 | – | – | 848 ⁽⁶⁾ | 5,276 | 0.00 |
| Mr David W H Tam | 21,618 | 9,014 | – | 21,171 ⁽⁶⁾ | 51,803 | 0.00 |

Notes:

- (1) 1,000 shares in the Bank and 4,371 shares in HSBC Holdings plc were held by a trust of which Dr John C C Chan and his wife were beneficiaries.
- (2) Ms L Y Chiang was entitled to fully control the voting power at general meetings of Happy Boom Enterprises Limited, a private company, which beneficially held all of those shares referred to above as her corporate interests.
- (3) 230,112 shares were held by a trust of which Mr Alexander A Flockhart was one of the trustees.
- (4) Mr Jenkin Hui was entitled to fully control the voting power at general meetings of Parc Palais Incorporated, a private company, which beneficially held all of those shares referred to above as his corporate interests.
- (5) 8,046 shares were jointly held by Mrs Dorothy K Y P Sit and her husband.
- (6) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives, as set against their respective names below:

| | Options (please refer to the options table below for details) | Conditional awards of shares under the HSBC Share Plans (please refer to the awards table below for further information) | Total |
|------------------------------------|--|---|-----------|
| Directors: | | | |
| Mrs Margaret Leung | 4,197 | 396,274 | 400,471 |
| Mr Alexander A Flockhart | 4,529 | 996,812 | 1,001,341 |
| Mr William W Leung | 8,051 | 24,884 | 32,935 |
| Mr Iain J Mackay | 1,531 | 253,502 | 255,033 |
| Mrs Dorothy K Y P Sit | 5,818 | 42,602 | 48,420 |
| Mr Peter T S Wong | – | 308,025 | 308,025 |
| Alternate Chief Executives: | | | |
| Mr Nixon L S Chan | 16,888 | 17,608 | 34,496 |
| Mr Andrew H C Fung | 4,197 | 38,776 | 42,973 |
| Mr Christopher H N Ho | 5,961 | 8,153 | 14,114 |
| Mr Andrew W L Leung | – | 848 | 848 |
| Mr David W H Tam | 19,508 | 1,663 | 21,171 |

Options

As at 31 December 2010, the Directors and Alternate Chief Executives mentioned below held unlisted physically settled options to acquire the number of ordinary shares of US\$0.50 each in HSBC Holdings plc set against their respective names. These options were granted for nil consideration by HSBC Holdings plc.

| | Options held as at 31 December 2010 | Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2010 | Exercise price per share | Date granted | Exercisable from | Exercisable until |
|--------------------------|---|--|--------------------------------|-----------------|---------------------|----------------------|
| Directors: | | | | | | |
| Mrs Margaret Leung | 4,197 | – | HK\$37.8797 | 29 Apr 2009 | 1 Aug 2014 | 31 Jan 2015 |
| Mr Alexander A Flockhart | 4,529 | – | £3.3116 | 29 Apr 2009 | 1 Aug 2014 | 31 Jan 2015 |

REPORT OF THE DIRECTORS

| | Options held as at 31 December 2010 | Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2010 | Exercise price per share | Date granted | Exercisable from | Exercisable until |
|------------------------------------|-------------------------------------|--|--------------------------|--------------|------------------|-------------------|
| Directors: | | | | | | |
| Mr William W Leung | – | 6,885 ⁽¹⁾ | £6.0216 | 2 May 2003 | 2 May 2006 | 1 May 2013 |
| | 7,459 | – | £7.2181 | 30 Apr 2004 | 30 Apr 2007 | 29 Apr 2014 |
| | – | 839 ⁽²⁾ | HK\$37.8797 | 29 Apr 2009 | 1 Aug 2010 | 31 Oct 2010 |
| | 592 ⁽³⁾ | – | HK\$62.9770 | 21 Apr 2010 | 1 Aug 2011 | 31 Oct 2011 |
| | <u>8,051</u> | | | | | |
| Mr Iain J Mackay | <u>1,531</u> | – | US\$11.8824 | 30 Apr 2008 | 1 Aug 2011 | 31 Jan 2012 |
| Mrs Dorothy K Y P Sit | 3,443 | – | £7.5919 | 23 Apr 2001 | 23 Apr 2004 | 22 Apr 2011 |
| | <u>2,375</u> | – | HK\$37.8797 | 29 Apr 2009 | 1 Aug 2012 | 31 Jan 2013 |
| | <u>5,818</u> | | | | | |
| Alternate Chief Executives: | | | | | | |
| Mr Nixon L S Chan | – | 5,738 ⁽⁴⁾ | £6.5009 | 3 Apr 2000 | 3 Apr 2003 | 2 Apr 2010 |
| | 4,820 | – | £7.5919 | 23 Apr 2001 | 23 Apr 2004 | 22 Apr 2011 |
| | 3,328 | – | £7.3244 | 7 May 2002 | 7 May 2005 | 6 May 2012 |
| | 3,615 | – | £6.0216 | 2 May 2003 | 2 May 2006 | 1 May 2013 |
| | 4,533 | – | £7.2181 | 30 Apr 2004 | 30 Apr 2009 | 29 Apr 2014 |
| | 592 ⁽³⁾ | – | HK\$62.9770 | 21 Apr 2010 | 1 Aug 2011 | 31 Oct 2011 |
| | <u>16,888</u> | | | | | |
| Mr Andrew H C Fung | <u>4,197</u> | – | HK\$37.8797 | 29 Apr 2009 | 1 Aug 2014 | 31 Jan 2015 |
| Mr Christopher H N Ho | 3,443 | – | £7.2181 | 30 Apr 2004 | 30 Apr 2009 | 29 Apr 2014 |
| | <u>2,518</u> | – | HK\$37.8797 | 29 Apr 2009 | 1 Aug 2012 | 31 Jan 2013 |
| | <u>5,961</u> | | | | | |
| Mr David W H Tam | 5,738 | – | £7.5919 | 23 Apr 2001 | 23 Apr 2004 | 22 Apr 2011 |
| | 6,311 | – | £7.3244 | 7 May 2002 | 7 May 2005 | 6 May 2012 |
| | <u>7,459</u> | – | £7.2181 | 30 Apr 2004 | 30 Apr 2009 | 29 Apr 2014 |
| | <u>19,508</u> | | | | | |

Notes:

(1) At the date of exercise, 13 October 2010, the market value per share was £6.7110.

(2) At the date of exercise, 6 October 2010, the market value per share was £6.6370.

(3) Notifications that Mr William W Leung and Mr Nixon L S Chan held these unlisted physically settled options to acquire shares of US\$0.50 each in HSBC Holdings plc were given by them in January 2011 on their becoming aware of the same.

(4) At the date of exercise, 26 March 2010, the market value per share was £6.8770.

Conditional Awards of Shares

As at 31 December 2010, the interests of the Directors and Alternate Chief Executives in the conditional awards of ordinary shares of US\$0.50 each in HSBC Holdings plc made in favour of them under the HSBC Share Plans were as follows:

| | Awards held as at 1 January 2010 | Awards made during the Director's/Alternate Chief Executive's term of office in 2010 | Awards released during the Director's/Alternate Chief Executive's term of office in 2010 | Awards held as at 31 December 2010 |
|------------------------------------|----------------------------------|--|--|------------------------------------|
| Directors: | | | | |
| Mrs Margaret Leung | 303,469 | 100,117 | 19,938 | 396,274 ⁽¹⁾ |
| Mr Alexander A Flockhart | 878,274 | 297,746 | 122,605 | 996,812 ^{(1)&(2)} |
| Mr William W Leung | 31,192 | 2,442 | 9,678 | 24,884 ⁽¹⁾ |
| Mr Iain J Mackay | 233,624 | 57,700 | 46,899 | 253,502 ⁽¹⁾ |
| Mrs Dorothy K Y P Sit | 37,307 | 15,984 | 12,173 | 42,602 ⁽¹⁾ |
| Mr Peter T S Wong | 240,639 | 89,323 | 31,941 | 308,025 ⁽¹⁾ |
| Alternate Chief Executives: | | | | |
| Mr Nixon L S Chan | 18,976 | 3,225 | 5,232 | 17,608 ⁽¹⁾ |
| Mr Andrew H C Fung | 22,280 | 19,353 | 4,064 | 38,776 ⁽¹⁾ |
| Mr Christopher H N Ho | 4,682 | 3,225 | – | 8,153 ⁽¹⁾ |
| Mr Andrew W L Leung | – | 826 | – | 848 ⁽¹⁾ |
| Mr David W H Tam | 7,621 | 1,620 | 5,713 | 1,663 ^{(1)&(2)} |

Notes:

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

(2) This takes into account the forfeiture of shares under the relevant Share Plan(s).

All the interests stated above represent long positions. As at 31 December 2010, no short positions were recorded in the Register of Directors' and Alternate Chief Executives' Interests and Short Positions required to be kept under section 352 of the SFO.

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

No right to subscribe for equity or debt securities of the Bank has been granted by the Bank to, nor have any such rights been exercised by, any person during the year ended 31 December 2010.

DIRECTORS' INTERESTS IN CONTRACTS

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

DIRECTORS' INTERESTS IN COMPETING BUSINESSES

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

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

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

Mr William W Leung is a Director of Yantai Bank Co., Ltd. ("Yantai Bank"), in which the Bank holds a 20.0% stake, and HSBC Global Asset Management (Hong Kong) Limited, a subsidiary of The Hongkong and Shanghai Banking Corporation Limited. Yantai Bank conducts general banking business in mainland China.

Mr Mark S McCombe is a Group General Manager of HSBC Holdings plc. He is also the Chief Executive Officer, Hong Kong of The Hongkong and Shanghai Banking Corporation Limited and a Director of various HSBC Group subsidiaries.

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

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

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

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

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

DIRECTORS' EMOLUMENTS

The emoluments of the Directors of the Bank (including Executive Directors and Independent Non-executive Directors) on a named basis are set out in note 19 to the financial statements for the year ended 31 December 2010.

SUBSTANTIAL INTERESTS IN SHARE CAPITAL

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2010, the following corporations had interests or short positions in the shares or underlying shares (as defined in the SFO) in the Bank set opposite their respective names:

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

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

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

All the interests stated above represent long positions. As at 31 December 2010, no short positions were recorded in the Register of Interests in Shares and Short Positions required to be kept under section 336 of the SFO.

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

Save for the redemption of all the (1) Series A HK\$1,000m 4.125% subordinated notes due 2015 and (2) Series B HK\$1,500m floating rate subordinated notes due 2015, both at par on 24 June 2010, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's listed securities during the year.

PUBLIC FLOAT

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

CODE ON CORPORATE GOVERNANCE PRACTICES

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

AUDITOR

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

On behalf of the Board

Raymond Ch'ien

Chairman

Hong Kong, 28 February 2011

2010

FINANCIAL STATEMENTS

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CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2010
(Expressed in millions of Hong Kong dollars)

| | | 2010 | 2009 (restated) |
|---|------|----------------|--------------------|
| | note | | |
| Interest income | 8 | 16,507 | 16,390 |
| Interest expense | 8 | (2,207) | (2,367) |
| Net interest income | | 14,300 | 14,023 |
| Fee income | | 5,895 | 5,190 |
| Fee expense | | (998) | (869) |
| Net fee income | 9 | 4,897 | 4,321 |
| Trading income | 10 | 2,059 | 1,923 |
| Net income/(loss) from financial instruments designated at fair value | 11 | 282 | (75) |
| Dividend income | 12 | 14 | 16 |
| Net earned insurance premiums | 13 | 11,307 | 11,519 |
| Other operating income | 14 | 1,558 | 1,089 |
| Total operating income | | 34,417 | 32,816 |
| Net insurance claims incurred and movement in policyholders' liabilities | 15 | (12,587) | (12,004) |
| Net operating income before loan impairment charges and other credit risk provisions | | 21,830 | 20,812 |
| Loan impairment charges and other credit risk provisions | 16 | (390) | (812) |
| Net operating income | | 21,440 | 20,000 |
| Employee compensation and benefits | | (3,717) | (3,378) |
| General and administrative expenses | | (2,917) | (2,733) |
| Depreciation of premises, plant and equipment | | (619) | (591) |
| Amortisation of intangible assets | | (102) | (84) |
| Total operating expenses | 17 | (7,355) | (6,786) |
| Operating profit | | 14,085 | 13,214 |
| Gains less losses from financial investments and fixed assets | 21 | 112 | 186 |
| Net surplus on property revaluation | 22 | 487 | 252 |
| Share of profits from associates | | 2,661 | 1,748 |
| Profit before tax | | 17,345 | 15,400 |
| Tax expense | 23 | (2,428) | (2,262) |
| Profit for the year | | 14,917 | 13,138 |
| Profit attributable to shareholders | | 14,917 | 13,138 |
| <i>(Figures in HK\$)</i> | | | |
| Earnings per share | 25 | 7.80 | 6.87 |

The notes on pages 104 to 249 form part of these financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)

| | 2010 | 2009 (restated) |
|--|---------------|--------------------|
| Profit for the year | 14,917 | 13,138 |
| Other comprehensive income | | |
| Premises: | | |
| – unrealised surplus on revaluation of premises | 2,102 | 1,475 |
| – deferred taxes | (343) | (182) |
| Available-for-sale investment reserve: | | |
| – fair value changes taken to/(from) equity: | | |
| – on debt securities | 774 | 3,908 |
| – on equity shares | (5) | 80 |
| – fair value changes transferred (to)/from income statement: | | |
| – on impairment | – | 4 |
| – on hedged items | (272) | 81 |
| – on disposal | (105) | (9) |
| – share of changes in equity of associates: | | |
| – fair value changes | 120 | (26) |
| – deferred taxes | (53) | (472) |
| Cash flow hedging reserve: | | |
| – fair value changes taken to equity | 291 | 407 |
| – fair value changes transferred to income statement | (414) | (864) |
| – deferred taxes | 21 | 69 |
| Defined benefit plans: | | |
| – actuarial gains on defined benefit plans | 11 | 1,877 |
| – deferred taxes | (2) | (309) |
| Exchange differences on translation of: | | |
| – financial statements of overseas branches, subsidiaries and associates | 687 | 3 |
| – others | 13 | 10 |
| Other comprehensive income for the year, net of tax | 2,825 | 6,052 |
| Total comprehensive income for the year | 17,742 | 19,190 |
| Total comprehensive income for the year attributable to shareholders | 17,742 | 19,190 |

CONSOLIDATED BALANCE SHEET

at 31 December 2010

(Expressed in millions of Hong Kong dollars)

| | | 2010 | 2009 (restated) |
|--|------|----------------|--------------------|
| | note | | |
| ASSETS | | | |
| Cash and balances with banks and other financial institutions | 30 | 44,411 | 22,086 |
| Placings with and advances to banks and other financial institutions | 31 | 110,564 | 104,551 |
| Trading assets | 32 | 26,055 | 66,597 |
| Financial assets designated at fair value | 33 | 7,114 | 5,450 |
| Derivative financial instruments | 34 | 5,593 | 5,050 |
| Advances to customers | 35 | 472,637 | 344,621 |
| Financial investments | 36 | 199,359 | 241,502 |
| Interest in associates | 38 | 15,666 | 10,226 |
| Investment properties | 39 | 3,251 | 2,872 |
| Premises, plant and equipment | 40 | 14,561 | 12,414 |
| Intangible assets | 41 | 5,394 | 4,214 |
| Other assets | 42 | 12,306 | 11,069 |
| Deferred tax assets | 49 | – | 16 |
| Total assets | | 916,911 | 830,668 |
| LIABILITIES AND EQUITY | | | |
| Liabilities | | | |
| Current, savings and other deposit accounts | 43 | 683,628 | 636,369 |
| Deposits from banks | | 15,586 | 4,870 |
| Trading liabilities | 44 | 42,581 | 38,391 |
| Financial liabilities designated at fair value | 45 | 457 | 1,456 |
| Derivative financial instruments | 34 | 4,683 | 4,251 |
| Certificates of deposit and other debt securities in issue | 46 | 3,095 | 1,826 |
| Other liabilities | 47 | 17,018 | 15,285 |
| Liabilities to customers under insurance contracts | 48 | 64,425 | 54,240 |
| Current tax liabilities | 49 | 344 | 52 |
| Deferred tax liabilities | 49 | 3,234 | 2,460 |
| Subordinated liabilities | 50 | 11,848 | 9,320 |
| Total liabilities | | 846,899 | 768,520 |
| Equity | | | |
| Share capital | 51 | 9,559 | 9,559 |
| Retained profits | | 42,966 | 37,752 |
| Other reserves | | 13,854 | 11,204 |
| Proposed dividends | 26 | 3,633 | 3,633 |
| Shareholders' funds | | 70,012 | 62,148 |
| Total equity and liabilities | | 916,911 | 830,668 |

Raymond K F Ch'ien *Chairman*

Margaret Leung *Vice-Chairman and Chief Executive*

Eric K C Li *Director*

Andrew W L Leung *Chief Financial Officer*

The notes on pages 104 to 249 form part of these financial statements.

BALANCE SHEET

at 31 December 2010

(Expressed in millions of Hong Kong dollars)

| | | 2010 | 2009 (restated) |
|--|------|----------------|--------------------|
| | note | | |
| ASSETS | | | |
| Cash and balances with banks and other financial institutions | 30 | 41,062 | 18,461 |
| Placings with and advances to banks and other financial institutions | 31 | 52,131 | 65,624 |
| Trading assets | 32 | 25,232 | 65,288 |
| Financial assets designated at fair value | 33 | 148 | 174 |
| Derivative financial instruments | 34 | 5,026 | 4,916 |
| Advances to customers | 35 | 423,074 | 299,179 |
| Amounts due from subsidiaries | | 93,445 | 87,360 |
| Financial investments | 36 | 103,106 | 156,715 |
| Investments in subsidiaries | 37 | 11,584 | 11,584 |
| Interest in associates | 38 | 5,172 | 2,546 |
| Investment properties | 39 | 2,100 | 1,883 |
| Premises, plant and equipment | 40 | 10,588 | 9,434 |
| Intangible assets | 41 | 442 | 399 |
| Other assets | 42 | 8,787 | 8,236 |
| Deferred tax assets | 49 | – | 2 |
| Total assets | | 781,897 | 731,801 |
| LIABILITIES AND EQUITY | | | |
| Liabilities | | | |
| Current, savings and other deposit accounts | 43 | 649,144 | 612,014 |
| Deposits from banks | | 15,585 | 4,469 |
| Trading liabilities | 44 | 30,106 | 35,071 |
| Financial liabilities designated at fair value | 45 | – | 1,003 |
| Derivative financial instruments | 34 | 4,528 | 4,180 |
| Certificates of deposit and other debt securities in issue | 46 | 3,095 | 1,826 |
| Amounts due to subsidiaries | | 8,899 | 9,960 |
| Other liabilities | 47 | 15,434 | 14,333 |
| Current tax liabilities | 49 | 320 | 10 |
| Deferred tax liabilities | 49 | 1,617 | 1,345 |
| Subordinated liabilities | 50 | 11,848 | 9,320 |
| Total liabilities | | 740,576 | 693,531 |
| Equity | | | |
| Share capital | 51 | 9,559 | 9,559 |
| Retained profits | 52 | 19,637 | 17,894 |
| Other reserves | 52 | 8,492 | 7,184 |
| Proposed dividends | 26 | 3,633 | 3,633 |
| Shareholders' funds | | 41,321 | 38,270 |
| Total equity and liabilities | | 781,897 | 731,801 |

Raymond K F Ch'ien *Chairman*

Margaret Leung *Vice-Chairman and Chief Executive*

Eric K C Li *Director*

Andrew W L Leung *Chief Financial Officer*

The notes on pages 104 to 249 form part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2010
(Expressed in millions of Hong Kong dollars)

| | 2010 | 2009 (restated) |
|--|---------------|--------------------|
| Share capital | | |
| At beginning and end of the year | 9,559 | 9,559 |
| Retained profits (including proposed dividends) | | |
| At beginning of the year | 41,385 | 38,260 |
| Dividends to shareholders | | |
| – dividends approved in respect of the previous year | (3,633) | (5,736) |
| – dividends declared in respect of the current year | (6,309) | (6,309) |
| Transfer | 218 | 455 |
| Total comprehensive income for the year | 14,938 | 14,715 |
| | 46,599 | 41,385 |
| Other reserves | | |
| Premises revaluation reserve | | |
| At beginning of the year | 7,885 | 7,047 |
| Transfer | (218) | (455) |
| Total comprehensive income for the year | 1,759 | 1,293 |
| | 9,426 | 7,885 |
| Available-for-sale investment reserve | | |
| At beginning of the year | (257) | (3,823) |
| Total comprehensive income for the year | 459 | 3,566 |
| | 202 | (257) |
| Cash flow hedging reserve | | |
| At beginning of the year | 174 | 562 |
| Total comprehensive income for the year | (102) | (388) |
| | 72 | 174 |
| Foreign exchange reserve | | |
| At beginning of the year | 1,382 | 1,379 |
| Total comprehensive income for the year | 687 | 3 |
| | 2,069 | 1,382 |
| Other reserve | | |
| At beginning of the year | 2,020 | 1,984 |
| Cost of share-based payment arrangements | 64 | 35 |
| Total comprehensive income for the year | 1 | 1 |
| | 2,085 | 2,020 |
| Total equity | | |
| At beginning of the year | 62,148 | 54,968 |
| Dividends to shareholders | (9,942) | (12,045) |
| Cost of share-based payment arrangements | 64 | 35 |
| Total comprehensive income for the year | 17,742 | 19,190 |
| | 70,012 | 62,148 |

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2010

(Expressed in millions of Hong Kong dollars)

| | | 2010 | 2009 |
|--|-------|-----------------|----------|
| | note | | |
| Net cash (outflow)/inflow from operating activities | 53(a) | (30,098) | 65,815 |
| Cash flows from investing activities | | | |
| Dividends received from associates | | 424 | 380 |
| Increase in interest in an associate | | (2,626) | (3) |
| Purchase of available-for-sale investments | | (27,401) | (49,642) |
| Purchase of held-to-maturity debt securities | | (1,113) | (513) |
| Proceeds from sale or redemption of available-for-sale investments | | 43,356 | 48,615 |
| Proceeds from redemption of held-to-maturity debt securities | | 260 | 182 |
| Purchase of fixed assets and intangible assets | | (915) | (312) |
| Proceeds from sale of fixed assets and assets held for sale | | 19 | 443 |
| Interest received from available-for-sale investments | | 1,632 | 4,429 |
| Dividends received from available-for-sale investments | | 12 | 13 |
| Net cash inflow from investing activities | | 13,648 | 3,592 |
| Cash flows from financing activities | | | |
| Dividends paid | | (9,942) | (12,045) |
| Interest paid for subordinated liabilities | | (63) | (126) |
| Proceeds from subordinated liabilities | | 6,025 | – |
| Repayment of subordinated liabilities | | (4,516) | – |
| Net cash outflow from financing activities | | (8,496) | (12,171) |
| (Decrease)/increase in cash and cash equivalents | | (24,946) | 57,236 |
| Cash and cash equivalents at 1 January | | 136,759 | 76,116 |
| Effect of foreign exchange rate changes | | 6,747 | 3,407 |
| Cash and cash equivalents at 31 December | 53(b) | 118,560 | 136,759 |

The notes on pages 104 to 249 form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

year ended 31 December 2010

(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 Hong Kong Exchanges and Clearing 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));
- leasehold land and buildings held for own use, where the value of the land cannot be reliably separated from the value of the building at inception of the lease and the entire lease is therefore classified as a finance lease (see note 4(s)); and
- leasehold land and buildings held for own use, where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years (see note 4(s)).

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

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

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and major sources of estimation uncertainty are discussed in note 6.

Disclosures under HKFRS 4 “Insurance Contract” and HKFRS 7 “Financial Instrument: Disclosure” relating to the nature and extent of risks have been included in note 61 “Financial risk management”.

2. NATURE OF BUSINESS

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

3. BASIS OF CONSOLIDATION

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

4. PRINCIPAL ACCOUNTING POLICIES

(a) Interest income and expense

Interest income and expense for all 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.

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(b) Non-interest income (continued)

(iv) Trading income

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

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

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

(c) Segment reporting

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

(d) Cash and cash equivalents

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

(e) Loans and advances to banks and customers

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

(f) Loan impairment

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 or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial restructuring; and
- a significant downgrading in credit rating by an external rating agency.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(f) Loan impairment (continued)

(i) Individually assessed loans (continued)

In determining impairment losses on individually assessed loans, the following factors are considered:

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

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

(ii) Collectively assessed loans

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

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

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.

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(f) Loan impairment (continued)

(iii) Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery 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.

(vi) Renegotiated loans

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

(g) Financial instruments

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

(i) Trading assets and trading liabilities

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments (continued)

(ii) Financial instruments designated at fair value

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

- eliminates or significantly reduces 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 classes of financial instrument so designated. The Group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.

Financial assets and financial liabilities so designated are recognised initially at fair value, with transaction costs taken directly to the income statement, and are subsequently remeasured at fair value. This designation, once made, is irrevocable in respect of the financial instruments to which it is made.

Gains and losses from changes in the fair value of such assets and liabilities and dividends are recognised in the income statement as they arise, within “Net income from financial instruments designated at fair value”. Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with financial assets or financial liabilities designated at fair value are also included in “Net income from financial instruments designated at fair value”.

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments (continued)

(iii) Available-for-sale financial assets

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

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

(iv) Held-to-maturity investments

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

(h) Derivative financial instruments

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

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

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

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

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

(i) Hedge accounting

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(i) Hedge accounting (continued)

(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 hedged 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 hedge

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

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

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

(iii) Hedge effectiveness testing

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

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

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

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

(iv) Derivatives that do not qualify for hedge accounting

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

(j) Sale and repurchase agreements

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

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(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 interest in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition, post tax results of the associate and any impairment losses for the year, whereas the Group's share of the post-acquisition post-tax items of the associate's other comprehensive income is recognised in the consolidated statement of comprehensive income.

Unrealised gains on transactions between the Group and its associate are eliminated to the extent of the Group's interest in the associate. Unrealised losses are also eliminated to the extent of the Group's interest in the associate unless the transaction provides evidence of an impairment of the asset transferred.

In the Bank's balance sheet, interest in associate is stated at cost less impairment allowances.

(q) Goodwill and intangible assets

(i) Goodwill arises on business combinations, including the acquisition of subsidiaries or associates when the cost of acquisition exceeds the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired and is reported in the consolidated balance sheet. Goodwill on acquisitions of associates is included in "Interest in associates". Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Goodwill is tested for impairment annually by comparing the recoverable amount from a cash-generating unit with the carrying value of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of, its fair value less cost to sell, and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less any accumulated impairment losses.

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

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

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

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(r) Investment property

Investment properties are land and/or buildings which are owned or held under a leasehold interest to earn rental income and/or for capital appreciation. Investment properties are stated in the balance sheet at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement. Fair values are determined by independent professional valuers, primarily on the basis of capitalization of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation or, both, are classified and accounted for as investment property on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 4(u)).

(s) Premises, plant and equipment

(i) The following land and buildings held for own use are stated in the balance sheet at their revalued amount, being their fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses:

- leasehold land and buildings where the fair value of the land cannot be reliably separated from the value of the building at inception of the lease and the premises are not clearly held under an operating lease; and
- leasehold land and buildings where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years.

Revaluations are performed by professionally qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value at the end of balance sheet date. Surpluses arising on revaluation are credited firstly to the income statement to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same land and buildings, and are thereafter taken to other comprehensive income and are accumulated separately in the “Premises revaluation reserve”. Deficits arising on revaluation, are firstly set off against any previous revaluation surpluses included in the “Premises revaluation reserve” in respect of the same land and building, and are thereafter recognised in the income statement.

Depreciation is calculated to write-off the valuation of the land and building over their estimated useful lives as follows:

- freehold land is not depreciated;
- leasehold land is depreciated over the unexpired terms of the leases; and
- buildings and improvements thereto are depreciated at the greater of 2 per cent per annum on the straight-line basis or over the unexpired terms of the leases.

On revaluation of the property, depreciation accumulated during the year will be eliminated. Depreciation charged on revaluation surplus of the properties is transferred from “Premises revaluation reserve” to “Retained profits”.

On disposal of the property, the profit and loss is calculated as the difference between the net sales proceeds and the net carrying amount and recognised in the income statement. Surpluses relating to the property disposed of included in the “Premises revaluation reserve” are transferred as movements in reserves to “Retained profits”.

(ii) Furniture, plant and other equipment, is stated at cost less depreciation calculated on the straight-line basis to write off the assets over their estimated useful lives, which are generally between 3 and 10 years. On disposal, the profit and loss is calculated as the difference between the net sales proceeds and the net carrying amount.

Premises, plant and equipment are subject to review for impairment if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(t) Interest in leasehold land held for own use under operating lease

The Government of Hong Kong owns all the land in Hong Kong and permits its use under leasehold arrangements. Similar arrangements exist in mainland China. At inception of the lease, where the cost of land is known or can be reliably determined and the term of the lease is less than 50 years, the Group records its interest in leasehold land and land use rights separately as operating leases. These leases are stated at cost less amortization and impairment losses. Amortization is calculated to write off the cost of the land on a straight-line basis over the terms of the lease. Where the cost of the land is unknown, or cannot be reliably determined, the land and buildings are accounted for together, as discussed above in 4(s)(i).

(u) Finance and operating leases

Leases which transfer substantially all the risks and rewards of ownership to the lessees are classified as finance leases. Leases which do not transfer substantially all the risks and rewards of ownership to the lessees are classified as operating leases, with the exceptions of land and building held under a leasehold interest as set out in notes 4(r) & 4(s).

(i) Finance leases

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

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

(ii) Operating leases

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

(v) Impairment of assets

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

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

(i) Held-to-maturity investments

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

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

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(v) Impairment of assets (continued)

(ii) Available-for-sale financial assets

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

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

Impairment losses on available-for-sale debt securities are recognised within “Loan impairment charges 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 in other comprehensive income and accumulated separately in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value; and
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised in other comprehensive income and accumulated separately in equity. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, only to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

(iii) Other assets

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

- premises and equipment (other than properties carried at revalued amounts);
- pre-paid interests in leasehold land classified as “Interest in leasehold land held for own use under operating lease”;
- investments in subsidiaries and associates; and
- intangible assets.

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(v) Impairment of assets (continued)

(iii) Other assets (continued)

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 in other comprehensive income or directly in equity, in which case the relevant amounts of tax are recognised in other comprehensive income or directly in equity, respectively. Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset.

Current tax is the expected tax payable on the taxable profits for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are settled on an individual taxable entity basis.

Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purpose and their tax bases. Deferred tax assets also arise from unused tax losses and unused tax credits.

Deferred tax liabilities are generally recognised for all taxable temporary differences. Deferred tax assets are recognised to the extent that it is probable that taxable profits will be available, against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates that are expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are not discounted. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to offset exists in the entity.

The carrying amount of deferred tax assets/liabilities is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the related tax benefit to be utilised.

NOTES TO THE FINANCIAL STATEMENTS

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(x) Employee benefits

(i) Salaries, annual bonuses, paid annual leave, leave passage and the cost to the Group of non-monetary benefits are accrued in the year in which the associated services are rendered by the employees. Provision is made in respect of paid leave entitlement accumulated during the year, which can be carried forward into future periods for compensated absence or payment in lieu if the employee leaves employment.

(ii) The Group provides retirement benefits for staff members and operates defined benefit and defined contribution schemes and participates in mandatory provident fund schemes in accordance with the relevant laws and regulations.

The retirement benefit costs of defined benefit schemes charged to the income statement are determined by calculating the current service cost, interest cost and expected return on scheme assets in accordance with a set of actuarial assumptions. Any actuarial gains and losses are fully recognised in shareholders' equity and presented in the statement of changes in equity in the period in which they arise.

The Group's net obligation in respect of defined benefit schemes is calculated separately for each scheme by estimating the amount of future benefit that employees have earned in return for their service in the current and prior years; that benefit is discounted to determine the present value, and the fair value of any scheme assets is deducted. The discount rate is the yield at the balance sheet date on high quality corporate bonds that have maturity dates approximating the terms of the Group's obligation. The calculation is performed by a qualified actuary using the Projected Unit Credit Method.

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

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

(y) Share-based payments

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

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

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

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(z) Translation of foreign currencies

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

Exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of separate subsidiary financial statements. In the consolidated financial statements, these exchange differences are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve.

(aa) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a present legal or constructive obligation as a result of past events and a reliable estimate can be made as to the amount of the obligation.

(ab) Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of the loans or debt instruments.

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

(ac) Insurance contracts

Through its insurance subsidiaries, the Group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. 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 insurance are accounted for when receivable, except in 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.

NOTES TO THE FINANCIAL STATEMENTS

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 insurance 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 insurance business, and are in force at the balance sheet date.

The value of the in-force long-term insurance 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 insurance business are included in other operating income on a pre-tax basis. The value of in-force long-term insurance business is reported under "Intangible assets" in the balance sheet.

(ad) Investment contracts

Customer liabilities under linked investment contracts are measured at fair value and reported under "Financial liabilities designated at fair value". The linked financial assets are measured at fair value and the movements in fair value are recognised in the income statement in "Net income from financial instruments designated at fair value".

Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Investment management fee receivables are recognised in the income statement over the period of the provision of the investment management services.

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

(ae) Debt securities in issue and subordinated liabilities

Debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest rate method, and are reported under "Debt securities in issue" or "Subordinated liabilities", except for those issued for trading or designated at fair value, which are carried at fair value and reported under the "Trading liabilities" and "Financial liabilities designated at fair value" in the balance sheet.

(af) 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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(ag) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are 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 Group adopted a number of HKFRSs or amendments to HKFRSs which had an insignificant or no effect on the consolidated financial statements. These are:

- Amendment to HKFRS 3 “Business Combinations” and HKAS 27 “Consolidated and Separate Financial Statements”.
- Amendment to HKAS 39 “Financial Instruments: Recognition and Measurement” – “Eligible Hedged Items”;
- Amendments to HKFRS 2 “Share-based Payment” – “Group Cash-settled Share-based Payment Transactions”;
- Hong Kong (IFRIC) Interpretation 17 “Distributions of Non-cash Assets to Owners”;
- HKFRS 1 (Revised) “First-time Adoption of Hong Kong Financial Reporting Standards”;
- Amendments to HKFRS 1 “First-time Adoption of Hong Kong Financial Reporting Standards” – “Additional Exemptions for First-time Adopters”;
- Amendment to HKFRS 1 “First-time Adoption of Hong Kong Financial Reporting Standards” – “Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters”;
- Hong Kong (IFRIC) Interpretation 18 “Transfer of Assets from Customers”; and
- Other amendments made under “Improvements to HKFRSs” in May 2009, except the amendment to leases as discussed below.

During the year the Group adopted the following HKFRSs and amendments to HKFRSs:

Hong Kong Accounting Standard 17, “Leases” (HKAS 17) has been amended with effect from 1 January 2010 (“the amendment”) as part of the “Improvements to HKFRS” issued in May 2009. Since 2005, and prior to the amendment, a number of significant interests in long-term leasehold land owned by the Group have been recorded as operating leases, measured at historical cost less amortisation in the balance sheet. Following the application of the amendment in 2010, such interests are reclassified as finance leases, included within “Premises, plant and equipment” in the balance sheet and carried at valuation (as discussed in note 4(s)). The amendment has been applied retrospectively and the corresponding prior-year comparatives have been adjusted accordingly.

NOTES TO THE FINANCIAL STATEMENTS

5. CHANGES IN ACCOUNTING POLICIES (continued)

The following primary statement lines have been impacted by the adoption of HKAS 17:

(i) For the Group

| <i>Figures in HK\$m</i> | As reported | Adjustment | Restated |
|---|-------------|------------|----------|
| Year ended 31 December 2009 | | | |
| Profit for the year | 13,221 | (83) | 13,138 |
| Total comprehensive income | 18,608 | 582 | 19,190 |
| Earnings per share (HK\$) | 6.92 | (0.05) | 6.87 |
| As at 31 December 2009 | | | |
| Premises, plant and equipment | 7,178 | 5,236 | 12,414 |
| Interest in leasehold land held for own use under operating lease | 536 | (536) | – |
| Deferred tax liabilities | 1,684 | 776 | 2,460 |
| Other reserves | 7,313 | 3,891 | 11,204 |
| Retained profits | 37,719 | 33 | 37,752 |
| As at 31 December 2008 | | | |
| Premises, plant and equipment | 7,090 | 4,553 | 11,643 |
| Interest in leasehold land held for own use under operating lease | 551 | (551) | – |
| Deferred tax assets | 201 | (175) | 26 |
| Deferred tax liabilities | 711 | 485 | 1,196 |
| Other reserves | 3,813 | 3,336 | 7,149 |
| Retained profits | 32,518 | 6 | 32,524 |

(ii) For the Bank

| <i>Figures in HK\$m</i> | As reported | Adjustment | Restated |
|---|-------------|------------|----------|
| As at 31 December 2009 | | | |
| Premises, plant and equipment | 4,198 | 5,236 | 9,434 |
| Interest in leasehold land held for own use under operating lease | 536 | (536) | – |
| Deferred tax liabilities | 569 | 776 | 1,345 |
| Other reserves | 3,293 | 3,891 | 7,184 |
| Retained profits | 17,861 | 33 | 17,894 |
| As at 31 December 2008 | | | |
| Premises, plant and equipment | 4,294 | 4,553 | 8,847 |
| Interest in leasehold land held for own use under operating lease | 551 | (551) | – |
| Deferred tax assets | 187 | (175) | 12 |
| Deferred tax liabilities | – | 485 | 485 |
| Other reserves | 1,195 | 3,336 | 4,531 |
| Retained profits | 15,563 | 6 | 15,569 |

6. ACCOUNTING ESTIMATES AND JUDGEMENTS

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

(a) Key sources of estimation uncertainty

(i) Impairment allowances on loans and advances

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

(ii) Valuation of financial instruments

The Group's accounting policy for valuation of financial instruments is included in note 4(n) and is discussed further within note 62 "Fair value of financial instruments".

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

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;
- an appropriate discount rate for the instrument. Management 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 derivatives.

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 into 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 reclassified from equity to the income statement, reducing the Group's operating profit.

NOTES TO THE FINANCIAL STATEMENTS

6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

(a) Key sources of estimation uncertainty (continued)

(iii) Insurance contracts

Classification

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

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

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in note 41(a). The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

Insurance liabilities

The estimation of insurance claims liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in note 61(d).

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

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

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

(ii) Held-to-maturity investments

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

(iii) Income taxes

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

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2010

The HKICPA has issued a number of amendments to HKFRSs and Interpretations which are not yet effective for the year ended 31 December 2010 and which have not been adopted in these financial statements.

HKFRS 9 “Financial Instruments” (“HKFRS 9”) was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. In November 2010, the HKICPA issued additions to HKFRS 9 dealing with financial liabilities. The main changes to the requirements of HKAS 39 are summarised below.

- All financial assets are classified into two measurement categories: amortised cost or fair value. These two categories replace the four categories under the current HKAS 39 “Financial Instruments: Recognition and Measurement”.
- Financial assets are classified on the basis of both an entity’s business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets.

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

- Financial assets are measured at fair value through profit or loss, if they do not meet the criteria specified for measurement at amortised cost or if doing so significantly reduces or eliminates an accounting mismatch. An entity has the option to designate all subsequent changes in fair value of an equity instrument not held for trading at fair value through other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.
- Financial assets which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under HKFRS 9.
- HKFRS 9 retains all the existing requirements for derecognition of financial instruments and most of the requirements for financial liabilities, except that for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts, fair value changes attributable to changes in own credit risk are to be presented in the statement of other comprehensive income, and are not subsequently reclassified to income statement but may be transferred within equity.

HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2013 with earlier application permitted. It is required to be applied retrospectively, but if adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. The Group is presently studying the implications of applying HKFRS 9. It is impracticable to quantify the impact of HKFRS 9 as at the date of publication of these financial statements.

The HKICPA issued HKAS 24 (Revised 2009) “Related Party Disclosures” in November 2009, which is effective for annual periods beginning on or after 1 January 2011. The revised standard simplifies the disclosure requirements for government-related entities and clarifies the definition of a related party. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued Hong Kong (IFRIC) Interpretation 19 “Extinguishing Financial Liabilities with Equity Instruments” in December 2009, which is effective for annual periods beginning on or after 1 July 2010. This interpretation provides guidance on how to account for the extinguishment of a financial liability by the issue of equity instruments. The Group does not expect adoption of this amendment to have a significant effect on the consolidated financial statements.

The HKICPA issued an Amendment to Hong Kong (IFRIC) Interpretation 14 “HKAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction” – “Prepayments of a Minimum Funding Requirement” in December 2009, which is effective for annual periods beginning on or after 1 January 2011. The amendment applies in the limited circumstances when an entity is subject to minimum funding requirements and makes an early payment of contributions to cover those requirements. The amendment permits such an entity to treat the benefit of such an early payment as an asset. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued “Improvements to HKFRSs” in May 2010, 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 2011, with earlier application permitted. The Group does not expect adoption of these amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued an amendment to HKFRS 7 “Financial Instruments: Disclosures” in October 2010 which requires additional disclosures for risk exposures arising from transferred financial assets. The amendment will be effective for annual periods beginning on or after 1 July 2011, with earlier application permitted. No disclosures are required for prior periods. The Group is presently studying the implications of applying this amendment to HKFRS 7.

The HKICPA issued an amendment to HKAS 12 “Income Taxes” in December 2010 whereby deferred taxes on an investment property, carried under the fair value model in IAS 40, will be measured presuming that an investment property is recovered entirely through sale. The presumption is rebutted if the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The amendments will be effective for annual periods beginning on or after 1 January 2012 with earlier application permitted.

NOTES TO THE FINANCIAL STATEMENTS

8. INTEREST INCOME/INTEREST EXPENSE

(a) Interest income

| | 2010 | 2009 |
|--|---------------|--------|
| Interest income arising from: | | |
| – financial assets that are not at fair value through profit or loss | 16,228 | 15,950 |
| – trading assets | 197 | 320 |
| – financial assets designated at fair value | 82 | 120 |
| | 16,507 | 16,390 |
| of which: | | |
| – interest income from listed investments | 1,436 | 1,801 |
| – interest income from unlisted investments | 3,072 | 3,569 |
| – interest income from impaired financial assets | 48 | 46 |

(b) Interest expense

| | 2010 | 2009 |
|--|--------------|-------|
| Interest expense arising from: | | |
| – financial liabilities that are not at fair value through profit or loss | 1,769 | 1,799 |
| – trading liabilities | 435 | 554 |
| – financial liabilities designated at fair value | 3 | 14 |
| | 2,207 | 2,367 |
| of which: | | |
| – interest expense from debt securities in issue maturing after five years | – | – |
| – interest expense from customer accounts maturing after five years | – | – |
| – interest expense from subordinated liabilities | 63 | 126 |

9. NET FEE INCOME

| | 2010 | 2009 |
|---|--------------|--------------|
| – stockbroking and related services | 1,468 | 1,566 |
| – retail investment funds | 1,039 | 604 |
| – structured investment products | 19 | 28 |
| – insurance agency | 256 | 190 |
| – account services | 349 | 291 |
| – private banking service fee | 160 | 129 |
| – remittances | 259 | 217 |
| – cards | 1,462 | 1,413 |
| – credit facilities | 195 | 135 |
| – trade services | 452 | 379 |
| – other | 236 | 238 |
| Fee income | 5,895 | 5,190 |
| Fee expense | (998) | (869) |
| | 4,897 | 4,321 |
| 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 | 1,810 | 1,658 |
| – fee income | 2,452 | 2,217 |
| – fee expense | (642) | (559) |
| Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers | 773 | 383 |
| – fee income | 973 | 557 |
| – fee expense | (200) | (174) |

10. TRADING INCOME

| | 2010 | 2009 |
|---|--------------|--------------|
| Foreign exchange | 1,768 | 1,792 |
| (Losses)/gains from hedging activities: | | |
| – fair value hedge | | |
| – on hedging instruments | (261) | 74 |
| – on the hedged items attributable to the hedged risk | 272 | (81) |
| – cash flow hedge | | |
| – net hedging income | – | 16 |
| Securities, derivatives and other trading activities | 280 | 122 |
| | 2,059 | 1,923 |

NOTES TO THE FINANCIAL STATEMENTS

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

| | 2010 | 2009 |
|--|------|------|
| Net income/(loss) on assets designated at fair value which back insurance and investment contracts | 297 | (54) |
| Net change in fair value of other financial instruments designated at fair value | (15) | (21) |
| | 282 | (75) |
| of which dividend income from: | | |
| – listed investments | 3 | 1 |
| – unlisted investments | 1 | 1 |
| | 4 | 2 |

12. DIVIDEND INCOME

| | 2010 | 2009 |
|------------------------|------|------|
| Dividend income: | | |
| – listed investments | 2 | 3 |
| – unlisted investments | 12 | 13 |
| | 14 | 16 |

13. NET EARNED INSURANCE PREMIUMS

| | Non-life insurance | Life insurance (non-linked) | Life insurance (linked) | Total |
|--|--------------------|-----------------------------|-------------------------|--------|
| 2010 | | | | |
| Gross written premiums | 470 | 11,031 | 11 | 11,512 |
| Movement in unearned premiums | (33) | – | – | (33) |
| Gross earned premiums | 437 | 11,031 | 11 | 11,479 |
| Gross written premiums ceded to reinsurers | (122) | (76) | – | (198) |
| Reinsurers' share of movement in unearned premiums | 26 | – | – | 26 |
| Reinsurers' share of gross earned premiums | (96) | (76) | – | (172) |
| Net earned insurance premiums | 341 | 10,955 | 11 | 11,307 |
| 2009 | | | | |
| Gross written premiums | 422 | 11,237 | 15 | 11,674 |
| Movement in unearned premiums | (18) | – | – | (18) |
| Gross earned premiums | 404 | 11,237 | 15 | 11,656 |
| Gross written premiums ceded to reinsurers | (93) | (59) | – | (152) |
| Reinsurers' share of movement in unearned premiums | 15 | – | – | 15 |
| Reinsurers' share of gross earned premiums | (78) | (59) | – | (137) |
| Net earned insurance premiums | 326 | 11,178 | 15 | 11,519 |

14. OTHER OPERATING INCOME

| | 2010 | 2009 |
|--|--------------|-------|
| Rental income from investment properties | 155 | 149 |
| Movement in present value of in-force long-term insurance business | 1,126 | 760 |
| Other | 277 | 180 |
| | 1,558 | 1,089 |

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

| | Non-life insurance | Life insurance (non-linked) | Life insurance (linked) | Total |
|---|-----------------------|-----------------------------------|-------------------------------|---------------|
| 2010 | | | | |
| Claims, benefits and surrenders paid | 113 | 2,402 | 24 | 2,539 |
| Movement in provisions | 21 | 10,085 | 4 | 10,110 |
| Gross claims incurred and movement in policyholders' liabilities | 134 | 12,487 | 28 | 12,649 |
| Reinsurers' share of claims, benefits and surrenders paid | (26) | (22) | - | (48) |
| Reinsurers' share of movement in provisions | - | (14) | - | (14) |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | (26) | (36) | - | (62) |
| Net insurance claims incurred and movement in policyholders' liabilities | 108 | 12,451 | 28 | 12,587 |
| 2009 | | | | |
| Claims, benefits and surrenders paid | 119 | 1,811 | 19 | 1,949 |
| Movement in provisions | (16) | 10,066 | 35 | 10,085 |
| Gross claims incurred and movement in policyholders' liabilities | 103 | 11,877 | 54 | 12,034 |
| Reinsurers' share of claims, benefits and surrenders paid | (10) | (18) | - | (28) |
| Reinsurers' share of movement in provisions | (1) | (1) | - | (2) |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | (11) | (19) | - | (30) |
| Net insurance claims incurred and movement in policyholders' liabilities | 92 | 11,858 | 54 | 12,004 |

NOTES TO THE FINANCIAL STATEMENTS

16. LOAN IMPAIRMENT CHARGES AND OTHER CREDIT RISK PROVISIONS

| | Group | | Bank | |
|---------------------------------------|--------------|---------|--------------|---------|
| | 2010 | 2009 | 2010 | 2009 |
| Loan impairment charges (note 35(b)): | | | | |
| – individually assessed | (186) | (310) | (97) | (285) |
| – collectively assessed | (204) | (502) | (185) | (503) |
| | (390) | (812) | (282) | (788) |
| of which: | | | | |
| – new and additional | (609) | (1,104) | (475) | (1,028) |
| – releases | 157 | 230 | 142 | 194 |
| – recoveries | 62 | 62 | 51 | 46 |
| | (390) | (812) | (282) | (788) |
| Other credit risk provisions | – | – | – | – |
| | (390) | (812) | (282) | (788) |

There was no impairment charge (2009: Nil) provided for available-for-sale debt securities by the Group and the Bank. There was also no impairment loss made in relation to held-to-maturity investments in 2010 (2009: Nil).

17. OPERATING EXPENSES

| | 2010 | 2009 (restated) |
|--|--------------|--------------------|
| Employee compensation and benefits: | | |
| – salaries and other costs* | 3,448 | 3,091 |
| – retirement benefit costs | | |
| – defined benefit scheme (note 58(a)) | 191 | 213 |
| – defined contribution scheme (note 58(b)) | 78 | 74 |
| | 3,717 | 3,378 |
| General and administrative expenses: | | |
| – rental expenses | 464 | 430 |
| – other premises and equipment | 902 | 900 |
| – marketing and advertising expenses | 470 | 382 |
| – other operating expenses | 1,081 | 1,021 |
| | 2,917 | 2,733 |
| Depreciation of business premises and equipment (note 40(a)) | 619 | 591 |
| Amortisation of intangible assets (note 41(c)) | 102 | 84 |
| | 7,355 | 6,786 |
| * of which: | | |
| share based payments (note 59(e)) | 100 | 101 |
| Cost efficiency ratio | 33.7% | 32.6% |

Included in operating expenses are minimum lease payments under operating leases of HK\$493 million (2009: HK\$461 million).

18. THE EMOLUMENTS OF THE FIVE HIGHEST PAID INDIVIDUALS

(a) The aggregate emoluments

| | 2010 | 2009 |
|---|-----------|-----------|
| Salaries, allowances and benefits in kind | 20 | 17 |
| Retirement scheme contributions | 2 | 2 |
| Discretionary bonuses | 10 | 10 |
| Share-based payments | 7 | 6 |
| | 39 | 35 |

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

| HK\$ | 2010 Number of Individuals | 2009 Number of Individuals |
|-------------------------|----------------------------------|----------------------------------|
| 4,000,001 – 4,500,000 | 1 | – |
| 5,000,001 – 5,500,000 | 1 | 1 |
| 5,500,001 – 6,000,000 | – | 1 |
| 6,000,001 – 6,500,000 | – | 1 |
| 6,500,001 – 7,000,000 | 2 | 1 |
| 10,500,001 – 11,000,000 | – | 1 |
| 16,000,001 – 16,500,000 | 1 | – |
| | 5 | 5 |

The emoluments of the five highest paid individuals set out above include the emoluments of two (2009: three) Executive Directors and one non-executive director (2009: one). Their respective directors' emoluments are included in note 19.

NOTES TO THE FINANCIAL STATEMENTS

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 ⁽⁴⁾ '000 | Discretionary Bonuses '000 | Share-based payments ⁽⁵⁾ '000 | Total 2010 '000 | Total 2009 '000 |
|--|--------------|--|---|----------------------------------|--|-----------------------|-----------------------|
| Executive Directors | | | | | | | |
| Ms Margaret Leung ⁽¹⁾ (Appointed on 6 May 09) | - | 5,981 | 825 | 5,380 | 4,089 | 16,275 | 4,834 |
| Mr William W C Leung ⁽²⁾ (Appointed on 7 Aug 09) | - | 3,538 | 405 | 454 | 807 | 5,204 | 1,874 |
| Mr Raymond C F Or (Resigned on 6 May 09) | - | - | - | - | - | - | 10,700 |
| Mr Joseph C Y Poon (Resigned on 30 Sep 09) | - | - | - | - | - | - | 6,038 |
| Mr Patrick K W Chan (Resigned on 6 May 09) | - | - | - | - | - | - | 2,841 |
| Non-Executive Directors | | | | | | | |
| Dr Raymond K F Ch'ien ⁽³⁾ | 367 | - | - | - | - | 367 | 360 |
| Mr Edgar D Ancona ⁽¹⁾ (Resigned on 31 Aug 09) | - | - | - | - | - | - | 187 |
| Mr Iain J Mackay ⁽¹⁾ (Appointed on 1 Sep 09) | 280 | - | - | - | - | 280 | 93 |
| Ms Dorothy K Y P Sit ⁽²⁾ (Appointed on 7 Aug 09) | - | 3,868 | 387 | 1,183 | 1,281 | 6,719 | 2,091 |
| Mr Alexander A Flockhart ⁽¹⁾ | 280 | - | - | - | - | 280 | 280 |
| Dr John C C Chan ⁽³⁾ | 340 | - | - | - | - | 340 | 340 |
| Dr Y T Cheng ⁽³⁾ (Resigned on 6 May 09) | - | - | - | - | - | - | 117 |
| Dr Marvin K T Cheung ⁽³⁾ | 360 | - | - | - | - | 360 | 360 |
| Mr Jenkin Hui ⁽³⁾ | 320 | - | - | - | - | 320 | 320 |
| Mr Peter T C Lee ⁽³⁾ (Deceased on 17 Oct 09) | - | - | - | - | - | - | 267 |
| Dr Eric K C Li ⁽³⁾ | 400 | - | - | - | - | 400 | 400 |
| Dr Vincent H S Lo | 280 | - | - | - | - | 280 | 280 |
| Dr David W K Sin ⁽³⁾ (Resigned on 6 May 09) | - | - | - | - | - | - | 117 |
| Mr Richard Y S Tang ⁽³⁾ | 478 | - | - | - | - | 478 | 473 |
| Mr Peter T S Wong ⁽¹⁾ | 280 | - | - | - | - | 280 | 280 |
| Ms L Y Chiang ⁽³⁾ (Appointed on 20 Sep 10) | 93 | - | - | - | - | 93 | - |
| Mr Michael W K Wu ⁽³⁾ (Appointed on 20 Sep 10) | 93 | - | - | - | - | 93 | - |
| Past Directors | | | | | | | |
| | - | - | 2,169 | - | - | 2,169 | 2,169 |
| | 3,571 | 13,387 | 3,786 | 7,017 | 6,177 | 33,938 | 34,421 |
| 2009 | 3,901 | 14,859 | 3,871 | 7,399 | 4,391 | | |

Notes :

- (1) Fees receivable as a Director of Hang Seng Bank Limited were surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy.
- (2) Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2010.
- (3) Independent Non-Executive Director.
- (4) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK\$2.2 million in 2010. The Bank made contributions during 2010 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.
- (5) 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 59.

20. AUDITORS' REMUNERATION

| | Group | | Bank | |
|---|-----------|------|-----------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Statutory audit services | 13 | 13 | 8 | 9 |
| Non-statutory audit services and others | 6 | 6 | 5 | 5 |
| | 19 | 19 | 13 | 14 |

21. GAINS LESS LOSSES FROM FINANCIAL INVESTMENTS AND FIXED ASSETS

| | 2010 | 2009 |
|--|------------|-------|
| Net gains from disposal of available-for-sale equity securities: | | |
| – reclassified from reserve | 9 | 165 |
| – net gains/(losses) arising in the year | 1 | (4) |
| | 10 | 161 |
| Net gains/(losses) from disposal of available-for-sale debt securities | 95 | (152) |
| Impairment of available-for-sale equity securities | – | (4) |
| Gains less losses on disposal of assets held for sale | 12 | 187 |
| Gains less losses on disposal of fixed assets | (5) | (6) |
| | 112 | 186 |

There was no impairment losses or gains less losses on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost for 2010 and 2009.

22. NET SURPLUS ON PROPERTY REVALUATION

| | 2010 | 2009 (restated) |
|--|------------|--------------------|
| Surplus of revaluation on investment properties (note 39(a)) | 474 | 250 |
| Surplus of revaluation on assets held for sale | 10 | – |
| Reversal of revaluation deficit on premises (note 40(a)) | 3 | 2 |
| | 487 | 252 |

NOTES TO THE FINANCIAL STATEMENTS

23. TAX EXPENSE

(a) Taxation in the consolidated income statement represents:

| | 2010 | 2009 (restated) |
|--|--------------|--------------------|
| Current tax – provision for Hong Kong profits tax | | |
| Tax for the year | 1,967 | 1,844 |
| Adjustment in respect of prior year | (19) | (3) |
| | 1,948 | 1,841 |
| Current tax – taxation outside Hong Kong | | |
| Tax for the year | 38 | 50 |
| Deferred tax (note 49(b)) | | |
| Origination and reversal of temporary differences | 442 | 371 |
| Total tax expense | 2,428 | 2,262 |

The current tax provision is based on the estimated assessable profit for 2010, 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 (2009: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

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

| | 2010 | 2009 (restated) |
|--|--------------|--------------------|
| Profit before tax | 17,345 | 15,400 |
| Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2009: 16.5%) | 2,862 | 2,541 |
| Tax effect of: | | |
| – different tax rates in other countries/areas | (172) | (139) |
| – non-taxable income and non-deductible expenses | (41) | (89) |
| – share of results of associates | (439) | (288) |
| – others | 218 | 237 |
| Actual charge for taxation | 2,428 | 2,262 |

24. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to shareholders, HK\$10,914 million (2009: HK\$10,258 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:

| | 2010 | 2009 (restated) |
|--|---------------|--------------------|
| Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements | 10,914 | 10,258 |
| Dividends declared during the year by subsidiaries from retained profits | 565 | 5 |
| The Bank's profit for the year | 11,479 | 10,263 |

25. EARNINGS PER SHARE

The calculation of earnings per share for 2010 is based on earnings of HK\$14,917 million (HK\$13,138 million in 2009) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2009).

26. DIVIDENDS PER SHARE

(a) Dividends attributable to the year:

| | 2010 | | 2009 | |
|----------------|-------------------|--------------|-------------------|--------------|
| | per share HK\$ | HK\$ million | per share HK\$ | HK\$ million |
| First interim | 1.10 | 2,103 | 1.10 | 2,103 |
| Second interim | 1.10 | 2,103 | 1.10 | 2,103 |
| Third interim | 1.10 | 2,103 | 1.10 | 2,103 |
| Fourth interim | 1.90 | 3,633 | 1.90 | 3,633 |
| | 5.20 | 9,942 | 5.20 | 9,942 |

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:

| | 2010 | 2009 |
|--|-------|-------|
| Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK\$1.90 per share (2009: HK\$3.00 per share) | 3,633 | 5,736 |

27. SEGMENTAL ANALYSIS

The Group's business comprises five customer groups. To be consistent with the way in which information is reported internally for the purposes of resource allocation and performance assessment, the Group identified the following five reportable segments.

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.

(a) Segment result

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

NOTES TO THE FINANCIAL STATEMENTS

27. SEGMENTAL ANALYSIS (continued)

(a) Segment result (continued)

| | Personal Financial Services | Commercial Banking | Corporate Banking | Treasury | Other | Total reportable segments | Inter- segment elimination | Total |
|---|-----------------------------------|-----------------------|----------------------|--------------|--------------|---------------------------------|----------------------------------|---------------|
| 2010 | | | | | | | | |
| Net interest income | 8,485 | 2,709 | 1,440 | 1,403 | 263 | 14,300 | – | 14,300 |
| Net fee income/(expense) | 3,423 | 1,209 | 188 | (29) | 106 | 4,897 | – | 4,897 |
| Trading income/(loss) | 630 | 334 | 11 | 1,162 | (78) | 2,059 | – | 2,059 |
| Net income/(loss) from financial instruments designated at fair value | 297 | – | – | (1) | (14) | 282 | – | 282 |
| Dividend income | – | 5 | – | – | 9 | 14 | – | 14 |
| Net earned insurance premiums | 11,059 | 246 | 2 | – | – | 11,307 | – | 11,307 |
| Other operating income | 1,271 | 23 | 1 | (1) | 712 | 2,006 | (448) | 1,558 |
| Total operating income | 25,165 | 4,526 | 1,642 | 2,534 | 998 | 34,865 | (448) | 34,417 |
| Net insurance claims incurred and movement in policyholders' liabilities | (12,436) | (152) | 1 | – | – | (12,587) | – | (12,587) |
| Net operating income before loan impairment charges and other credit risk provisions | 12,729 | 4,374 | 1,643 | 2,534 | 998 | 22,278 | (448) | 21,830 |
| Loan impairment charges and other credit risk provisions | (209) | (178) | (3) | – | – | (390) | – | (390) |
| Net operating income | 12,520 | 4,196 | 1,640 | 2,534 | 998 | 21,888 | (448) | 21,440 |
| Total operating expenses* | (4,864) | (1,703) | (379) | (327) | (530) | (7,803) | 448 | (7,355) |
| Operating profit | 7,656 | 2,493 | 1,261 | 2,207 | 468 | 14,085 | – | 14,085 |
| Gains less losses from financial investments and fixed assets | – | – | 5 | 95 | 12 | 112 | – | 112 |
| Net surplus on property revaluation | – | – | – | – | 487 | 487 | – | 487 |
| Share of profits from associates | 216 | 1,255 | – | 1,059 | 131 | 2,661 | – | 2,661 |
| Profit before tax | 7,872 | 3,748 | 1,266 | 3,361 | 1,098 | 17,345 | – | 17,345 |
| Share of profit before tax | 45.4% | 21.6% | 7.3% | 19.4% | 6.3% | 100.0% | – | 100.0% |
| Operating profit excluding loan impairment charges and other credit risk provisions | 7,865 | 2,671 | 1,264 | 2,207 | 468 | 14,475 | – | 14,475 |
| * Depreciation/amortisation included in total operating expenses | (175) | (34) | (5) | (4) | (503) | (721) | – | (721) |
| Total assets | 264,827 | 180,013 | 130,148 | 304,898 | 37,025 | 916,911 | – | 916,911 |
| Total liabilities | 581,118 | 141,518 | 50,862 | 39,268 | 34,133 | 846,899 | – | 846,899 |
| Interest in associates | 1,384 | 6,197 | – | 5,626 | 2,459 | 15,666 | – | 15,666 |
| Non-current assets incurred during the year | 128 | 39 | 5 | 4 | 739 | 915 | – | 915 |

27. SEGMENTAL ANALYSIS (continued)

(a) Segment result (continued)

| | Personal Financial Services | Commercial Banking | Corporate Banking | Treasury | Other | Total reportable segments | Inter- segment elimination | Total |
|---|-----------------------------------|-----------------------|----------------------|--------------|--------------|---------------------------------|----------------------------------|---------------|
| 2009 (restated) | | | | | | | | |
| Net interest income | 8,195 | 2,011 | 1,158 | 2,162 | 497 | 14,023 | - | 14,023 |
| Net fee income/(expense) | 3,000 | 1,114 | 145 | (35) | 97 | 4,321 | - | 4,321 |
| Trading income/(loss) | 662 | 245 | 8 | 1,054 | (46) | 1,923 | - | 1,923 |
| Net (loss)/income from financial instruments designated at fair value | (54) | - | - | 5 | (26) | (75) | - | (75) |
| Dividend income | 2 | 6 | - | - | 8 | 16 | - | 16 |
| Net earned insurance premiums | 11,293 | 225 | 1 | - | - | 11,519 | - | 11,519 |
| Other operating income | 898 | 29 | 1 | - | 632 | 1,560 | (471) | 1,089 |
| Total operating income | 23,996 | 3,630 | 1,313 | 3,186 | 1,162 | 33,287 | (471) | 32,816 |
| Net insurance claims incurred and movement in policyholders' liabilities | (11,868) | (134) | (2) | - | - | (12,004) | - | (12,004) |
| Net operating income before loan impairment charges and other credit risk provisions | 12,128 | 3,496 | 1,311 | 3,186 | 1,162 | 21,283 | (471) | 20,812 |
| Loan impairment charges and other credit risk provisions | (454) | (278) | (78) | (2) | - | (812) | - | (812) |
| Net operating income | 11,674 | 3,218 | 1,233 | 3,184 | 1,162 | 20,471 | (471) | 20,000 |
| Total operating expenses* | (4,671) | (1,507) | (332) | (268) | (479) | (7,257) | 471 | (6,786) |
| Operating profit | 7,003 | 1,711 | 901 | 2,916 | 683 | 13,214 | - | 13,214 |
| Gains less losses from financial investments and fixed assets | 96 | 53 | 14 | (152) | 175 | 186 | - | 186 |
| Net surplus on property revaluation | - | - | - | - | 252 | 252 | - | 252 |
| Share of profits from associates | 159 | 873 | - | 629 | 87 | 1,748 | - | 1,748 |
| Profit before tax | 7,258 | 2,637 | 915 | 3,393 | 1,197 | 15,400 | - | 15,400 |
| Share of profit before tax | 47.1% | 17.1% | 5.9% | 22.0% | 7.9% | 100.0% | - | 100.0% |
| Operating profit excluding loan impairment charges and other credit risk provisions | 7,457 | 1,989 | 979 | 2,918 | 683 | 14,026 | - | 14,026 |
| * Depreciation/amortisation included in total operating expenses | (173) | (31) | (7) | (4) | (460) | (675) | - | (675) |
| Total assets | 234,723 | 96,490 | 88,135 | 377,561 | 33,759 | 830,668 | - | 830,668 |
| Total liabilities | 554,357 | 123,996 | 37,477 | 21,503 | 31,187 | 768,520 | - | 768,520 |
| Interest in associates | 847 | 4,284 | - | 2,707 | 2,388 | 10,226 | - | 10,226 |
| Non-current assets incurred during the year | 181 | 34 | 5 | - | 92 | 312 | - | 312 |

NOTES TO THE FINANCIAL STATEMENTS

27. SEGMENTAL ANALYSIS (continued)

(b) Geographic information

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

| | 2010 | | 2009 (restated) | |
|---|----------------|------------|--------------------|------------|
| | | % | | % |
| Total operating income | | | | |
| – Hong Kong | 32,124 | 93 | 30,923 | 94 |
| – Americas | 1,047 | 3 | 885 | 3 |
| – Mainland and others | 1,246 | 4 | 1,008 | 3 |
| | 34,417 | 100 | 32,816 | 100 |
| Profit before tax | | | | |
| – Hong Kong | 13,722 | 79 | 12,825 | 83 |
| – Americas | 996 | 6 | 799 | 5 |
| – Mainland and others | 2,627 | 15 | 1,776 | 12 |
| | 17,345 | 100 | 15,400 | 100 |
| Total assets | | | | |
| – Hong Kong | 752,206 | 82 | 710,167 | 85 |
| – Americas | 68,216 | 7 | 63,808 | 8 |
| – Mainland and others | 96,489 | 11 | 56,693 | 7 |
| | 916,911 | 100 | 830,668 | 100 |
| Total liabilities | | | | |
| – Hong Kong | 786,304 | 93 | 734,618 | 96 |
| – Americas | 1,187 | – | 1,109 | – |
| – Mainland and others | 59,408 | 7 | 32,793 | 4 |
| | 846,899 | 100 | 768,520 | 100 |
| Interest in associates | | | | |
| – Hong Kong | 989 | 6 | 916 | 9 |
| – Americas | – | – | – | – |
| – Mainland and others | 14,677 | 94 | 9,310 | 91 |
| | 15,666 | 100 | 10,226 | 100 |
| Non-current assets* | | | | |
| – Hong Kong | 22,262 | 96 | 19,183 | 98 |
| – Americas | – | – | – | – |
| – Mainland and others | 944 | 4 | 317 | 2 |
| | 23,206 | 100 | 19,500 | 100 |
| Contingent liabilities and commitments | | | | |
| – Hong Kong | 223,659 | 83 | 198,996 | 92 |
| – Americas | – | – | – | – |
| – Mainland and others | 44,589 | 17 | 18,038 | 8 |
| | 268,248 | 100 | 217,034 | 100 |

* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY

The maturity analysis is based on the remaining contractual maturity at the balance sheet date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

| | Group | | | | | | | | Total |
|--|---------------------|-------------------------------------|--|---------------------------------------|-------------------------------------|-----------------|---------------|-------------------------|----------------|
| | Repayable on demand | One month or less but not on demand | Over one month but within three months | Over three months but within one year | Over one year but within five years | Over five years | Trading | No contractual maturity | |
| 2010 | | | | | | | | | |
| Assets | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 44,411 | - | - | - | - | - | - | - | 44,411 |
| Placings with and advances to banks and other financial institutions | 4,730 | 51,706 | 48,475 | 5,185 | - | 468 | - | - | 110,564 |
| Trading assets | - | - | - | - | - | - | 26,055 | - | 26,055 |
| Financial assets designated at fair value | - | 50 | 7 | 384 | 3,951 | 48 | - | 2,674 | 7,114 |
| Derivative financial instruments | - | 20 | 74 | 113 | 288 | 16 | 5,082 | - | 5,593 |
| Advances to customers | 10,198 | 65,179 | 34,733 | 71,444 | 151,430 | 139,653 | - | - | 472,637 |
| Financial investments: | | | | | | | | | |
| - available-for-sale investments | - | 8,957 | 12,112 | 56,453 | 63,465 | 1,216 | - | 855 | 143,058 |
| - held-to-maturity debt securities | - | 226 | 521 | 2,936 | 21,101 | 31,517 | - | - | 56,301 |
| Interest in associates | - | - | - | - | - | - | - | 15,666 | 15,666 |
| Investment properties | - | - | - | - | - | - | - | 3,251 | 3,251 |
| Premises, plant and equipment | - | - | - | - | - | - | - | 14,561 | 14,561 |
| Intangible assets | - | - | - | - | - | - | - | 5,394 | 5,394 |
| Other assets | 4,980 | 2,765 | 2,390 | 1,708 | 74 | 18 | - | 371 | 12,306 |
| Deferred tax assets | - | - | - | - | - | - | - | - | - |
| | 64,319 | 128,903 | 98,312 | 138,223 | 240,309 | 172,936 | 31,137 | 42,772 | 916,911 |
| Liabilities | | | | | | | | | |
| Current, savings and other deposit accounts | 536,363 | 78,218 | 37,862 | 29,611 | 1,574 | - | - | - | 683,628 |
| Deposits from banks | 6,387 | 7,688 | 1,394 | - | 117 | - | - | - | 15,586 |
| Trading liabilities | - | - | - | - | - | - | 42,581 | - | 42,581 |
| Financial liabilities designated at fair value | 2 | - | - | - | - | 455 | - | - | 457 |
| Derivative financial instruments | - | - | - | 99 | 819 | 56 | 3,709 | - | 4,683 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| - certificates of deposit in issue | - | 96 | 447 | 112 | 2,440 | - | - | - | 3,095 |
| Other liabilities | 6,954 | 3,293 | 2,597 | 1,598 | 97 | 25 | - | 2,454 | 17,018 |
| Liabilities to customers under insurance contracts | - | - | - | - | - | - | - | 64,425 | 64,425 |
| Current tax liabilities | - | - | - | 344 | - | - | - | - | 344 |
| Deferred tax liabilities | - | - | - | - | - | - | - | 3,234 | 3,234 |
| Subordinated liabilities | - | - | - | 3,495 | 2,328 | 6,025 | - | - | 11,848 |
| | 549,706 | 89,295 | 42,300 | 35,259 | 7,375 | 6,561 | 46,290 | 70,113 | 846,899 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | 18 | - | 18 |
| - financial assets designated at fair value | - | - | - | - | - | - | - | - | - |
| - available-for-sale investments | - | 120 | 700 | 1,813 | 1,246 | - | - | 43 | 3,922 |
| - held-to-maturity debt securities | - | 20 | 79 | 259 | 861 | 1,572 | - | - | 2,791 |
| | - | 140 | 779 | 2,072 | 2,107 | 1,572 | 18 | 43 | 6,731 |
| Debt securities included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | 25,305 | - | 25,305 |
| - financial assets designated at fair value | - | 50 | 7 | 384 | 3,951 | 48 | - | - | 4,440 |
| - available-for-sale investments | - | 8,837 | 11,412 | 54,640 | 62,219 | 1,216 | - | 486 | 138,810 |
| - held-to-maturity debt securities | - | 206 | 442 | 2,677 | 20,240 | 29,945 | - | - | 53,510 |
| | - | 9,093 | 11,861 | 57,701 | 86,410 | 31,209 | 25,305 | 486 | 222,065 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| - trading liabilities | - | - | - | - | - | - | 26 | - | 26 |
| - financial liabilities designated at fair value | - | - | - | - | - | - | - | - | - |
| - issue at amortised cost | - | 96 | 447 | 112 | 2,440 | - | - | - | 3,095 |
| | - | 96 | 447 | 112 | 2,440 | - | 26 | - | 3,121 |

NOTES TO THE FINANCIAL STATEMENTS

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

| | Group | | | | | | | | Total |
|--|---------------------|-------------------------------------|--|---------------------------------------|-------------------------------------|-----------------|---------|-------------------------|---------|
| | Repayable on demand | One month or less but not on demand | Over one month but within three months | Over three months but within one year | Over one year but within five years | Over five years | Trading | No contractual maturity | |
| 2009 (restated) | | | | | | | | | |
| Assets | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 22,086 | - | - | - | - | - | - | - | 22,086 |
| Placings with and advances to banks and other financial institutions | 4,352 | 72,226 | 25,557 | 2,416 | - | - | - | - | 104,551 |
| Trading assets | - | - | - | - | - | - | 66,597 | - | 66,597 |
| Financial assets designated at fair value | - | - | 20 | 646 | 4,201 | 58 | - | 525 | 5,450 |
| Derivative financial instruments | - | 7 | 34 | 232 | 118 | - | 4,659 | - | 5,050 |
| Advances to customers | 9,254 | 22,927 | 25,005 | 51,673 | 121,394 | 114,368 | - | - | 344,621 |
| Financial investments: | | | | | | | | | |
| - available-for-sale investments | - | 18,050 | 16,426 | 48,560 | 108,360 | 628 | - | 809 | 192,833 |
| - held-to-maturity debt securities | - | 31 | 282 | 1,395 | 21,538 | 25,423 | - | - | 48,669 |
| Interest in associates | - | - | - | - | - | - | - | 10,226 | 10,226 |
| Investment properties | - | - | - | - | - | - | - | 2,872 | 2,872 |
| Premises, plant and equipment | - | - | - | - | - | - | - | 12,414 | 12,414 |
| Intangible assets | - | - | - | - | - | - | - | 4,214 | 4,214 |
| Other assets | 4,558 | 2,682 | 1,838 | 1,511 | 126 | 14 | - | 340 | 11,069 |
| Deferred tax assets | - | - | - | - | - | - | - | 16 | 16 |
| | 40,250 | 115,923 | 69,162 | 106,433 | 255,737 | 140,491 | 71,256 | 31,416 | 830,668 |
| Liabilities | | | | | | | | | |
| Current, savings and other deposit accounts | 494,026 | 81,129 | 38,108 | 22,427 | 679 | - | - | - | 636,369 |
| Deposits from banks | 2,964 | 1,737 | 28 | 25 | 116 | - | - | - | 4,870 |
| Trading liabilities | - | - | - | - | - | - | 38,391 | - | 38,391 |
| Financial liabilities designated at fair value | 3 | - | - | 1,000 | - | - | - | 453 | 1,456 |
| Derivative financial instruments | - | - | 6 | 21 | 630 | 13 | 3,581 | - | 4,251 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| - certificates of deposit in issue | - | 159 | 171 | 1,177 | 319 | - | - | - | 1,826 |
| Other liabilities | 6,044 | 3,158 | 1,955 | 1,452 | 150 | 116 | - | 2,410 | 15,285 |
| Liabilities to customers under insurance contracts | - | - | - | - | - | - | - | 54,240 | 54,240 |
| Current tax liabilities | - | - | - | 52 | - | - | - | - | 52 |
| Deferred tax liabilities | - | - | - | - | - | - | - | 2,460 | 2,460 |
| Subordinated liabilities | - | - | - | 3,516 | 5,804 | - | - | - | 9,320 |
| | 503,037 | 86,183 | 40,268 | 29,670 | 7,698 | 129 | 41,972 | 59,563 | 768,520 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | - | - | - |
| - financial assets designated at fair value | - | - | - | 130 | - | - | - | (1) | 129 |
| - available-for-sale investments | - | - | 1,493 | 2,061 | 2,026 | 116 | - | 38 | 5,734 |
| - held-to-maturity debt securities | - | - | 23 | 161 | 941 | 806 | - | - | 1,931 |
| | - | - | 1,516 | 2,352 | 2,967 | 922 | - | 37 | 7,794 |
| Debt securities included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | 66,590 | - | 66,590 |
| - financial assets designated at fair value | - | - | 20 | 516 | 4,201 | 58 | - | 3 | 4,798 |
| - available-for-sale investments | - | 18,050 | 14,933 | 46,499 | 106,334 | 512 | - | 424 | 186,752 |
| - held-to-maturity debt securities | - | 31 | 259 | 1,234 | 20,597 | 24,617 | - | - | 46,738 |
| | - | 18,081 | 15,212 | 48,249 | 131,132 | 25,187 | 66,590 | 427 | 304,878 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| - trading liabilities | - | - | - | - | - | - | 478 | - | 478 |
| - financial liabilities designated at fair value | - | - | - | - | - | - | - | - | - |
| - issue at amortised cost | - | 159 | 171 | 1,177 | 319 | - | - | - | 1,826 |
| | - | 159 | 171 | 1,177 | 319 | - | 478 | - | 2,304 |

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

| | Bank | | | | | | | | Total |
|--|---------------------|-------------------------------------|--|---------------------------------------|-------------------------------------|-----------------|---------------|-------------------------|----------------|
| | Repayable on demand | One month or less but not on demand | Over one month but within three months | Over three months but within one year | Over one year but within five years | Over five years | Trading | No contractual maturity | |
| 2010 | | | | | | | | | |
| Assets | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 41,062 | - | - | - | - | - | - | - | 41,062 |
| Placings with and advances to banks and other financial institutions | 2,120 | 16,999 | 28,875 | 4,137 | - | - | - | - | 52,131 |
| Trading assets | - | - | - | - | - | - | 25,232 | - | 25,232 |
| Financial assets designated at fair value | - | - | - | - | 148 | - | - | - | 148 |
| Derivative financial instruments | - | 19 | 72 | 92 | 55 | 16 | 4,772 | - | 5,026 |
| Advances to customers | 10,187 | 61,578 | 25,706 | 62,337 | 134,127 | 129,139 | - | - | 423,074 |
| Amounts due from subsidiaries | 66,716 | 1,577 | 13,028 | 6,494 | 5,630 | - | - | - | 93,445 |
| Financial investments: | | | | | | | | | |
| - available-for-sale investments | - | 7,321 | 6,918 | 47,381 | 39,857 | 1,047 | - | 582 | 103,106 |
| Investments in subsidiaries | - | - | - | - | - | - | - | 11,584 | 11,584 |
| Interest in associates | - | - | - | - | - | - | - | 5,172 | 5,172 |
| Investment properties | - | - | - | - | - | - | - | 2,100 | 2,100 |
| Premises, plant and equipment | - | - | - | - | - | - | - | 10,588 | 10,588 |
| Intangible assets | - | - | - | - | - | - | - | 442 | 442 |
| Other assets | 4,652 | 2,176 | 1,298 | 538 | 17 | - | - | 106 | 8,787 |
| Deferred tax assets | - | - | - | - | - | - | - | - | - |
| | 124,737 | 89,670 | 75,897 | 120,979 | 179,834 | 130,202 | 30,004 | 30,574 | 781,897 |
| Liabilities | | | | | | | | | |
| Current, savings and other deposit accounts | 526,103 | 73,458 | 32,405 | 16,145 | 1,033 | - | - | - | 649,144 |
| Deposits from banks | 6,386 | 7,688 | 1,394 | - | 117 | - | - | - | 15,585 |
| Trading liabilities | - | - | - | - | - | - | 30,106 | - | 30,106 |
| Derivative financial instruments | - | - | - | 95 | 587 | 44 | 3,802 | - | 4,528 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| - certificates of deposit in issue | - | 96 | 447 | 112 | 2,440 | - | - | - | 3,095 |
| Amounts due to subsidiaries | 4,222 | 4,337 | 338 | 2 | - | - | - | - | 8,899 |
| Other liabilities | 6,704 | 2,912 | 1,739 | 805 | 26 | 18 | - | 3,230 | 15,434 |
| Current tax liabilities | - | - | - | 320 | - | - | - | - | 320 |
| Deferred tax liabilities | - | - | - | - | - | - | - | 1,617 | 1,617 |
| Subordinated liabilities | - | - | - | 3,495 | 2,328 | 6,025 | - | - | 11,848 |
| | 543,415 | 88,491 | 36,323 | 20,974 | 6,531 | 6,087 | 33,908 | 4,847 | 740,576 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | 18 | - | 18 |
| - financial assets designated at fair value | - | - | - | - | - | - | - | - | - |
| - available-for-sale investments | - | 120 | 75 | 1,444 | 1,246 | - | - | 43 | 2,928 |
| - held-to-maturity debt securities | - | - | - | - | - | - | - | - | - |
| | - | 120 | 75 | 1,444 | 1,246 | - | 18 | 43 | 2,946 |
| Debt securities included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | 24,482 | - | 24,482 |
| - financial assets designated at fair value | - | - | - | - | 148 | - | - | - | 148 |
| - available-for-sale investments | - | 7,201 | 6,843 | 45,937 | 38,611 | 1,047 | - | 418 | 100,057 |
| - held-to-maturity debt securities | - | - | - | - | - | - | - | - | - |
| | - | 7,201 | 6,843 | 45,937 | 38,759 | 1,047 | 24,482 | 418 | 124,687 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| - trading liabilities | - | - | - | - | - | - | 26 | - | 26 |
| - financial liabilities designated at fair value | - | - | - | - | - | - | - | - | - |
| - issue at amortised cost | - | 96 | 447 | 112 | 2,440 | - | - | - | 3,095 |
| | - | 96 | 447 | 112 | 2,440 | - | 26 | - | 3,121 |

NOTES TO THE FINANCIAL STATEMENTS

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

| | Repayable on demand | One month or less but not on demand | Over one month but within three months | Over three months but within one year | Bank Over one year but within five years | Over five years | Trading | No contractual maturity | Total |
|--|---------------------------|--|---|--|--|--------------------|---------|-------------------------------|---------|
| 2009 (restated) | | | | | | | | | |
| Assets | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 18,461 | - | - | - | - | - | - | - | 18,461 |
| Placings with and advances to banks and other financial institutions | 1,326 | 45,657 | 17,809 | 832 | - | - | - | - | 65,624 |
| Trading assets | - | - | - | - | - | - | 65,288 | - | 65,288 |
| Financial assets designated at fair value | - | - | - | 20 | 144 | - | - | 10 | 174 |
| Derivative financial instruments | - | 7 | 24 | 227 | 101 | - | 4,557 | - | 4,916 |
| Advances to customers | 9,248 | 20,461 | 20,035 | 42,646 | 105,426 | 101,363 | - | - | 299,179 |
| Amounts due from subsidiaries | 61,771 | 1,783 | 18,373 | 3,449 | 1,984 | - | - | - | 87,360 |
| Financial investments: | | | | | | | | | |
| - available-for-sale investments | - | 15,619 | 11,365 | 39,353 | 89,143 | 629 | - | 606 | 156,715 |
| Investments in subsidiaries | - | - | - | - | - | - | - | 11,584 | 11,584 |
| Interest in associates | - | - | - | - | - | - | - | 2,546 | 2,546 |
| Investment properties | - | - | - | - | - | - | - | 1,883 | 1,883 |
| Premises, plant and equipment | - | - | - | - | - | - | - | 9,434 | 9,434 |
| Intangible assets | - | - | - | - | - | - | - | 399 | 399 |
| Other assets | 4,464 | 2,210 | 1,013 | 389 | 74 | - | - | 86 | 8,236 |
| Deferred tax assets | - | - | - | - | - | - | - | 2 | 2 |
| | 95,270 | 85,737 | 68,619 | 86,916 | 196,872 | 101,992 | 69,845 | 26,550 | 731,801 |
| Liabilities | | | | | | | | | |
| Current, savings and other deposit accounts | 485,929 | 78,600 | 33,958 | 13,177 | 350 | - | - | - | 612,014 |
| Deposits from banks | 2,963 | 1,337 | 28 | 25 | 116 | - | - | - | 4,469 |
| Trading liabilities | - | - | - | - | - | - | 35,071 | - | 35,071 |
| Financial liabilities designated at fair value | - | - | - | 1,000 | - | - | - | 3 | 1,003 |
| Derivative financial instruments | - | - | 6 | 21 | 568 | 13 | 3,572 | - | 4,180 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| - certificates of deposit in issue | - | 159 | 171 | 1,177 | 319 | - | - | - | 1,826 |
| Amounts due to subsidiaries | 4,749 | 4,974 | 237 | - | - | - | - | - | 9,960 |
| Other liabilities | 5,834 | 3,046 | 1,431 | 708 | 82 | 17 | - | 3,215 | 14,333 |
| Current tax liabilities | - | - | - | 10 | - | - | - | - | 10 |
| Deferred tax liabilities | - | - | - | - | - | - | - | 1,345 | 1,345 |
| Subordinated liabilities | - | - | - | 3,516 | 5,804 | - | - | - | 9,320 |
| | 499,475 | 88,116 | 35,831 | 19,634 | 7,239 | 30 | 38,643 | 4,563 | 693,531 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | - | - | - |
| - financial assets designated at fair value | - | - | - | - | - | - | - | - | - |
| - available-for-sale investments | - | - | 621 | 1,194 | 1,158 | 116 | - | 37 | 3,126 |
| - held-to-maturity debt securities | - | - | - | - | - | - | - | - | - |
| | - | - | 621 | 1,194 | 1,158 | 116 | - | 37 | 3,126 |
| Debt securities included in: | | | | | | | | | |
| - trading assets | - | - | - | - | - | - | 65,281 | - | 65,281 |
| - financial assets designated at fair value | - | - | - | 20 | 144 | - | - | 10 | 174 |
| - available-for-sale investments | - | 15,619 | 10,744 | 38,159 | 87,985 | 513 | - | 422 | 153,442 |
| - held-to-maturity debt securities | - | - | - | - | - | - | - | - | - |
| | - | 15,619 | 10,744 | 38,179 | 88,129 | 513 | 65,281 | 432 | 218,897 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| - trading liabilities | - | - | - | - | - | - | 478 | - | 478 |
| - financial liabilities designated at fair value | - | - | - | - | - | - | - | - | - |
| - issue at amortised cost | - | 159 | 171 | 1,177 | 319 | - | - | - | 1,826 |
| | - | 159 | 171 | 1,177 | 319 | - | 478 | - | 2,304 |

29. ACCOUNTING CLASSIFICATIONS

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

| | Group | | | | | | Total |
|--|---------|-----------------------------|------------------------------------|----------------------|--------------------------|----------------------------|----------------|
| | Trading | Designated at fair value | Available- for-sale/ hedging | Held-to- maturity | Loans and receivables | Other amortised cost | |
| 2010 | | | | | | | |
| Cash and balances with banks and other financial institutions | - | - | - | - | - | 44,411 | 44,411 |
| Placings with and advances to banks and other financial institutions | - | - | - | - | 110,564 | - | 110,564 |
| Derivative financial instruments | 5,082 | - | 511 | - | - | - | 5,593 |
| Advances to customers | - | - | - | - | 472,637 | - | 472,637 |
| Investment securities | 25,331 | 7,114 | 143,058 | 56,301 | - | - | 231,804 |
| Acceptances and endorsements | - | - | - | - | - | 3,751 | 3,751 |
| Other financial assets | 724 | - | - | - | - | 7,881 | 8,605 |
| Total financial assets | 31,137 | 7,114 | 143,569 | 56,301 | 583,201 | 56,043 | 877,365 |
| Non-financial assets | | | | | | | 39,546 |
| Total assets | | | | | | | 916,911 |
| Current, savings and other deposit accounts | 20,852 | - | - | - | - | 683,628 | 704,480 |
| Deposits from banks | - | - | - | - | - | 15,586 | 15,586 |
| Derivative financial instruments | 3,697 | 12 | 974 | - | - | - | 4,683 |
| Certificates of deposit and other debt securities in issue | 2,738 | - | - | - | - | 3,095 | 5,833 |
| Other financial liabilities | 18,991 | - | - | - | - | 10,716 | 29,707 |
| Subordinated liabilities | - | - | - | - | - | 11,848 | 11,848 |
| Liabilities to customers under investment contracts | - | 457 | - | - | - | - | 457 |
| Acceptances and endorsements | - | - | - | - | - | 3,751 | 3,751 |
| Total financial liabilities | 46,278 | 469 | 974 | - | - | 728,624 | 776,345 |
| Non-financial liabilities | | | | | | | 70,554 |
| Total liabilities | | | | | | | 846,899 |

NOTES TO THE FINANCIAL STATEMENTS

29. ACCOUNTING CLASSIFICATIONS (continued)

| | Group | | | | | | |
|---|---------------|-----------------------------|------------------------------------|----------------------|--------------------------|----------------------------|----------------|
| | Trading | Designated at fair value | Available- for-sale/ hedging | Held-to- maturity | Loans and receivables | Other amortised cost | Total |
| 2009 (restated) | | | | | | | |
| Cash and balances with banks and other financial institutions | - | - | - | - | - | 22,086 | 22,086 |
| Placings with and advances to banks and other financial institutions | - | - | - | - | 104,551 | - | 104,551 |
| Derivative financial instruments | 4,641 | 18 | 391 | - | - | - | 5,050 |
| Advances to customers | - | - | - | - | 344,621 | - | 344,621 |
| Investment securities | 66,596 | 5,450 | 192,833 | 48,669 | - | - | 313,548 |
| Acceptances and endorsements | - | - | - | - | - | 3,584 | 3,584 |
| Other financial assets | 1 | - | - | - | - | 7,142 | 7,143 |
| Total financial assets | 71,238 | 5,468 | 193,224 | 48,669 | 449,172 | 32,812 | 800,583 |
| Non-financial assets | | | | | | | 30,085 |
| Total assets | | | | | | | 830,668 |
| Current, savings and other deposit accounts | 22,212 | - | - | - | - | 636,369 | 658,581 |
| Deposits from banks | - | - | - | - | - | 4,870 | 4,870 |
| Derivative financial instruments | 3,568 | 13 | 670 | - | - | - | 4,251 |
| Certificates of deposit and other debt securities in issue | 3,247 | - | - | - | - | 1,826 | 5,073 |
| Other financial liabilities | 12,932 | - | - | - | - | 9,242 | 22,174 |
| Subordinated liabilities | - | 1,003 | - | - | - | 9,320 | 10,323 |
| Liabilities to customers under investment contracts | - | 453 | - | - | - | - | 453 |
| Acceptances and endorsements | - | - | - | - | - | 3,584 | 3,584 |
| Total financial liabilities | 41,959 | 1,469 | 670 | - | - | 665,211 | 709,309 |
| Non-financial liabilities | | | | | | | 59,211 |
| Total liabilities | | | | | | | 768,520 |

29. ACCOUNTING CLASSIFICATIONS (continued)

| | Bank | | | | | | Total |
|---|---------|-----------------------------|------------------------------------|----------------------|--------------------------|----------------------------|----------------|
| | Trading | Designated at fair value | Available- for-sale/ hedging | Held-to- maturity | Loans and receivables | Other amortised cost | |
| 2010 | | | | | | | |
| Cash and balances with banks and other financial institutions | - | - | - | - | - | 41,062 | 41,062 |
| Placings with and advances to banks and other financial institutions | - | - | - | - | 52,131 | - | 52,131 |
| Derivative financial instruments | 4,772 | - | 254 | - | - | - | 5,026 |
| Advances to customers | - | - | - | - | 423,074 | - | 423,074 |
| Investment securities | 24,508 | 148 | 103,106 | - | - | - | 127,762 |
| Amounts due from subsidiaries | - | - | - | - | - | 93,445 | 93,445 |
| Acceptances and endorsements | - | - | - | - | - | 2,363 | 2,363 |
| Other financial assets | 724 | - | - | - | - | 6,026 | 6,750 |
| Total financial assets | 30,004 | 148 | 103,360 | - | 475,205 | 142,896 | 751,613 |
| Non-financial assets | | | | | | | 30,284 |
| Total assets | | | | | | | 781,897 |
| Current, savings and other deposit accounts | 8,377 | - | - | - | - | 649,144 | 657,521 |
| Deposits from banks | - | - | - | - | - | 15,585 | 15,585 |
| Derivative financial instruments | 3,793 | 9 | 726 | - | - | - | 4,528 |
| Certificates of deposit and other debt securities in issue | 2,738 | - | - | - | - | 3,095 | 5,833 |
| Amounts due to subsidiaries | - | - | - | - | - | 8,899 | 8,899 |
| Other financial liabilities | 18,991 | - | - | - | - | 10,672 | 29,663 |
| Subordinated liabilities | - | - | - | - | - | 11,848 | 11,848 |
| Acceptances and endorsements | - | - | - | - | - | 2,363 | 2,363 |
| Total financial liabilities | 33,899 | 9 | 726 | - | - | 701,606 | 736,240 |
| Non-financial liabilities | | | | | | | 4,336 |
| Total liabilities | | | | | | | 740,576 |

NOTES TO THE FINANCIAL STATEMENTS

29. ACCOUNTING CLASSIFICATIONS (continued)

| | Trading | Designated at fair value | Available- for-sale/ hedging | Bank Held-to- maturity | Loans and receivables | Other amortised cost | Total |
|---|---------------|-----------------------------|------------------------------------|------------------------------|--------------------------|----------------------------|----------------|
| 2009 (restated) | | | | | | | |
| Cash and balances with banks and other financial institutions | - | - | - | - | - | 18,461 | 18,461 |
| Placings with and advances to banks and other financial institutions | - | - | - | - | 65,624 | - | 65,624 |
| Derivative financial instruments | 4,540 | 17 | 359 | - | - | - | 4,916 |
| Advances to customers | - | - | - | - | 299,179 | - | 299,179 |
| Investment securities | 65,287 | 174 | 156,715 | - | - | - | 222,176 |
| Amounts due from subsidiaries | - | - | - | - | - | 87,360 | 87,360 |
| Acceptances and endorsements | - | - | - | - | - | 2,435 | 2,435 |
| Other financial assets | 1 | - | - | - | - | 5,606 | 5,607 |
| Total financial assets | 69,828 | 191 | 157,074 | - | 364,803 | 113,862 | 705,758 |
| Non-financial assets | | | | | | | 26,043 |
| Total assets | | | | | | | 731,801 |
| Current, savings and other deposit accounts | 18,892 | - | - | - | - | 612,014 | 630,906 |
| Deposits from banks | - | - | - | - | - | 4,469 | 4,469 |
| Derivative financial instruments | 3,559 | 13 | 608 | - | - | - | 4,180 |
| Certificates of deposit and other debt securities in issue | 3,247 | - | - | - | - | 1,826 | 5,073 |
| Amounts due to subsidiaries | - | - | - | - | - | 9,960 | 9,960 |
| Other financial liabilities | 12,932 | - | - | - | - | 9,525 | 22,457 |
| Subordinated liabilities | - | 1,003 | - | - | - | 9,320 | 10,323 |
| Acceptances and endorsements | - | - | - | - | - | 2,435 | 2,435 |
| Total financial liabilities | 38,630 | 1,016 | 608 | - | - | 649,549 | 689,803 |
| Non-financial liabilities | | | | | | | 3,728 |
| Total liabilities | | | | | | | 693,531 |

30. CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

| | Group | | Bank | |
|--|---------------|--------|---------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Cash in hand | 6,101 | 4,299 | 5,857 | 4,079 |
| Balances with central banks | 6,591 | 3,397 | 4,250 | 924 |
| Balances with banks and other financial institutions | 31,719 | 14,390 | 30,955 | 13,458 |
| | 44,411 | 22,086 | 41,062 | 18,461 |

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

| | Group | | Bank | |
|--|----------------|---------|---------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Placings with and advances to banks and other financial institutions maturing within one month | 56,437 | 76,579 | 19,119 | 46,984 |
| Placings with and advances to banks and other financial institutions maturing after one month but less than one year | 53,659 | 27,972 | 33,012 | 18,640 |
| Placings with and advances to banks and other financial institutions maturing after one year | 468 | – | – | – |
| | 110,564 | 104,551 | 52,131 | 65,624 |

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2010 by the Group and the Bank (2009: Nil).

NOTES TO THE FINANCIAL STATEMENTS

32. TRADING ASSETS

| | Group | | Bank | |
|--|---------------|---------------|---------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| Treasury bills | 20,204 | 62,028 | 20,204 | 62,028 |
| Certificates of deposit | 18 | – | 18 | – |
| Other debt securities | 5,101 | 4,562 | 4,278 | 3,253 |
| Debt securities | 25,323 | 66,590 | 24,500 | 65,281 |
| Equity shares | 8 | 6 | 8 | 6 |
| Total trading securities | 25,331 | 66,596 | 24,508 | 65,287 |
| Other* | 724 | 1 | 724 | 1 |
| Total trading assets | 26,055 | 66,597 | 25,232 | 65,288 |
| Debt securities: | | | | |
| – listed in Hong Kong | 3,876 | 2,712 | 3,876 | 2,712 |
| – listed outside Hong Kong | 170 | 157 | 170 | 157 |
| | 4,046 | 2,869 | 4,046 | 2,869 |
| – unlisted | 21,277 | 63,721 | 20,454 | 62,412 |
| | 25,323 | 66,590 | 24,500 | 65,281 |
| Equity shares: | | | | |
| – listed in Hong Kong | 8 | 6 | 8 | 6 |
| – unlisted | – | – | – | – |
| | 8 | 6 | 8 | 6 |
| Total trading securities | 25,331 | 66,596 | 24,508 | 65,287 |
| Debt securities | | | | |
| Issued by public bodies: | | | | |
| – central governments and central banks | 24,905 | 65,817 | 24,129 | 64,508 |
| – other public sector entities | 101 | 369 | 101 | 369 |
| | 25,006 | 66,186 | 24,230 | 64,877 |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | 149 | 292 | 102 | 292 |
| – corporate entities | 168 | 112 | 168 | 112 |
| | 317 | 404 | 270 | 404 |
| | 25,323 | 66,590 | 24,500 | 65,281 |
| Equity shares | | | | |
| Issued by corporate entities | 8 | 6 | 8 | 6 |
| Total trading securities | 25,331 | 66,596 | 24,508 | 65,287 |

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

33. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

| | Group | | Bank | |
|--|--------------|-------|------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Certificates of deposit | – | 129 | – | – |
| Other debt securities | 4,440 | 4,798 | 148 | 174 |
| Debt securities | 4,440 | 4,927 | 148 | 174 |
| Equity shares | 583 | 21 | – | – |
| Investment funds | 2,091 | 502 | – | – |
| | 7,114 | 5,450 | 148 | 174 |
| Debt securities: | | | | |
| – listed in Hong Kong | 11 | 3 | – | – |
| – listed outside Hong Kong | 184 | 194 | 148 | 154 |
| | 195 | 197 | 148 | 154 |
| – unlisted | 4,245 | 4,730 | – | 20 |
| | 4,440 | 4,927 | 148 | 174 |
| Equity shares: | | | | |
| – listed in Hong Kong | 583 | 21 | – | – |
| Investment funds: | | | | |
| – listed in Hong Kong | 23 | – | – | – |
| – listed outside Hong Kong | 65 | 69 | – | – |
| | 88 | 69 | – | – |
| – unlisted | 2,003 | 433 | – | – |
| | 2,091 | 502 | – | – |
| | 7,114 | 5,450 | 148 | 174 |
| Debt securities | | | | |
| Issued by public bodies: | | | | |
| – central governments and central banks | 148 | 154 | 148 | 154 |
| – other public sector entities | 105 | 168 | – | – |
| | 253 | 322 | 148 | 154 |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | 4,113 | 4,464 | – | – |
| – corporate entities | 74 | 141 | – | 20 |
| | 4,187 | 4,605 | – | 20 |
| | 4,440 | 4,927 | 148 | 174 |
| Equity shares | | | | |
| Issued by banks and other financial institutions | 69 | – | – | – |
| Issued by corporate entities | 514 | 21 | – | – |
| | 583 | 21 | – | – |
| Investment funds | | | | |
| Issued by corporate entities | 2,091 | 502 | – | – |
| | 7,114 | 5,450 | 148 | 174 |

NOTES TO THE FINANCIAL STATEMENTS

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 61(c).

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading, or financial instruments designated at fair value, or designated as either fair value hedge or cash flow hedge. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives.

Trading derivatives

Most of the Group's trading derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters.

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.

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(b) Cash flow hedge

The Group is exposed to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio for financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedge of forecast transactions.

Gains and losses are initially recognised in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2010, the amount of cash flow hedging reserve transferred to the income statement comprised HK\$414 million (2009: HK\$848 million) included in net interest income and nil balance included in net trading income (2009: HK\$16 million).

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2010 and 2009. During the years of 2010 and 2009, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur. In 2010, there was no gain recognised due to termination of such forecast transactions (2009: HK\$16 million).

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

| | Group | | |
|--------------------------------|-----------------------------|--|--|
| | Three months or less | Over three months but within one year | Over one year but within five years |
| At 31 December 2010 | | | |
| Cash inflows from assets | 78,389 | 40,443 | 21,869 |
| Cash outflows from liabilities | – | – | – |
| Net cash inflows | 78,389 | 40,443 | 21,869 |
| At 31 December 2009 | | | |
| Cash inflows from assets | 45,526 | 39,564 | 20,587 |
| Cash outflows from liabilities | – | – | – |
| Net cash inflows | 45,526 | 39,564 | 20,587 |

NOTES TO THE FINANCIAL STATEMENTS

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 | | | | | |
|--|------------------|-------------------|------------------------|------------------|-------------------|------------------------|
| | 2010 | | | 2009 | | |
| | Contract amounts | Derivative assets | Derivative liabilities | Contract amounts | Derivative assets | Derivative liabilities |
| Derivatives held for trading | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | 495,913 | 2,471 | 1,802 | 382,260 | 2,289 | 608 |
| – currency swaps | 17,366 | 190 | 139 | 20,837 | 261 | 132 |
| – currency options purchased | 41,183 | 59 | – | 30,561 | 83 | – |
| – currency options written | 46,657 | – | 87 | 40,105 | – | 197 |
| – other exchange rate contracts | 101 | 1 | 3 | 226 | 3 | 1 |
| | 601,220 | 2,721 | 2,031 | 473,989 | 2,636 | 938 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 234,425 | 1,748 | 1,557 | 162,662 | 1,552 | 1,622 |
| – interest rate options purchased | 25 | – | – | 143 | – | – |
| – interest rate options written | 25 | – | – | 142 | – | – |
| – other interest rate contracts | 1,555 | – | – | 407 | – | 1 |
| | 236,030 | 1,748 | 1,557 | 163,354 | 1,552 | 1,623 |
| Equity and other contracts: | | | | | | |
| – equity swaps | 5,980 | 32 | 99 | 5,706 | 29 | 994 |
| – equity options purchased | 5,503 | 168 | – | 1,705 | 91 | – |
| – equity options written | 1,731 | – | 8 | 1,317 | – | 13 |
| – other equity contracts | 8 | – | – | 6 | – | – |
| – spot and forward contracts and others | 3,669 | 413 | 2 | 2,651 | 333 | – |
| | 16,891 | 613 | 109 | 11,385 | 453 | 1,007 |
| Total derivatives held for trading | 854,141 | 5,082 | 3,697 | 648,728 | 4,641 | 3,568 |
| Derivatives embedded in financial assets designated at fair value | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | 769 | – | 3 | 89 | 1 | – |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 140 | – | 9 | 1,160 | 17 | 13 |
| | 909 | – | 12 | 1,249 | 18 | 13 |
| Cash flow hedge derivatives | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 78,389 | 256 | 19 | 45,526 | 366 | 13 |
| Fair value hedge derivatives | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 27,122 | 255 | 955 | 21,028 | 25 | 657 |
| Total derivatives | 960,561 | 5,593 | 4,683 | 716,531 | 5,050 | 4,251 |

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

| | Bank | | | | | |
|--|------------------|-------------------|------------------------|------------------|-------------------|------------------------|
| | 2010 | | | 2009 | | |
| | Contract amounts | Derivative assets | Derivative liabilities | Contract amounts | Derivative assets | Derivative liabilities |
| Derivatives held for trading | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | 496,363 | 2,379 | 1,880 | 381,799 | 2,275 | 602 |
| – currency swaps | 17,366 | 190 | 139 | 20,837 | 260 | 132 |
| – currency options purchased | 41,220 | 60 | – | 30,606 | 83 | – |
| – currency options written | 46,694 | – | 127 | 40,105 | – | 199 |
| – other exchange rate contracts | 101 | 1 | 3 | 226 | 3 | 1 |
| | 601,744 | 2,630 | 2,149 | 473,573 | 2,621 | 934 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 227,205 | 1,662 | 1,509 | 166,030 | 1,543 | 1,612 |
| – interest rate options purchased | 25 | – | – | 143 | – | – |
| – interest rate options written | 25 | – | – | 142 | – | – |
| – other interest rate contracts | 1,554 | – | – | 407 | – | 1 |
| | 228,809 | 1,662 | 1,509 | 166,722 | 1,543 | 1,613 |
| Equity and other contracts: | | | | | | |
| – equity swaps | 7,997 | 59 | 125 | 7,366 | 29 | 998 |
| – equity options purchased | 1,732 | 8 | – | 1,296 | 13 | – |
| – equity options written | 1,731 | – | 8 | 1,317 | – | 13 |
| – other equity contracts | 8 | – | – | 6 | – | – |
| – spot and forward contracts and others | 3,695 | 413 | 2 | 2,808 | 334 | 1 |
| | 15,163 | 480 | 135 | 12,793 | 376 | 1,012 |
| Total derivatives held for trading | 845,716 | 4,772 | 3,793 | 653,088 | 4,540 | 3,559 |
| Derivatives embedded in financial assets designated at fair value | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 140 | – | 9 | 1,160 | 17 | 13 |
| Cash flow hedge derivatives | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 76,495 | 232 | 19 | 43,898 | 351 | 13 |
| Fair value hedge derivatives | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 14,976 | 22 | 707 | 16,634 | 8 | 595 |
| Total derivatives | 937,327 | 5,026 | 4,528 | 714,780 | 4,916 | 4,180 |

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.

NOTES TO THE FINANCIAL STATEMENTS

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

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

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

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

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

The Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2010 and 2009 were calculated based on the advanced internal ratings-based approach.

| | Group | | | Bank | | |
|-------------------------------------|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
| | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| 2010 | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | 431,732 | 2,738 | 1,417 | 428,192 | 2,599 | 1,337 |
| – currency swaps | 17,366 | 433 | 70 | 17,366 | 433 | 70 |
| – currency options purchased | 41,755 | 820 | 642 | 41,762 | 820 | 642 |
| – other exchange rate contracts | 101 | 5 | – | 101 | 5 | – |
| | 490,954 | 3,996 | 2,129 | 487,421 | 3,857 | 2,049 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 340,076 | 2,522 | 602 | 318,816 | 2,084 | 472 |
| – interest rate options purchased | 25 | – | – | 25 | – | – |
| – other interest rate contracts | – | – | – | – | – | – |
| | 340,101 | 2,522 | 602 | 318,841 | 2,084 | 472 |
| Equity and other contracts: | | | | | | |
| – equity swaps | 5,980 | 391 | 65 | 7,997 | 525 | 72 |
| – equity options purchased | 1,732 | 112 | 72 | 1,732 | 112 | 72 |
| – others | 17 | 2 | – | 33 | 4 | – |
| | 7,729 | 505 | 137 | 9,762 | 641 | 144 |

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 |
| 2009 | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | 334,133 | 5,573 | 689 | 332,869 | 5,546 | 649 |
| – currency swaps | 20,837 | 1,090 | 250 | 20,837 | 1,090 | 250 |
| – currency options purchased | 30,561 | 548 | 239 | 30,591 | 549 | 239 |
| – other exchange rate contracts | 226 | 6 | – | 226 | 6 | – |
| | 385,757 | 7,217 | 1,178 | 384,523 | 7,191 | 1,138 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 230,376 | 2,640 | 413 | 221,751 | 2,575 | 396 |
| – interest rate options purchased | 143 | – | – | 143 | – | – |
| – other interest rate contracts | – | – | – | – | – | – |
| | 230,519 | 2,640 | 413 | 221,894 | 2,575 | 396 |
| Equity and other contracts: | | | | | | |
| – equity swaps | 5,706 | 383 | 31 | 5,706 | 383 | 31 |
| – equity options purchased | 1,296 | 91 | 61 | 1,296 | 91 | 61 |
| | 7,002 | 474 | 92 | 7,002 | 474 | 92 |

35. ADVANCES TO CUSTOMERS

(a) Advances to customers

| | Group | | Bank | |
|----------------------------------|----------------|---------|----------------|---------|
| | 2010 | 2009 | 2010 | 2009 |
| Gross advances to customers | 474,473 | 346,586 | 424,506 | 300,842 |
| Less: loan impairment allowances | | | | |
| – individually assessed | (1,118) | (1,151) | (844) | (957) |
| – collectively assessed | (718) | (814) | (588) | (706) |
| | 472,637 | 344,621 | 423,074 | 299,179 |

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

| | Group | | Bank | |
|----------------------------------|-------------|------|-------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| | % | % | % | % |
| Loan impairment allowances: | | | | |
| – individually assessed | 0.24 | 0.33 | 0.20 | 0.32 |
| – collectively assessed | 0.15 | 0.23 | 0.14 | 0.23 |
| Total loan impairment allowances | 0.39 | 0.56 | 0.34 | 0.55 |

NOTES TO THE FINANCIAL STATEMENTS

35. ADVANCES TO CUSTOMERS (continued)

(b) Loan impairment allowances against advances to customers

| | Group | | |
|---|-----------------------|-----------------------|-------|
| | Individually assessed | Collectively assessed | Total |
| 2010 | | | |
| At 1 January | 1,151 | 814 | 1,965 |
| Amounts written off | (227) | (345) | (572) |
| Recoveries of advances written off in previous years | 18 | 44 | 62 |
| New impairment allowances charged to income statement (note 16) | 296 | 313 | 609 |
| Impairment allowances released to income statement (note 16) | (110) | (109) | (219) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (16) | (3) | (19) |
| Exchange | 6 | 4 | 10 |
| At 31 December | 1,118 | 718 | 1,836 |
| 2009 | | | |
| At 1 January | 1,241 | 802 | 2,043 |
| Amounts written off | (394) | (526) | (920) |
| Recoveries of advances written off in previous years | 24 | 38 | 62 |
| New impairment allowances charged to income statement (note 16) | 564 | 540 | 1,104 |
| Impairment allowances released to income statement (note 16) | (254) | (38) | (292) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (30) | (2) | (32) |
| At 31 December | 1,151 | 814 | 1,965 |

| | Bank | | |
|---|-----------------------|-----------------------|-------|
| | Individually assessed | Collectively assessed | Total |
| 2010 | | | |
| At 1 January | 957 | 706 | 1,663 |
| Amounts written off | (211) | (344) | (555) |
| Recoveries of advances written off in previous years | 7 | 44 | 51 |
| New impairment allowances charged to income statement (note 16) | 162 | 313 | 475 |
| Impairment allowances released to income statement (note 16) | (65) | (128) | (193) |
| Other movement | – | – | – |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (6) | (3) | (9) |
| At 31 December | 844 | 588 | 1,432 |
| 2009 | | | |
| At 1 January | 1,046 | 695 | 1,741 |
| Amounts written off | (349) | (526) | (875) |
| Recoveries of advances written off in previous years | 9 | 37 | 46 |
| New impairment allowances charged to income statement (note 16) | 488 | 540 | 1,028 |
| Impairment allowances released to income statement (note 16) | (203) | (37) | (240) |
| Other movement | (16) | – | (16) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (18) | (3) | (21) |
| At 31 December | 957 | 706 | 1,663 |

35. ADVANCES TO CUSTOMERS (continued)

(c) Impaired advances and allowances

| | Group | | Bank | |
|---|----------------|---------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Gross impaired advances | 1,990 | 2,508 | 1,462 | 1,761 |
| Individually assessed allowances | (1,118) | (1,151) | (844) | (957) |
| Net impaired advances | 872 | 1,357 | 618 | 804 |
| Individually assessed allowances as a percentage of gross impaired advances | 56.2% | 45.9% | 57.7% | 54.3% |
| Gross impaired advances as a percentage of gross advances to customers | 0.4% | 0.7% | 0.3% | 0.6% |

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

| | Group | | Bank | |
|---|----------------|---------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Gross individually assessed impaired advances | 1,886 | 2,434 | 1,358 | 1,687 |
| Individually assessed allowances | (1,118) | (1,151) | (844) | (957) |
| | 768 | 1,283 | 514 | 730 |
| Gross individually assessed impaired advances as a percentage of gross advances to customers | 0.4% | 0.7% | 0.3% | 0.6% |
| Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers | 682 | 1,024 | 464 | 569 |

Collateral includes any tangible security that has a determinable 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.

NOTES TO THE FINANCIAL STATEMENTS

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 | |
|--|--------------|------------|--------------|------------|
| | | % | | % |
| 2010 | | | | |
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of: | | | | |
| – more than three months but not more than six months | 137 | – | 126 | – |
| – more than six months but not more than one year | 89 | – | 88 | – |
| – more than one year | 1,147 | 0.3 | 904 | 0.3 |
| | 1,373 | 0.3 | 1,118 | 0.3 |
| of which: | | | | |
| – individually impaired allowances | (994) | | (805) | |
| – covered portion of overdue loans and advances | 354 | | 291 | |
| – uncovered portion of overdue loans and advances | 1,019 | | 827 | |
| – current market value held against the covered portion of overdue loans and advances | 586 | | 514 | |
| 2009 | | | | |
| 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 | 241 | 0.1 | 204 | 0.1 |
| – more than six months but not more than one year | 353 | 0.1 | 333 | 0.1 |
| – more than one year | 864 | 0.2 | 539 | 0.2 |
| | 1,458 | 0.4 | 1,076 | 0.4 |
| of which: | | | | |
| – individually impaired allowances | (984) | | (879) | |
| – covered portion of overdue loans and advances | 553 | | 231 | |
| – uncovered portion of overdue loans and advances | 905 | | 845 | |
| – current market value held against the covered portion of overdue loans and advances | 1,095 | | 580 | |

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 | |
|-------------|------------|----------|-----------|----------|
| | | % | | % |
| 2010 | 194 | – | 95 | – |
| 2009 | 703 | 0.2 | 423 | 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.

| | Group | | | | |
|----------------------------|-----------------------------|---|-------------------------------|----------------------------------|----------------------------------|
| | Gross advances to customers | Individually impaired advances to customers | Overdue advances to customers | Individually assessed allowances | Collectively assessed allowances |
| At 31 December 2010 | | | | | |
| Hong Kong | 392,836 | 1,452 | 1,112 | 838 | 545 |
| Rest of Asia-Pacific | 76,308 | 345 | 257 | 234 | 162 |
| Others | 5,329 | 89 | 4 | 46 | 11 |
| | 474,473 | 1,886 | 1,373 | 1,118 | 718 |
| At 31 December 2009 | | | | | |
| Hong Kong | 308,457 | 1,842 | 1,076 | 915 | 695 |
| Rest of Asia-Pacific | 30,872 | 565 | 380 | 225 | 101 |
| Others | 7,257 | 27 | 2 | 11 | 18 |
| | 346,586 | 2,434 | 1,458 | 1,151 | 814 |

| | Bank | | | | |
|----------------------------|-----------------------------|---|-------------------------------|----------------------------------|----------------------------------|
| | Gross advances to customers | Individually impaired advances to customers | Overdue advances to customers | Individually assessed allowances | Collectively assessed allowances |
| At 31 December 2010 | | | | | |
| Hong Kong | 374,776 | 1,308 | 1,094 | 831 | 528 |
| Rest of Asia-Pacific | 46,404 | 32 | 20 | 12 | 56 |
| Others | 3,326 | 18 | 4 | 1 | 4 |
| | 424,506 | 1,358 | 1,118 | 844 | 588 |
| At 31 December 2009 | | | | | |
| Hong Kong | 288,474 | 1,588 | 1,029 | 898 | 682 |
| Rest of Asia-Pacific | 7,265 | 82 | 45 | 58 | 14 |
| Others | 5,103 | 17 | 2 | 1 | 10 |
| | 300,842 | 1,687 | 1,076 | 957 | 706 |

NOTES TO THE FINANCIAL STATEMENTS

35. ADVANCES TO CUSTOMERS (continued)

(g) Gross advances to customers by industry sector

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

| | Group | | Group | |
|--|----------------|---|----------------|---|
| | 2010 | % of gross advances covered by collateral | 2009 | % of gross advances covered by collateral |
| Gross advances to customers for use in Hong Kong | | | | |
| Industrial, commercial and financial sectors | | | | |
| – property development | 41,818 | 34.6 | 23,618 | 36.1 |
| – property investment | 99,023 | 84.1 | 75,264 | 82.3 |
| – financial concerns | 3,047 | 32.1 | 2,720 | 33.9 |
| – stockbrokers | 165 | 82.1 | 480 | 42.9 |
| – wholesale and retail trade | 11,439 | 43.3 | 7,812 | 49.5 |
| – manufacturing | 16,988 | 30.7 | 12,080 | 30.4 |
| – transport and transport equipment | 7,938 | 69.2 | 6,503 | 83.3 |
| – recreational activities | 532 | 99.6 | 37 | 41.4 |
| – information technology | 1,957 | 0.7 | 1,247 | 2.4 |
| – other | 27,815 | 43.1 | 24,405 | 43.9 |
| | 210,722 | 60.3 | 154,166 | 61.8 |
| Individuals | | | | |
| – advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme | 14,834 | 100.0 | 14,647 | 99.9 |
| – advances for the purchase of other residential properties | 112,394 | 100.0 | 96,651 | 99.7 |
| – credit card advances | 15,735 | – | 13,818 | – |
| – other | 13,776 | 30.9 | 11,961 | 45.3 |
| | 156,739 | 83.9 | 137,077 | 84.9 |
| Total gross advances for use in Hong Kong | 367,461 | 70.4 | 291,243 | 72.7 |
| Trade finance | 63,660 | 18.3 | 19,215 | 35.6 |
| Gross advances for use outside Hong Kong | 43,352 | 57.4 | 36,128 | 55.4 |
| Gross advances to customers | 474,473 | 62.2 | 346,586 | 68.8 |

35. ADVANCES TO CUSTOMERS (continued)

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

| | 2010 | | Bank | | 2009 | |
|--|----------------|---|----------------|--|-------------|---|
| | | % 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 | 41,818 | 34.6 | 23,618 | | 36.1 | |
| – property investment | 97,994 | 84.5 | 74,128 | | 82.8 | |
| – financial concerns | 3,047 | 32.1 | 2,720 | | 33.9 | |
| – stockbrokers | 165 | 82.1 | 480 | | 42.9 | |
| – wholesale and retail trade | 11,439 | 43.3 | 7,812 | | 49.5 | |
| – manufacturing | 16,987 | 30.7 | 12,079 | | 30.4 | |
| – transport and transport equipment | 7,102 | 65.9 | 4,841 | | 77.6 | |
| – recreational activities | 532 | 99.6 | 37 | | 41.4 | |
| – information technology | 1,957 | 0.7 | 1,247 | | 2.4 | |
| – other | 27,796 | 43.1 | 24,335 | | 44.1 | |
| | 208,837 | 60.2 | 151,297 | | 61.5 | |
| Individuals | | | | | | |
| – advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme | 5,695 | 100.0 | 3,446 | | 99.6 | |
| – advances for the purchase of other residential properties | 109,776 | 100.0 | 93,028 | | 99.7 | |
| – credit card advances | 15,735 | – | 13,818 | | – | |
| – other | 13,773 | 30.9 | 11,954 | | 45.3 | |
| | 144,979 | 82.6 | 122,246 | | 83.1 | |
| Total gross advances for use in Hong Kong | 353,816 | 69.4 | 273,543 | | 71.2 | |
| Trade finance | 63,660 | 18.3 | 19,215 | | 35.6 | |
| Gross advances for use outside Hong Kong | 7,030 | 22.4 | 8,084 | | 17.2 | |
| Gross advances to customers | 424,506 | 61.0 | 300,842 | | 67.4 | |

NOTES TO THE FINANCIAL STATEMENTS

35. ADVANCES TO CUSTOMERS (continued)

(h) Net investments in finance leases

Advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring by the lessee the leased asset at nominal value at the end of the lease period. The total minimum lease payments receivable and their present value at the year-end are as follows:

| | Group | | Bank | |
|-------------------------|--------------|-------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Finance leases | 9 | 24 | 9 | 24 |
| Hire purchase contracts | 5,751 | 5,630 | 4,918 | 3,963 |
| | 5,760 | 5,654 | 4,927 | 3,987 |

| | Group | | |
|---|--|--|---|
| | Present value of minimum lease payments receivable | Interest income relating to future periods | Total minimum lease payments receivable |
| 2010 | | | |
| Amounts receivable: | | | |
| – within one year | 260 | 54 | 314 |
| – after one year but within five years | 1,026 | 166 | 1,192 |
| – after five years | 4,500 | 1,029 | 5,529 |
| | 5,786 | 1,249 | 7,035 |
| Loans impairment allowances | (26) | | |
| Net investments in finance leases and hire purchase contracts | 5,760 | | |
| 2009 | | | |
| Amounts receivable: | | | |
| – within one year | 371 | 93 | 464 |
| – after one year but within five years | 1,486 | 312 | 1,798 |
| – after five years | 3,813 | 614 | 4,427 |
| | 5,670 | 1,019 | 6,689 |
| Loans impairment allowances | (16) | | |
| Net investments in finance leases and hire purchase contracts | 5,654 | | |

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 |
| 2010 | | | |
| Amounts receivable: | | | |
| – within one year | 189 | 36 | 225 |
| – after one year but within five years | 766 | 111 | 877 |
| – after five years | 3,994 | 977 | 4,971 |
| | <u>4,949</u> | <u>1,124</u> | <u>6,073</u> |
| Loans impairment allowances | (22) | | |
| Net investments in finance leases and hire purchase contracts | <u>4,927</u> | | |
| 2009 | | | |
| Amounts receivable: | | | |
| – within one year | 250 | 57 | 307 |
| – after one year but within five years | 1,053 | 196 | 1,249 |
| – after five years | 2,696 | 462 | 3,158 |
| | <u>3,999</u> | <u>715</u> | <u>4,714</u> |
| Loans impairment allowances | (12) | | |
| Net investments in finance leases and hire purchase contracts | <u>3,987</u> | | |

NOTES TO THE FINANCIAL STATEMENTS

36. FINANCIAL INVESTMENTS

| | Group | | Bank | |
|---|----------------|---------|----------------|---------|
| | 2010 | 2009 | 2010 | 2009 |
| Financial investments: | | | | |
| – which may be repledged or resold by counterparties | 207 | 141 | 207 | 141 |
| – which may not be repledged or resold or are not subject to repledge or resale by counterparties | 199,152 | 241,361 | 102,899 | 156,574 |
| | 199,359 | 241,502 | 103,106 | 156,715 |
| Held-to-maturity debt securities at amortised cost | 56,301 | 48,669 | – | – |
| Available-for-sale at fair value: | | | | |
| – debt securities | 142,732 | 192,486 | 102,985 | 156,568 |
| – equity shares | 326 | 347 | 121 | 147 |
| | 199,359 | 241,502 | 103,106 | 156,715 |
| Treasury bills | 18,010 | 53,973 | 17,225 | 49,277 |
| Certificates of deposit | 6,713 | 7,665 | 2,928 | 3,126 |
| Other debt securities | 174,310 | 179,517 | 82,832 | 104,165 |
| Debt securities | 199,033 | 241,155 | 102,985 | 156,568 |
| Equity shares | 326 | 347 | 121 | 147 |
| | 199,359 | 241,502 | 103,106 | 156,715 |

There was no overdue debt securities at 31 December 2010 (31 December 2009: Nil).

(a) Held-to-maturity debt securities

| | Group | | Bank | |
|---|---------------|--------|------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Listed in Hong Kong | 997 | 634 | – | – |
| Listed outside Hong Kong | 9,822 | 5,627 | – | – |
| | 10,819 | 6,261 | – | – |
| Unlisted | 45,482 | 42,408 | – | – |
| | 56,301 | 48,669 | – | – |
| Issued by public bodies: | | | | |
| – central governments and central banks | 272 | 244 | – | – |
| – other public sector entities | 7,563 | 7,235 | – | – |
| | 7,835 | 7,479 | – | – |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | 36,225 | 32,145 | – | – |
| – corporate entities | 12,241 | 9,045 | – | – |
| | 48,466 | 41,190 | – | – |
| | 56,301 | 48,669 | – | – |
| Fair value of held-to-maturity debt securities: | | | | |
| – listed | 11,189 | 6,384 | – | – |
| – unlisted | 47,138 | 43,421 | – | – |
| | 58,327 | 49,805 | – | – |

There was no held-to-maturity debt securities determined to be impaired at 31 December 2010 for the Group and the Bank (31 December 2009: Nil).

36. FINANCIAL INVESTMENTS (continued)

(b) Available-for-sale debt securities

| | Group | | Bank | |
|--|---------|---------|---------|---------|
| | 2010 | 2009 | 2010 | 2009 |
| Listed in Hong Kong | 8,786 | 6,973 | 8,780 | 6,960 |
| Listed outside Hong Kong | 57,317 | 60,991 | 43,528 | 45,769 |
| | 66,103 | 67,964 | 52,308 | 52,729 |
| Unlisted | 76,629 | 124,522 | 50,677 | 103,839 |
| | 142,732 | 192,486 | 102,985 | 156,568 |
| Issued by public bodies: | | | | |
| – central governments and central banks | 38,735 | 64,532 | 28,757 | 58,372 |
| – other public sector entities | 15,478 | 17,830 | 10,371 | 14,974 |
| | 54,213 | 82,362 | 39,128 | 73,346 |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | 83,075 | 101,167 | 60,100 | 77,782 |
| – corporate entities | 5,444 | 8,957 | 3,757 | 5,440 |
| | 88,519 | 110,124 | 63,857 | 83,222 |
| | 142,732 | 192,486 | 102,985 | 156,568 |

At 31 December 2010 and 2009, there were no available-for-sale debt securities individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities for the Group and the Bank.

(c) Available-for-sale equity shares

| | Group | | Bank | |
|------------------------------|-------|------|------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Listed in Hong Kong | 47 | 60 | – | 5 |
| Listed outside Hong Kong | 64 | 85 | 64 | 85 |
| | 111 | 145 | 64 | 90 |
| Unlisted | 215 | 202 | 57 | 57 |
| | 326 | 347 | 121 | 147 |
| Issued by corporate entities | 326 | 347 | 121 | 147 |

There were no available-for-sale equity securities individually determined to be impaired during the year of 2010 for the Group and the Bank. For the year of 2009, certain available-for-sale equity securities of the Group and the Bank 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).

NOTES TO THE FINANCIAL STATEMENTS

37. INVESTMENTS IN SUBSIDIARIES

| | Bank | |
|--------------------------|--------|--------|
| | 2010 | 2009 |
| Unlisted shares, at cost | 11,584 | 11,584 |

The principal subsidiaries of the Bank are:

| Name of company | Place of incorporation | Principal activities | Issued equity capital |
|---|----------------------------|--|-----------------------|
| Hang Seng Bank (China) Limited | People's Republic of China | Banking | RMB4,500,000,000 |
| Hang Seng Finance Limited | Hong Kong SAR | Lending | HK\$1,000,000,000 |
| Hang Seng Credit Limited | Hong Kong SAR | Lending | HK\$200,000,000 |
| Hang Seng Bank (Bahamas) Limited | Bahamas | Banking | US\$1,000,000 |
| Hang Seng Finance (Bahamas) Limited | Bahamas | Finance | US\$5,000 |
| Hang Seng Bank (Trustee) Limited | Hong Kong SAR | Trustee service | HK\$3,000,000 |
| Hang Seng (Nominee) Limited | Hong Kong SAR | Nominee service | HK\$100,000 |
| Hang Seng Life Limited | Hong Kong SAR | Retirement benefits and life assurance | HK\$970,000,000 |
| Hang Seng Insurance Company Limited | Hong Kong SAR | Retirement benefits and life assurance | HK\$4,626,184,570 |
| 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.

38. INTEREST IN ASSOCIATES

| | Group | | Bank | |
|-------------------------------|---------------|--------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Unlisted investments, at cost | – | – | 912 | 912 |
| Listed investments, at cost | – | – | 4,260 | 1,634 |
| Share of net assets | 15,119 | 9,691 | – | – |
| Intangible asset | 84 | 106 | – | – |
| Goodwill | 463 | 429 | – | – |
| | 15,666 | 10,226 | 5,172 | 2,546 |

The associates are:

| Name of company | Place of incorporation and operation | Principal activity | Group's interest in equity capital | Issued equity capital |
|--|--------------------------------------|---------------------|------------------------------------|-----------------------|
| Unlisted | | | | |
| Barrowgate Limited | Hong Kong SAR | Property investment | 24.64% | HK\$10,000 |
| Yantai Bank Co., Ltd. (Formerly known as 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 | 12.80% | RMB5,992,000,000 |

Interest in associates included listed investment of HK\$13,752 million (2009: HK\$8,406 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK\$21,753 million (2009: HK\$29,261 million).

In accordance with Hong Kong Accounting Standard 28 "Investments in Associates", an associate is an entity over which the investor has significant influence, including the power to participate in the financial and operating policy decisions without controlling the management of the investee. Usually a holding of less than 20 per cent is presumed not to have significant influence, unless such influence can be clearly demonstrated. The interests are recognised at cost and dividends accounted for as declared.

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. ("IB") and Yantai Bank Co., Ltd. ("Yantai Bank") are owned directly by the Bank.

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

For the year ended 31 December 2010, the financial results of IB and Yantai Bank were included in the financial statements based on financial statements drawn up to 30 September 2010, but taking into account any changes in the subsequent period from 1 October 2010 to 31 December 2010 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.

NOTES TO THE FINANCIAL STATEMENTS

38. INTEREST IN ASSOCIATES (continued)

The Bank participated in the rights issue in the first half of 2010 at an investment cost of RMB2.3 billion. This increased the Bank's equity interest in IB from 12.78 per cent to 12.80 per cent as at 31 December 2010. 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 |
|----------------------------|------------------|------------------|----------------|---------------|---------------|---------------|
| 2010 | | | | | | |
| 100 per cent | 2,173,920 | 2,061,507 | 112,413 | 49,336 | 29,003 | 20,333 |
| Group's effective interest | 281,332 | 266,213 | 15,119 | 6,462 | 3,801 | 2,661 |
| 2009 | | | | | | |
| 100 per cent | 1,473,189 | 1,402,699 | 70,490 | 34,418 | 21,038 | 13,380 |
| Group's effective interest | 191,044 | 181,353 | 9,691 | 4,496 | 2,748 | 1,748 |

There was no impairment loss on our interest in associates for the years ended 31 December 2010 and 2009.

39. INVESTMENT PROPERTIES

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2010, and were updated for any material changes in the valuation as at 31 December 2010. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

(a) Movement of investment properties

| | Group | | Bank | |
|---|--------------|-------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| At 1 January | 2,872 | 2,593 | 1,883 | 1,714 |
| Surplus on revaluation credited to income statement (note 22) | 474 | 250 | 291 | 153 |
| Transfer (to)/from assets held for sale | (78) | 16 | (78) | 16 |
| Transfer (to)/from premises (note 40(a)) | (17) | 13 | 4 | – |
| At 31 December | 3,251 | 2,872 | 2,100 | 1,883 |

(b) Terms of lease

| | Group | | Bank | |
|--|--------------|-------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Leaseholds | | | | |
| Held in Hong Kong: | | | | |
| – long leases (over 50 years unexpired) | 1,086 | 1,272 | 533 | 506 |
| – medium leases (10 to 50 years unexpired) | 2,165 | 1,600 | 1,567 | 1,377 |
| Held outside Hong Kong: | | | | |
| – medium leases (10 to 50 years unexpired) | – | – | – | – |
| | 3,251 | 2,872 | 2,100 | 1,883 |

39. INVESTMENT PROPERTIES (continued)

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

The direct operating expenses arising from investment properties were HK\$21 million in 2010 (2009: HK\$21 million) for the Group and the Bank. Of this amount, HK\$19 million (2009: 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 | |
|-------------------------------------|------------|------|------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Less than one year | 120 | 107 | 72 | 67 |
| Over one year but within five years | 91 | 54 | 59 | 35 |
| | 211 | 161 | 131 | 102 |

40. PREMISES, PLANT AND EQUIPMENT

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2010, and were updated for any material changes in the valuation as at 31 December 2010. 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 |
| 2010 | | | |
| Cost or valuation: | | | |
| At 1 January | 11,638 | 3,387 | 15,025 |
| Exchange adjustments | 20 | 15 | 35 |
| Additions | 585 | 175 | 760 |
| Disposals | – | (75) | (75) |
| Elimination of accumulated depreciation on revalued premises | (329) | – | (329) |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | 2,102 | – | 2,102 |
| – credited to income statement (note 22) | 3 | – | 3 |
| Transfer to assets held for sale | (137) | – | (137) |
| Transfer from investment property (note 39(a)) | 17 | – | 17 |
| At 31 December | 13,899 | 3,502 | 17,401 |
| Accumulated depreciation: | | | |
| At 1 January | – | (2,611) | (2,611) |
| Exchange adjustments | – | (9) | (9) |
| Charge for the year (note 17) | (330) | (289) | (619) |
| Written off on disposal | – | 70 | 70 |
| Elimination of accumulated depreciation on revalued premises | 329 | – | 329 |
| At 31 December | (1) | (2,839) | (2,840) |
| Net book value at 31 December | 13,898 | 663 | 14,561 |

NOTES TO THE FINANCIAL STATEMENTS

40. PREMISES, PLANT AND EQUIPMENT (continued)

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

| | Premises (restated) | Group Plant and equipment | Total (restated) |
|--|------------------------|---------------------------------|---------------------|
| 2009 | | | |
| Cost or valuation: | | | |
| At 1 January | 10,714 | 3,421 | 14,135 |
| Exchange adjustments | – | – | – |
| Additions | – | 160 | 160 |
| Disposals | – | (192) | (192) |
| Elimination of accumulated depreciation on revalued premises | (287) | – | (287) |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | 1,475 | – | 1,475 |
| – credited to income statement (note 22) | 2 | – | 2 |
| Transfer to assets held for sale | (253) | – | (253) |
| Transfer to investment property (note 39(a)) | (13) | – | (13) |
| Other | – | (2) | (2) |
| At 31 December | 11,638 | 3,387 | 15,025 |
| Accumulated depreciation: | | | |
| At 1 January | – | (2,492) | (2,492) |
| Charge for the year (note 17) | (287) | (304) | (591) |
| Written off on disposal | – | 185 | 185 |
| Elimination of accumulated depreciation on revalued premises | 287 | – | 287 |
| At 31 December | – | (2,611) | (2,611) |
| Net book value at 31 December | 11,638 | 776 | 12,414 |

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

| | Bank | | |
|--|---------------|---------------------|----------------|
| | Premises | Plant and equipment | Total |
| 2010 | | | |
| Cost or valuation: | | | |
| At 1 January | 8,837 | 3,006 | 11,843 |
| Additions | – | 114 | 114 |
| Disposals | – | (66) | (66) |
| Elimination of accumulated depreciation on revalued premises | (259) | – | (259) |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | 1,667 | – | 1,667 |
| – credited to income statement | 3 | – | 3 |
| Transfer to assets held for sale | (137) | – | (137) |
| Transfer to investment property (note 39(a)) | (4) | – | (4) |
| At 31 December | 10,107 | 3,054 | 13,161 |
| Accumulated depreciation: | | | |
| At 1 January | – | (2,409) | (2,409) |
| Charge for the year | (259) | (226) | (485) |
| Written off on disposal | – | 62 | 62 |
| Elimination of accumulated depreciation on revalued premises | 259 | – | 259 |
| At 31 December | – | (2,573) | (2,573) |
| Net book value at 31 December | 10,107 | 481 | 10,588 |

| | Bank | | |
|--|------------------------|---------------------|---------------------|
| | Premises (restated) | Plant and equipment | Total (restated) |
| 2009 | | | |
| Cost or valuation: | | | |
| At 1 January | 8,144 | 3,050 | 11,194 |
| Additions | – | 142 | 142 |
| Disposals | – | (186) | (186) |
| Elimination of accumulated depreciation on revalued premises | (225) | – | (225) |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | 1,170 | – | 1,170 |
| – credited to income statement | 2 | – | 2 |
| Transfer to assets held for sale | (254) | – | (254) |
| At 31 December | 8,837 | 3,006 | 11,843 |
| Accumulated depreciation: | | | |
| At 1 January | – | (2,347) | (2,347) |
| Charge for the year | (225) | (243) | (468) |
| Written off on disposal | – | 181 | 181 |
| Elimination of accumulated depreciation on revalued premises | 225 | – | 225 |
| At 31 December | – | (2,409) | (2,409) |
| Net book value at 31 December | 8,837 | 597 | 9,434 |

NOTES TO THE FINANCIAL STATEMENTS

40. PREMISES, PLANT AND EQUIPMENT (continued)

(b) Terms of lease

The net book value of premises comprises:

| | Group | | Bank | |
|--|---------------|--------------------|---------------|--------------------|
| | 2010 | 2009 (restated) | 2010 | 2009 (restated) |
| Leaseholds | | | | |
| Held in Hong Kong: | | | | |
| – long leases (over 50 years unexpired) | 1,031 | 1,583 | 759 | 796 |
| – medium leases (10 to 50 years unexpired) | 12,099 | 9,906 | 9,311 | 8,009 |
| – short leases (under 10 years unexpired) | 36 | 31 | 36 | 31 |
| Held outside Hong Kong: | | | | |
| – long leases (over 50 years unexpired) | 8 | 7 | – | – |
| – medium leases (10 to 50 years unexpired) | 725 | 111 | 1 | 1 |
| | 13,899 | 11,638 | 10,107 | 8,837 |

(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 | |
|---|--------------|--------------------|--------------|--------------------|
| | 2010 | 2009 (restated) | 2010 | 2009 (restated) |
| Cost less accumulated depreciation at 31 December | 2,923 | 2,358 | 1,209 | 1,237 |

41. INTANGIBLE ASSETS

| | Group | | Bank | |
|--|--------------|-------|------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Present value of in-force long-term insurance business | 4,593 | 3,466 | – | – |
| Internally developed software | 429 | 385 | 428 | 384 |
| Acquired software | 43 | 34 | 14 | 15 |
| Goodwill | 329 | 329 | – | – |
| | 5,394 | 4,214 | 442 | 399 |

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

| | Group | |
|---|--------------|-------|
| | 2010 | 2009 |
| At 1 January | 3,466 | 2,707 |
| Addition from current year new business | 803 | 747 |
| Movement from in-force business | 324 | 12 |
| At 31 December | 4,593 | 3,466 |

41. INTANGIBLE ASSETS (continued)

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

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

| | 2010 | 2009 |
|---------------------|-------|-------|
| Risk discount rate | 11.0% | 11.0% |
| Expenses inflation | 3.0% | 3.0% |
| Average lapse rate: | | |
| – 1st year | 3.4% | 3.4% |
| – 2nd year onwards | 1.3% | 1.4% |

The sensitivity of PVIF valuation to changes in individual assumptions at the balance sheet dates is shown in note 61(d).

(b) Goodwill

| | Group | | Bank | |
|---------------------------------|-------|------|------|------|
| | 2010 | 2009 | 2010 | 2009 |
| At 1 January and at 31 December | 329 | 329 | – | – |

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

During 2010, there was no impairment of goodwill (2009: 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 2010, the present value of in-force long-term insurance business and the expected value of future business. The present value of the in-force long-term insurance business is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 41(a) and 61(d).

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

| | Group | | Bank | |
|-------------------------------|-------|-------|-------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Cost: | | | | |
| At 1 January | 666 | 532 | 641 | 522 |
| Additions | 155 | 152 | 140 | 138 |
| Disposals | (5) | (20) | (5) | (19) |
| Exchange and others | 1 | 2 | – | – |
| At 31 December | 817 | 666 | 776 | 641 |
| Accumulated amortisation: | | | | |
| At 1 January | (247) | (183) | (242) | (180) |
| Charge for the year (note 17) | (102) | (84) | (96) | (81) |
| Written off on disposals | 5 | 20 | 4 | 19 |
| Exchange and others | (1) | – | – | – |
| At 31 December | (345) | (247) | (334) | (242) |
| Net book value at 31 December | 472 | 419 | 442 | 399 |

During 2010, there was no impairment on internally developed application software and acquired software (2009: Nil).

NOTES TO THE FINANCIAL STATEMENTS

42. OTHER ASSETS

| | Group | | Bank | |
|--|---------------|--------|--------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Items in the course of collection from other banks | 4,673 | 4,343 | 4,673 | 4,343 |
| Prepayments and accrued income | 2,259 | 1,835 | 835 | 804 |
| Assets held for sale* | | | | |
| – repossessed assets | 12 | 47 | 7 | 30 |
| – other assets held for sale | 206 | – | 206 | – |
| Acceptances and endorsements | 3,751 | 3,584 | 2,363 | 2,435 |
| Retirement benefit assets | 95 | 86 | 95 | 86 |
| Other accounts | 1,310 | 1,174 | 608 | 538 |
| | 12,306 | 11,069 | 8,787 | 8,236 |

* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2010 and 2009.

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

43. CURRENT, SAVINGS AND OTHER DEPOSIT ACCOUNTS

| | Group | | Bank | |
|---|----------------|---------|----------------|---------|
| | 2010 | 2009 | 2010 | 2009 |
| Current, savings and other deposit accounts: | | | | |
| – as stated in balance sheet | 683,628 | 636,369 | 649,144 | 612,014 |
| – structured deposits reported as trading liabilities (note 44) | 20,852 | 22,212 | 8,377 | 18,892 |
| | 704,480 | 658,581 | 657,521 | 630,906 |
| By type: | | | | |
| – demand and current accounts | 59,116 | 53,450 | 59,104 | 53,409 |
| – savings accounts | 466,158 | 437,440 | 456,818 | 429,062 |
| – time and other deposits | 179,206 | 167,691 | 141,599 | 148,435 |
| | 704,480 | 658,581 | 657,521 | 630,906 |

44. TRADING LIABILITIES

| | Group | | Bank | |
|---|---------------|--------|---------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Structured certificates of deposit in issue (note 46) | 26 | 478 | 26 | 478 |
| Other debt securities in issue (note 46) | 2,712 | 2,769 | 2,712 | 2,769 |
| Structured deposits (note 43) | 20,852 | 22,212 | 8,377 | 18,892 |
| Short positions in securities and others | 18,991 | 12,932 | 18,991 | 12,932 |
| | 42,581 | 38,391 | 30,106 | 35,071 |

45. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

| | Group | | Bank | |
|---|------------|--------------|----------|--------------|
| | 2010 | 2009 | 2010 | 2009 |
| 4.125% callable fixed rate subordinated notes (note 50) | – | 1,003 | – | 1,003 |
| Liabilities to customers under investment contracts | 457 | 453 | – | – |
| | 457 | 1,456 | – | 1,003 |

The Bank has exercised its option to redeem the callable fixed rate notes at par of HK\$1,000 million in June 2010. At 31 December 2009, 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\$3 million. The accumulated amount of the change in fair value attributable to change in credit risk for the Group and the Bank was HK\$46 million and the change for the year ended 31 December 2009 was HK\$8 million for the Group and the Bank.

46. CERTIFICATES OF DEPOSIT AND OTHER DEBT SECURITIES IN ISSUE

| | Group | | Bank | |
|---|--------------|--------------|--------------|--------------|
| | 2010 | 2009 | 2010 | 2009 |
| Certificates of deposit and other debt securities in issue: | | | | |
| – as stated in balance sheet | 3,095 | 1,826 | 3,095 | 1,826 |
| – structured certificates of deposit in issue reported as trading liabilities (note 44) | 26 | 478 | 26 | 478 |
| – other structured debt securities in issue reported as trading liabilities (note 44) | 2,712 | 2,769 | 2,712 | 2,769 |
| | 5,833 | 5,073 | 5,833 | 5,073 |
| By type: | | | | |
| – certificates of deposit in issue | 3,121 | 2,304 | 3,121 | 2,304 |
| – other debt securities in issue | 2,712 | 2,769 | 2,712 | 2,769 |
| | 5,833 | 5,073 | 5,833 | 5,073 |

47. OTHER LIABILITIES

| | Group | | Bank | |
|--|---------------|---------------|---------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| Items in the course of transmission to other banks | 7,208 | 6,304 | 7,208 | 6,303 |
| Accruals | 2,385 | 2,039 | 1,783 | 1,668 |
| Acceptances and endorsements | 3,751 | 3,584 | 2,363 | 2,435 |
| Retirement benefit liabilities | 1,718 | 1,712 | 1,718 | 1,712 |
| Other | 1,956 | 1,646 | 2,362 | 2,215 |
| | 17,018 | 15,285 | 15,434 | 14,333 |

NOTES TO THE FINANCIAL STATEMENTS

48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS

| | 2010 | | | 2009 | | |
|-----------------------------------|--------|-------------|--------|--------|-------------|--------|
| | Gross | Reinsurance | Net | Gross | Reinsurance | Net |
| Non-life insurance | | | | | | |
| Unearned premiums | 227 | (75) | 152 | 192 | (52) | 140 |
| Notified claims | 160 | (18) | 142 | 146 | (19) | 127 |
| Claims incurred but not reported | 41 | (9) | 32 | 43 | (8) | 35 |
| Other | 49 | (1) | 48 | 47 | (1) | 46 |
| | 477 | (103) | 374 | 428 | (80) | 348 |
| Policyholders' liabilities | | | | | | |
| Life (non-linked) | 63,722 | (35) | 63,687 | 53,588 | (19) | 53,569 |
| Life (linked) | 226 | - | 226 | 224 | - | 224 |
| | 63,948 | (35) | 63,913 | 53,812 | (19) | 53,793 |
| | 64,425 | (138) | 64,287 | 54,240 | (99) | 54,141 |

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

The movement of liabilities under insurance contracts was as follows:

(a) Non-life insurance

| | Group | | |
|--|-------|-------------|-------|
| | Gross | Reinsurance | Net |
| 2010 | | | |
| Unearned premiums | | | |
| At 1 January | 192 | (52) | 140 |
| Gross written premiums | 470 | (122) | 348 |
| Gross earned premiums | (437) | 96 | (341) |
| Exchange and other movements | 2 | 3 | 5 |
| At 31 December | 227 | (75) | 152 |
| Notified and incurred but not reported claims | | | |
| At 1 January | | | |
| - notified claims | 146 | (19) | 127 |
| - claims incurred but not reported | 43 | (8) | 35 |
| | 189 | (27) | 162 |
| Claims paid | (113) | 26 | (87) |
| Claims incurred | 134 | (26) | 108 |
| | 21 | - | 21 |
| Exchange and other movements | (9) | - | (9) |
| At 31 December | | | |
| - notified claims | 160 | (18) | 142 |
| - claims incurred but not reported | 41 | (9) | 32 |
| | 201 | (27) | 174 |
| Other | 49 | (1) | 48 |
| | 477 | (103) | 374 |

48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(a) Non-life insurance (continued)

| | Gross | Group Reinsurance | Net |
|--|-------|----------------------|-------|
| 2009 | | | |
| Unearned premiums | | | |
| At 1 January | 199 | (42) | 157 |
| Gross written premiums | 422 | (93) | 329 |
| Gross earned premiums | (404) | 78 | (326) |
| Exchange and other movements | (25) | 5 | (20) |
| At 31 December | 192 | (52) | 140 |
| Notified and incurred but not reported claims | | | |
| At 1 January | | | |
| – notified claims | 162 | (22) | 140 |
| – claims incurred but not reported | 43 | (8) | 35 |
| | 205 | (30) | 175 |
| Claims paid | (119) | 10 | (109) |
| Claims incurred | 103 | (11) | 92 |
| | (16) | (1) | (17) |
| Exchange and other movements | – | 4 | 4 |
| At 31 December | | | |
| – notified claims | 146 | (19) | 127 |
| – claims incurred but not reported | 43 | (8) | 35 |
| | 189 | (27) | 162 |
| Other | 47 | (1) | 46 |
| | 428 | (80) | 348 |

NOTES TO THE FINANCIAL STATEMENTS

48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(b) Policyholders' liabilities

| | Group | | |
|--|---------------|-------------|---------------|
| | Gross | Reinsurance | Net |
| 2010 | | | |
| Life (non-linked) | | | |
| At 1 January | 53,588 | (19) | 53,569 |
| Benefits paid | (2,402) | 22 | (2,380) |
| Claims incurred and movement in policyholders' liabilities | 12,487 | (36) | 12,451 |
| Exchange and other movements | 49 | (2) | 47 |
| At 31 December | 63,722 | (35) | 63,687 |
| Life (linked) | | | |
| At 1 January | 224 | – | 224 |
| Benefits paid | (24) | – | (24) |
| Claims incurred and movement in policyholders' liabilities | 28 | – | 28 |
| Exchange and other movements | (2) | – | (2) |
| At 31 December | 226 | – | 226 |
| | 63,948 | (35) | 63,913 |

| | Group | | |
|--|---------------|-------------|---------------|
| | Gross | Reinsurance | Net |
| 2009 | | | |
| Life (non-linked) | | | |
| At 1 January | 43,211 | (18) | 43,193 |
| Benefits paid | (1,811) | 18 | (1,793) |
| Claims incurred and movement in policyholders' liabilities | 11,877 | (19) | 11,858 |
| Exchange and other movements | 311 | – | 311 |
| At 31 December | 53,588 | (19) | 53,569 |
| Life (linked) | | | |
| At 1 January | 194 | – | 194 |
| Benefits paid | (19) | – | (19) |
| Claims incurred and movement in policyholders' liabilities | 54 | – | 54 |
| Exchange and other movements | (5) | – | (5) |
| At 31 December | 224 | – | 224 |
| | 53,812 | (19) | 53,793 |

49. CURRENT TAX AND DEFERRED TAX

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

| | Group | | Bank | |
|--|-------|--------------------|-------|--------------------|
| | 2010 | 2009 (restated) | 2010 | 2009 (restated) |
| Current taxation recoverable (included in "Other assets") | 12 | 5 | – | – |
| Deferred tax assets | – | 16 | – | 2 |
| | 12 | 21 | – | 2 |
| Current tax liabilities: | | | | |
| Provision for Hong Kong profits tax | 337 | 41 | 316 | 2 |
| Provision for taxation outside Hong Kong | 7 | 11 | 4 | 8 |
| | 344 | 52 | 320 | 10 |
| Deferred tax liabilities | 3,234 | 2,460 | 1,617 | 1,345 |
| | 3,578 | 2,512 | 1,937 | 1,355 |

(b) Deferred tax assets and liabilities recognised

The major components of deferred tax (assets)/liabilities recognised in the balance sheet and the movements during the year are as follows:

| | Group | | | | | | |
|---|---|---------------------------|----------------------------|--|-----------------|-------|-------|
| | Depreciation allowances in excess of related depreciation | Revaluation of properties | Loan impairment allowances | Fair value adjustments for available-for-sale financial assets | Cash flow hedge | Other | Total |
| 2010 | | | | | | | |
| At 1 January | 119 | 1,964 | (99) | 5 | 35 | 420 | 2,444 |
| (Credited)/charged to income statement (note 23(a)) | (13) | 40 | 14 | – | – | 401 | 442 |
| Charged/(credited) to reserves | – | 344 | – | 23 | (21) | 2 | 348 |
| At 31 December | 106 | 2,348 | (85) | 28 | 14 | 823 | 3,234 |
| 2009 (restated) | | | | | | | |
| At 1 January | 124 | 1,758 | (99) | (476) | 104 | (241) | 1,170 |
| (Credited)/charged to income statement (note 23(a)) | (5) | 24 | – | – | – | 352 | 371 |
| Charged/(credited) to reserves | – | 182 | – | 481 | (69) | 309 | 903 |
| At 31 December | 119 | 1,964 | (99) | 5 | 35 | 420 | 2,444 |

NOTES TO THE FINANCIAL STATEMENTS

49. CURRENT TAX AND DEFERRED TAX (continued)

(b) Deferred tax assets and liabilities recognised (continued)

| | Bank | | | | | | |
|--|---|---------------------------------|----------------------------------|--|--------------------|--------------|--------------|
| | Depreciation allowances in excess of related depreciation | Revaluation of properties | Loan impairment allowances | Fair value adjustments for available- for-sale financial assets | Cash flow hedge | Other | Total |
| 2010 | | | | | | | |
| At 1 January | 118 | 1,578 | (98) | 4 | 35 | (294) | 1,343 |
| (Credited)/charged to income statement | (17) | 16 | 14 | – | – | (15) | (2) |
| Charged/(credited) to reserves | – | 274 | – | 21 | (21) | 2 | 276 |
| At 31 December | 101 | 1,868 | (84) | 25 | 14 | (307) | 1,617 |
| 2009 (restated) | | | | | | | |
| At 1 January | 126 | 1,431 | (98) | (480) | 104 | (610) | 473 |
| (Credited)/charged to income statement | (8) | 14 | – | – | – | 7 | 13 |
| Charged/(credited) to reserves | – | 133 | – | 484 | (69) | 309 | 857 |
| At 31 December | 118 | 1,578 | (98) | 4 | 35 | (294) | 1,343 |

(c) Deferred tax assets not recognised

At the end of the balance sheet dates, the Group has not recognised deferred tax assets in respect of tax losses and revaluation loss on debt securities of subsidiaries amounting to HK\$70 million (2009: HK\$25 million) which are considered unlikely to be utilised. Of this amount, HK\$40 million (2009: HK\$25 million) has no expiry date and HK\$30 million (2009: Nil) is scheduled to expire within five years.

(d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised in 2010 (2009: Nil).

50. SUBORDINATED LIABILITIES

| | | Group | | Bank | |
|---|--|---------------|--------|---------------|--------|
| | | 2010 | 2009 | 2010 | 2009 |
| Nominal value | Description | | | | |
| Amount owed to third parties | | | | | |
| HK\$1,500 million | Callable floating rate subordinated notes due June 2015 ⁽¹⁾ | – | 1,499 | – | 1,499 |
| HK\$1,000 million | 4.125% callable fixed rate subordinated notes due June 2015 ⁽¹⁾ | – | 1,003 | – | 1,003 |
| US\$450 million | Callable floating rate subordinated notes due July 2016 ⁽²⁾ | 3,495 | 3,483 | 3,495 | 3,483 |
| US\$300 million | Callable floating rate subordinated notes due July 2017 ⁽³⁾ | 2,328 | 2,321 | 2,328 | 2,321 |
| Amount owed to HSBC Group undertakings | | | | | |
| US\$260 million | Callable floating rate subordinated loan debt due December 2015 ⁽⁴⁾ | – | 2,017 | – | 2,017 |
| US\$775 million | Floating rate subordinated loan debt due December 2020 ⁽⁴⁾ | 6,025 | – | 6,025 | – |
| | | 11,848 | 10,323 | 11,848 | 10,323 |
| Representing: | | | | | |
| – measured at amortised cost | | 11,848 | 9,320 | 11,848 | 9,320 |
| – designated at fair value (note 45) | | – | 1,003 | – | 1,003 |
| | | 11,848 | 10,323 | 11,848 | 10,323 |

The above subordinated notes (excluding the subordinated loan debt due December 2020) 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) The Bank has exercised its option to redeem these subordinated notes at par of HK\$2,500 million in aggregate in June 2010.

(2) 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.

(3) 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.

(4) The Bank has exercised its option to redeem this subordinated loan debt at par of US\$260 million and replenished by a new issue of US\$775 million subordinated loan debt in December 2010.

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

51. SHARE CAPITAL

Authorised:

The authorised share capital of the Bank is HK\$11,000 million (2009: HK\$11,000 million) divided into 2,200 million shares (2009: 2,200 million shares) of HK\$5 each.

| | 2010 | 2009 |
|---|--------------|-------|
| Issued and fully paid: | | |
| 1,911,842,736 shares (2009: 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 (2009: Nil).

NOTES TO THE FINANCIAL STATEMENTS

52. RESERVES

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity. Details of the changes in the Bank's individual components of equity between the beginning and the end of the year are set out below:

| | Bank | |
|--|----------------|--------------------|
| | 2010 | 2009 (restated) |
| Retained profits (including proposed dividends) | 23,270 | 21,527 |
| Premises revaluation reserve | 7,654 | 6,447 |
| Cash flow hedging reserve | 72 | 180 |
| Available-for-sale investment reserve: | | |
| – on debt securities | 109 | (51) |
| – on equity securities | 34 | 50 |
| Capital redemption reserve | 99 | 99 |
| Other reserves | 524 | 459 |
| Total reserves (including proposed dividends) | 31,762 | 28,711 |
| Retained profits (including proposed dividends) | | |
| At beginning of the year | 21,527 | 21,305 |
| Dividends to shareholders: | | |
| – dividends approved in respect of the previous year | (3,633) | (5,736) |
| – dividends declared in respect of the current year | (6,309) | (6,309) |
| Transfer | 185 | 429 |
| Total comprehensive income for the year | 11,500 | 11,838 |
| | 23,270 | 21,527 |
| Premises revaluation reserve | | |
| At beginning of the year | 6,447 | 5,839 |
| Transfer | (185) | (429) |
| Total comprehensive income for the year | 1,392 | 1,037 |
| | 7,654 | 6,447 |
| Cash flow hedging reserve | | |
| At beginning of the year | 180 | 528 |
| Total comprehensive income for the year | (108) | (348) |
| | 72 | 180 |
| Available-for-sale investment reserve | | |
| At beginning of the year | (1) | (2,355) |
| Total comprehensive income for the year | 144 | 2,354 |
| | 143 | (1) |
| Capital redemption reserve | | |
| At beginning of the year | 99 | 99 |
| Total comprehensive income for the year | – | – |
| | 99 | 99 |
| Other reserve | | |
| At beginning of the year | 459 | 420 |
| Costs of share-based payment arrangements | 64 | 35 |
| Total comprehensive income for the year | 1 | 4 |
| | 524 | 459 |
| Total reserves (including proposed dividends) | 31,762 | 28,711 |

52. 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 realised profits which can be distributed to shareholders.

Regulatory reserve

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a “regulatory reserve” from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2010, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group to shareholders by HK\$1,654 million (2009: HK\$920 million).

Retained profits

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

Premises revaluation reserve

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

The premises revaluation reserve included HK\$117 million in relation to a premise classified as assets held for sale, included in “Other assets” in the consolidated balance sheet at 31 December 2010 (31 December 2009: Nil).

Cash flow hedging reserve

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

Available-for-sale investment reserve

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

Capital redemption reserve

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

Other reserves

Other reserves mainly comprise foreign exchange reserve and share-based payment reserve. The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations. The share-based payment reserve is used to record the corresponding amount of share options granted by ultimate holding company to the Group’s employees and other cost of share-based payment arrangement. Other reserves also included the gain on dilution of investment in an associate of HK\$1,465 million transferred from retained profits.

At 31 December 2010, the aggregate amount of reserves available for distribution to equity shareholders of the Bank as calculated under the provision of section 79B of the Hong Kong Companies Ordinance amounted to HK\$20,556 million (2009: HK\$19,568 million). After considering regulatory capital requirement and business development needs, an amount of HK\$3,633 million has been declared as the proposed fourth interim dividends in respect of the financial year ended 31 December 2010 (2009: HK\$3,633 million). The difference between the aggregate distributable reserves of HK\$20,556 million and the Bank’s retained profit of HK\$23,270 million as reported above mainly represents the exclusion of unrealised revaluation gain on investment properties and the above regulatory reserve of the Bank.

NOTES TO THE FINANCIAL STATEMENTS

53. RECONCILIATION OF CASH FLOW STATEMENT

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

| | 2010 | 2009 (restated) |
|--|-----------------|--------------------|
| Operating profit | 14,085 | 13,214 |
| Net interest income | (14,300) | (14,023) |
| Dividend income | (14) | (16) |
| Loan impairment charges and other credit risk provisions | 390 | 812 |
| Impairment of available-for-sale equity securities | – | 4 |
| Depreciation | 619 | 591 |
| Amortisation of intangible assets | 102 | 84 |
| Amortisation of available-for-sale investments | 80 | 76 |
| Amortisation of held-to-maturity debt securities | 5 | 1 |
| Advances written off net of recoveries | (510) | (858) |
| Interest received | 15,219 | 11,126 |
| Interest paid | (2,301) | (1,478) |
| Operating profit before changes in working capital | 13,375 | 9,533 |
| Change in treasury bills and certificates of deposit with original maturity more than three months | 32,409 | (41,353) |
| Change in placings with and advances to banks maturing after one month | (26,155) | (5,418) |
| Change in trading assets | 24,451 | 77,386 |
| Change in financial assets designated at fair value | 501 | 797 |
| Change in derivative financial instruments | (111) | (8,640) |
| Change in advances to customers | (127,906) | (15,454) |
| Change in other assets | (15,680) | (4,416) |
| Change in financial liabilities designated at fair value | (2) | 8 |
| Change in current, savings and other deposit accounts | 47,259 | 74,186 |
| Change in deposits from banks | 10,716 | (6,566) |
| Change in trading liabilities | 4,190 | (9,891) |
| Change in certificates of deposit and other debt securities in issue | 1,269 | (946) |
| Change in other liabilities | 15,448 | 4,048 |
| Elimination of exchange differences and other non-cash items | (8,158) | (5,538) |
| Cash (used in)/generated from operating activities | (28,394) | 67,736 |
| Taxation paid | (1,704) | (1,921) |
| Net cash (outflow)/inflow from operating activities | (30,098) | 65,815 |

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

| | 2010 | 2009 |
|--|----------------|----------------|
| Cash and balances with banks and other financial institutions | 44,411 | 22,086 |
| Placings with and advances to banks and other financial institutions maturing within one month | 53,457 | 74,459 |
| Treasury bills | 20,692 | 40,214 |
| | 118,560 | 136,759 |

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\$13,331 million at 31 December 2010 (2009: HK\$8,410 million).

54. CONTINGENT LIABILITIES AND COMMITMENTS

a) Off-balance sheet contingent liabilities and commitments

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

For the purposes of these financial statements, acceptances and endorsements are recognised on the balance sheet in “Other assets” and “Other liabilities” in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules (“the Capital Rules”), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK\$3,751 million (2009: HK\$3,584 million) and HK\$2,363 million (2009: HK\$2,435 million) respectively.

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

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

The risk-weighted assets at balance sheet dates were calculated based on the “Advanced internal ratings-based approach”.

| | Group | | | Bank | | |
|---|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
| | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| 2010 | | | | | | |
| Direct credit substitutes | 4,365 | 4,220 | 3,231 | 3,263 | 3,118 | 2,129 |
| Transaction-related contingencies | 455 | 337 | 168 | 351 | 300 | 134 |
| Trade-related contingencies | 10,593 | 3,516 | 2,008 | 8,935 | 2,737 | 1,530 |
| Forward asset purchases | 51 | 51 | 51 | 51 | 51 | 51 |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | | | | | |
| – not unconditionally cancellable* | 38,273 | 17,788 | 7,479 | 34,363 | 15,191 | 5,767 |
| – unconditionally cancellable | 198,724 | 66,852 | 20,649 | 170,333 | 60,379 | 15,042 |
| | 252,461 | 92,764 | 33,586 | 217,296 | 81,776 | 24,653 |

NOTES TO THE FINANCIAL STATEMENTS

54. CONTINGENT LIABILITIES AND COMMITMENTS (continued)

a) Off-balance sheet contingent liabilities and commitments (continued)

| | Group | | | Bank | | |
|--|------------------|---------------------------|-----------------------|------------------|---------------------------|-----------------------|
| | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| 2009 | | | | | | |
| Direct credit substitutes | 3,121 | 2,987 | 1,785 | 3,121 | 2,987 | 1,785 |
| Transaction-related contingencies | 550 | 289 | 155 | 328 | 244 | 101 |
| Trade-related contingencies | 9,451 | 2,465 | 1,466 | 8,144 | 2,096 | 1,172 |
| Forward asset purchases | 36 | 36 | 36 | 36 | 36 | 36 |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | | | | | |
| – not unconditionally cancellable* | 29,069 | 16,447 | 7,720 | 26,796 | 14,330 | 5,957 |
| – unconditionally cancellable | 158,817 | 53,514 | 15,036 | 147,079 | 50,369 | 12,603 |
| | 201,044 | 75,738 | 26,198 | 185,504 | 70,062 | 21,654 |

* 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 2010 were HK\$13,264 million and HK\$25,009 million respectively (2009: HK\$13,371 million and HK\$15,698 million).

b) Contingencies

There is no material litigation expected to result in a significant adverse effect on the financial position of the Group, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

55. ASSETS PLEDGED AS SECURITY FOR LIABILITIES

At 31 December 2010, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements for the Group and the Bank amounted to HK\$18,971 million (Group and Bank in 2009: HK\$12,929 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK\$19,270 million (Group and Bank in 2009: HK\$13,153 million) and mainly comprised items included in “Trading assets” and “Financial investments”.

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

56. CAPITAL COMMITMENTS

| | Group | | Bank | |
|---|------------|------|------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Expenditure authorised and contracted for | 162 | 73 | 121 | 65 |
| Expenditure authorised but not contracted for | – | – | – | – |

57. LEASE COMMITMENTS

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

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

| | Group | | Bank | |
|----------------------------|--------------|------|------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Within one year | 454 | 414 | 338 | 296 |
| Between one and five years | 717 | 360 | 611 | 256 |
| Over five years | 14 | – | – | – |
| | 1,185 | 774 | 949 | 552 |

58. EMPLOYEE RETIREMENT BENEFITS

(a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme (“HSBDBS”), which is the principal scheme which covers about 40 per cent of the Group’s employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme (“HSBPS”) and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme (“HSBNTBS”). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The latest annual actuarial valuations at 31 December 2010 were performed by E Chiu, fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Ltd, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the balance sheet at year-end and retirement benefits costs recognised in the income statement for the year in respect of these defined benefit schemes are set out below.

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

| | Group and Bank | | |
|--|----------------|--------------|--------------|
| | HSBDBS | HSBPS | HSBNTBS |
| 2010 | | | |
| Present value of funded obligations (note 58(a)(iii)) | (5,710) | (157) | (2) |
| Fair value of scheme assets (note 58(a)(iv)) | 3,992 | 222 | 32 |
| Net (liabilities)/assets recognised in the balance sheet (note 58(a)(v)) | (1,718) | 65 | 30 |
| Reported as “Assets” | – | 65 | 30 |
| Reported as “Liabilities” | (1,718) | – | – |
| | (1,718) | 65 | 30 |
| Obligations covered by scheme assets (%) | 70 | 141 | 1,600 |
| 2009 | | | |
| Present value of funded obligations (note 58(a)(iii)) | (5,557) | (170) | (2) |
| Fair value of scheme assets (note 58(a)(iv)) | 3,845 | 225 | 33 |
| Net (liabilities)/assets recognised in the balance sheet (note 58(a)(v)) | (1,712) | 55 | 31 |
| Reported as “Assets” | – | 55 | 31 |
| Reported as “Liabilities” | (1,712) | – | – |
| | (1,712) | 55 | 31 |
| Obligations covered by scheme assets (%) | 69 | 132 | 1,650 |

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 97 per cent (2009: 100 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK\$109 million (surplus in 2009: HK\$14 million). On a wind-up basis, the actuarial value of the scheme assets represented 102 per cent (2009: 100 per cent) of the members’ vested benefits, based on salaries at that date, and the resulting surplus amounted to HK\$71 million (surplus in 2009: HK\$19 million).

NOTES TO THE FINANCIAL STATEMENTS

58. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

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

| | Group and Bank | | |
|--|----------------|------------|-----------|
| | HSBDDBS | HSBPS | HSBNTBS |
| 2010 | | | |
| Equity | 1,297 | 29 | – |
| Bonds | 2,570 | 170 | – |
| Certificates of deposit issued by the Bank | – | – | – |
| Ordinary shares issued by ultimate holding company | 45 | – | – |
| Other | 80 | 23 | 32 |
| | 3,992 | 222 | 32 |
| 2009 | | | |
| Equity | 945 | 28 | – |
| Bonds | 2,724 | 171 | – |
| Certificates of deposit issued by the Bank | – | – | – |
| Ordinary shares issued by ultimate holding company | 48 | – | – |
| Other | 128 | 26 | 33 |
| | 3,845 | 225 | 33 |

(iii) Change in the present value of scheme obligations

| | Group and Bank | | |
|--------------------------|----------------|------------|----------|
| | HSBDDBS | HSBPS | HSBNTBS |
| 2010 | | | |
| At 1 January | 5,557 | 170 | 2 |
| Current service cost | 267 | – | – |
| Interest cost | 141 | 4 | – |
| Actuarial losses/(gains) | 51 | (3) | 1 |
| Benefits paid | (306) | (14) | (1) |
| At 31 December | 5,710 | 157 | 2 |
| 2009 | | | |
| At 1 January | 6,961 | 219 | 3 |
| Current service cost | 349 | – | – |
| Interest cost | 82 | 3 | – |
| Actuarial gains | (1,491) | (37) | (1) |
| Benefits paid | (344) | (15) | – |
| At 31 December | 5,557 | 170 | 2 |

58. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(iv) Change in the fair value of scheme assets

| | Group and Bank | | |
|----------------------------------|----------------|-------------|------------|
| | HSBDBS | HSBPS | HSBNTBS |
| 2010 | | | |
| At 1 January | 3,845 | 225 | 33 |
| Contributions by the Bank | 183 | – | – |
| Expected return on scheme assets | 212 | 8 | 1 |
| Experience gains/(losses) | 58 | 3 | (1) |
| Benefits paid | (306) | (14) | (1) |
| At 31 December | 3,992 | 222 | 32 |
| 2009 | | | |
| At 1 January | 3,430 | 218 | 33 |
| Contributions by the Bank | 212 | – | – |
| Expected return on scheme assets | 211 | 9 | 1 |
| Experience gains/(losses) | 336 | 13 | (1) |
| Benefits paid | (344) | (15) | – |
| At 31 December | 3,845 | 225 | 33 |

The Group and the Bank expect to make HK\$231 million of contributions to defined benefit schemes during the following year (2009: HK\$188 million).

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

| | Group and Bank | | |
|--|----------------|------------|------------|
| | HSBDBS | HSBPS | HSBNTBS |
| 2010 | | | |
| At 1 January | (1,712) | 55 | 31 |
| Contributions by the Bank | 183 | – | – |
| Net (expense)/income recognised in the income statement (note 58(a)(vi)) | (196) | 4 | 1 |
| Net actuarial gains/(losses) | 7 | 6 | (2) |
| At 31 December | (1,718) | 65 | 30 |
| Experience losses on scheme liabilities | (14) | (1) | (1) |
| Experience gains/(losses) on scheme assets | 58 | 3 | (1) |
| (Losses)/gains from change in actuarial assumptions | (37) | 4 | – |
| Net actuarial gains/(losses) | 7 | 6 | (2) |
| 2009 | | | |
| At 1 January | (3,531) | (1) | 30 |
| Contributions by the Bank | 212 | – | – |
| Net (expense)/income recognised in the income statement (note 58(a)(vi)) | (220) | 6 | 1 |
| Net actuarial gains | 1,827 | 50 | – |
| At 31 December | (1,712) | 55 | 31 |
| Experience gains on scheme liabilities | 288 | 5 | – |
| Experience gains/(losses) on scheme assets | 336 | 13 | (1) |
| Gains from change in actuarial assumptions | 1,203 | 32 | 1 |
| Net actuarial gains | 1,827 | 50 | – |

NOTES TO THE FINANCIAL STATEMENTS

58. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

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

| | Group | | |
|---|--------|-------|---------|
| | HSBDBS | HSBPS | HSBNTBS |
| 2010 | | | |
| Current service cost | (267) | – | – |
| Interest cost | (141) | (4) | – |
| Expected return on scheme assets | 212 | 8 | 1 |
| Net (expense)/income for the year (note 17) | (196) | 4 | 1 |
| Actual return on scheme assets | 270 | 11 | – |
| 2009 | | | |
| Current service cost | (349) | – | – |
| Interest cost | (82) | (3) | – |
| Expected return on scheme assets | 211 | 9 | 1 |
| Net (expense)/income for the year (note 17) | (220) | 6 | 1 |
| Actual return on scheme assets | 547 | 22 | – |

The net actuarial gains recognised in the Group's retained profit during 2010 in respect of defined benefit schemes were HK\$9 million (net actuarial gains of HK\$1,568 million during 2009). The total cumulative amount of actuarial losses recognised in the retained profit was HK\$1,902 million (2009: the cumulative amount of actuarial losses was HK\$1,911 million). The total effect of the limit on schemes surpluses in 2010 and 2009 in respect of defined benefit schemes was nil.

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

| | Group and Bank | | |
|--|----------------|------------|--------------|
| | HSBDBS % | HSBPS % | HSBNTBS % |
| 2010 | | | |
| Discount rate | 2.9 | 2.9 | 2.9 |
| Expected rate of return on scheme assets | 4.5 | 4.0 | 2.5 |
| Expected rate of salary increases | 5.0 | 5.0 | 5.0 |
| Expected rate of pension increases | – | 1.0 | – |
| 2009 | | | |
| Discount rate | 2.6 | 2.6 | 2.6 |
| Expected rate of return on scheme assets | 5.5 | 4.0 | 3.0 |
| Expected rate of salary increases | 5.0 | 5.0 | 5.0 |
| Expected rate of pension increases | – | 1.0 | – |

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

58. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(viii) Amounts for the current and previous years

| | Group and Bank | | | | |
|---|----------------|---------|---------|---------|-------|
| | 2010 | 2009 | 2008 | 2007 | 2006 |
| Defined benefit obligations | 5,869 | 5,729 | 7,183 | 5,913 | 3,905 |
| Plan assets | 4,246 | 4,103 | 3,681 | 5,388 | 4,728 |
| Net (deficits)/surpluses | (1,623) | (1,626) | (3,502) | (525) | 823 |
| Experience (losses)/gains on scheme liabilities | (16) | 293 | 260 | (212) | (36) |
| Experience gains/(losses) on scheme assets | 60 | 348 | (1,989) | 416 | 413 |
| (Losses)/gains from change in actuarial assumptions | (33) | 1,236 | (1,287) | (1,711) | (113) |

(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:

| | 2010 | 2009 |
|---|-----------|------|
| Amounts charged to the income statement (note 17) | 78 | 74 |

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 (2009: Nil).

59. SHARE-BASED PAYMENTS

The Group participated in various share compensation plans operated by the HSBC Group for acquiring of HSBC Holdings plc shares. They are the Savings-Related Share Option Plan, Executive/Group Share Option Plan and Restricted Share 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 (2009: 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.

NOTES TO THE FINANCIAL STATEMENTS

59. 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 date of balance sheet, are as follows:

(i) Option scheme with exercise price set in pounds sterling

| | 2010 | | 2009 | |
|-----------------------------|--------------------------------------|---------------|--------------------------------------|---------------|
| | Weighted average exercise price £ | Number ('000) | Weighted average exercise price £ | Number ('000) |
| Outstanding at 1 January | 5.82 | 29 | 6.55 | 543 |
| Exercised in the year | 5.82 | (23) | 5.64 | (171) |
| Lapsed in the year | 5.82 | (6) | 6.55 | (387) |
| Adjustment for rights issue | – | – | 5.69 | 44 |
| Outstanding at 31 December | – | – | 5.82 | 29 |
| Exercisable at 31 December | – | – | – | – |

The weighted average share price at the date of exercise for share options exercised during the year was £6.53 (2009: £6.56).

There was no option outstanding at the end of the year 2010. The option outstanding at 31 December 2009 had an exercise price of £5.82 with a weighted average remaining contractual life of 1.08 years.

(ii) Option scheme with exercise price set in Hong Kong dollars

| | 2010 | | 2009 | |
|-----------------------------|---|---------------|---|---------------|
| | Weighted average exercise price HK\$ | Number ('000) | Weighted average exercise price HK\$ | Number ('000) |
| Outstanding at 1 January | 38.30 | 12,193 | 106.14 | 2,296 |
| Granted in the year | 62.97 | 1,561 | 37.88 | 12,292 |
| Exercised in the year | 37.98 | (1,749) | 90.14 | (11) |
| Lapsed in the year | 38.30 | (713) | 102.99 | (2,526) |
| Adjustment for rights issue | – | – | 92.30 | 142 |
| Outstanding at 31 December | 41.18 | 11,292 | 38.30 | 12,193 |
| Exercisable at 31 December | – | – | – | – |

The weighted average share price at the date of exercise for share options exercised during the year was HK\$79.38 (2009: HK\$83.33).

The options outstanding at the year end of 2010 had an exercise price in the range of HK\$37.88 to HK\$94.51 (2009: HK\$37.88 to HK\$94.51), and a weighted average remaining contractual life of 2.82 years (2009: 3.50 years).

The weighted average fair value of options granted during 2010 was HK\$18.80 (2009: HK\$15.74).

59. 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 balance sheet date, are as follows:

| | 2010 | | 2009 | |
|-----------------------------|--------------------------------------|---------------|--------------------------------------|---------------|
| | Weighted average exercise price £ | Number ('000) | Weighted average exercise price £ | Number ('000) |
| Outstanding at 1 January | 7.04 | 2,652 | 7.93 | 2,747 |
| Exercised in the year | 7.35 | (145) | 7.55 | (60) |
| Lapsed in the year | 7.04 | (256) | 7.93 | (441) |
| Adjustment for rights issue | – | – | 6.99 | 406 |
| Outstanding at 31 December | 7.10 | 2,251 | 7.04 | 2,652 |
| Exercisable at 31 December | 7.10 | 2,251 | 7.04 | 2,652 |

The weighted average share price at the date of exercise for share options exercised during the year was £6.65 (2009: £5.86).

The options outstanding at the year end of 2010 had an exercise price in the range of £6.02 to £7.59 (2009: £6.02 to £7.59), and a weighted average remaining contractual life of 2.15 years (2009: 2.89 years).

(c) Calculation of fair value

The recognition of compensation cost of share option is based on the fair value of the options on grant date. The calculation of the fair value of HSBC share option is centrally managed by HSBC Holdings plc. Fair values of share options, measured at the date of grant of the options are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. Expected dividends are incorporated into the valuation model for share options and awards where applicable. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

NOTES TO THE FINANCIAL STATEMENTS

59. 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 |
|----------------------------------|---|---|---|
| 2010 | | | |
| Risk-free interest rate (%) | 0.7 | 1.9 | 2.9 |
| Expected life (years) | 1 | 3 | 5 |
| Expected volatility (%) | 30 | 30 | 30 |
| Share price at grant date (HK\$) | 82.05 | 82.05 | 82.05 |
| 2009 | | | |
| Risk-free interest rate (%) | 0.7 | 2.1 | 2.4 |
| Expected life (years) | 1 | 3 | 5 |
| Expected volatility (%) | 50 | 35 | 30 |
| Share price at grant date (HK\$) | 53.34 | 53.34 | 53.34 |

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 share awards are made to eligible employees for retention purposes or as part of deferral of annual bonus. According to the terms of the share scheme, the shares awarded has a vesting period of three years, commencing from the first anniversary of the date of award.

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.

| | 2010 Number (‘000) | 2009 Number (‘000) |
|----------------------------|--------------------------|--------------------------|
| Outstanding at 1 January | 957 | 917 |
| Additions during the year | 28 | 181 |
| Released in the year | (182) | (141) |
| Outstanding at 31 December | 803 | 957 |

The closing price of the HSBC Holdings plc share at 31 December 2010 was £6.51 (2009: £7.09).

The weighted average remaining vesting period as at 31 December 2010 was 1.21 years (2009: 1.33 years).

59. SHARE-BASED PAYMENTS (continued)

(e) Employee expenses

During 2010, HK\$100 million was charged to the income statement in respect of share-based payment transactions settled in equity (2009: HK\$101 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.

60. MATERIAL RELATED-PARTY TRANSACTIONS

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

In 2010, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The Group used the IT service of, and shared an automated teller machine network with, its immediate holding company. The Group also shared certain IT projects with and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. A fellow subsidiary company was appointed as fund manager to manage the Group's investment portfolios. The Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies.

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

In May 2010, Hang Seng Bank (China) Limited entered into a conditional agreement with HSBC Bank (China) Company Limited to purchase a property situated in Shanghai, PRC for a total consideration of RMB510 million. The transaction was completed in November 2010 after obtaining regulatory and government approvals.

NOTES TO THE FINANCIAL STATEMENTS

60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

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

| | Group | | | | | |
|--|--|---------------|---------------------|------------|--------------|------------|
| | Immediate holding company and its subsidiaries | | Fellow subsidiaries | | Associates | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Interest income | 84 | 245 | – | – | 11 | 2 |
| Interest expense | (39) | (43) | (3) | (3) | – | (3) |
| Other operating income | 104 | 17 | – | 1 | 1 | 2 |
| Operating expenses* | (740) | (736) | (442) | (415) | (14) | (12) |
| Amounts due from: | | | | | | |
| Cash and balances with banks and other financial institutions | 463 | 1,495 | 2,081 | 758 | 5 | 13 |
| Placings with and advances to banks and other financial institutions | 8,915 | 10,841 | – | – | 1,141 | – |
| Derivative financial instruments | 586 | 373 | 19 | 10 | – | – |
| Financial assets designated at fair value | 3,541 | 3,346 | – | – | – | – |
| Advances to customers | – | – | – | – | 233 | 233 |
| Financial investments | 334 | 412 | – | – | – | – |
| Other assets | 64 | 55 | – | 10 | 3 | 3 |
| | 13,903 | 16,522 | 2,100 | 778 | 1,382 | 249 |
| Amounts due to: | | | | | | |
| Current, savings and other deposit accounts | 332 | 1,527 | – | 126 | 68 | 63 |
| Deposits from banks | 2,484 | 1,309 | 8 | 4 | 117 | 116 |
| Derivative financial instruments | 494 | 1,238 | 59 | 76 | – | – |
| Subordinated liabilities | 6,025 | 2,017 | – | – | – | – |
| Other liabilities | 326 | 246 | 67 | 84 | – | – |
| | 9,661 | 6,337 | 134 | 290 | 185 | 179 |
| Derivative contracts: | | | | | | |
| Contract amount | 75,230 | 46,180 | 15,780 | 18,280 | – | – |
| Guarantees: | | | | | | |
| Guarantees issued | 2 | – | – | – | 116 | 116 |
| Committed facilities: | | | | | | |
| Committed facilities from | 826 | – | – | – | – | – |
| Committed facilities to | – | – | – | – | – | – |

* 2010 Operating expenses included payment of HK\$97 million (2009: HK\$107 million) of software costs which were capitalised as intangible assets in the balance sheet of the Group.

60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

| | Bank | | | | | | | |
|--|--|--------------|---------------------|------------|---------------|---------------|------------|------------|
| | Immediate holding company and its subsidiaries | | Fellow subsidiaries | | Subsidiaries | | Associates | |
| | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Amounts due from: | | | | | | | | |
| Cash and balances with banks and other financial institutions | 390 | 1,397 | 2,018 | 701 | - | - | - | - |
| Placings with and advances to banks and other financial institutions | 4,683 | 5,196 | - | - | - | - | 552 | - |
| Derivative financial instruments | 418 | 280 | 19 | 10 | 88 | 1 | - | - |
| Financial assets designated at fair value | - | - | - | - | - | - | - | - |
| Advances to customers | - | - | - | - | - | - | - | - |
| Amounts due from subsidiaries | - | - | - | - | 93,445 | 87,360 | - | - |
| Financial investments | - | - | - | - | - | - | - | - |
| Other assets | 18 | 17 | - | 5 | - | - | 3 | 3 |
| | 5,509 | 6,890 | 2,037 | 716 | 93,533 | 87,361 | 555 | 3 |
| Amounts due to: | | | | | | | | |
| Current, savings and other deposit accounts | 233 | 1,527 | - | 126 | - | - | 68 | 63 |
| Deposits from banks | 2,484 | 1,309 | 8 | 4 | - | - | 117 | 116 |
| Derivative financial instruments | 334 | 1,230 | 59 | 75 | 298 | 18 | - | - |
| Subordinated liabilities | 6,025 | 2,017 | - | - | - | - | - | - |
| Amounts due to subsidiaries | - | - | - | - | 8,899 | 9,960 | - | - |
| Other liabilities | 276 | 194 | 65 | 82 | - | - | - | - |
| | 9,352 | 6,277 | 132 | 287 | 9,197 | 9,978 | 185 | 179 |
| Derivative contracts: | | | | | | | | |
| Contract amount | 57,371 | 40,975 | 15,780 | 18,280 | 33,333 | 12,220 | - | - |
| Guarantees: | | | | | | | | |
| Guarantees issued | 2 | - | - | - | 559 | 543 | 116 | 116 |
| Guarantees received | - | - | - | - | 159 | 142 | - | - |
| Committed facilities: | | | | | | | | |
| Committed facilities from | - | - | - | - | - | - | - | - |
| Committed facilities to | - | - | - | - | 2,332 | - | - | - |

NOTES TO THE FINANCIAL STATEMENTS

60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(b) Key management personnel remuneration

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

| | Group | | Bank | |
|--------------------------|-----------|------|-----------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Employee benefits | 30 | 39 | 30 | 39 |
| Post-employment benefits | 4 | 5 | 4 | 5 |
| Share-based payments | 7 | 6 | 7 | 6 |
| | 41 | 50 | 41 | 50 |

(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 | |
|--|---------------|--------|---------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Interest received | 173 | 232 | 173 | 230 |
| Interest paid | 4 | 5 | 4 | 5 |
| Fees and exchange income received | 18 | 16 | 18 | 16 |
| Loans and advances | 12,153 | 9,834 | 11,361 | 9,254 |
| Deposits | 2,906 | 2,096 | 2,906 | 2,085 |
| Undrawn commitments | 1,969 | 3,206 | 1,670 | 3,167 |
| Maximum aggregate amount of loans and advances during the year | 14,539 | 21,401 | 13,398 | 19,836 |

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

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

60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(d) Loans to officers

Loans to officers of the Bank disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

| | Group | | Bank | |
|--|-------|------|------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Aggregate amount of relevant transactions outstanding at 31 December | 11 | 73 | 11 | 69 |
| Maximum aggregate amount of relevant transactions during the year | 20 | 132 | 20 | 127 |

(e) Associates

Information relating to associates and transactions with associates can be found in notes 38 and 60(a).

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2010 was HK\$233 million (2009: HK\$233 million).

The Bank has been assisting Industrial Bank Co., Ltd. in managing and growing the credit card business.

The Bank has entered into Technical Support Agreement with Yantai Bank Co., Ltd. ("Yantai Bank") to provide technical support and assistance in relation to various banking operations and businesses of Yantai Bank.

(f) Ultimate holding company

The Group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the Group. As disclosed in note 59, the Group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under "Other reserves". The balance of this reserve as at 31 December 2010 amounted to HK\$510 million comprising HK\$514 million relating to share option schemes and negative reserve amounted to HK\$4 million relating to share award schemes (2009: HK\$446 million comprising HK\$445 million relating to share option schemes and HK\$1 million relating to share award schemes).

(g) Employee retirement benefits

At 31 December 2010, defined benefit scheme assets amounted to HK\$1,269 million (2009: HK\$1,341 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK\$10 million (2009: HK\$10 million).

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT

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

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various management committees, including the Executive Committee, Audit Committee, Asset and Liability Management Committee ("ALCO") and Risk Management Committee ("RMC").

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising of senior executives from Risk, Legal, Compliance, Finance, and Operations/IT, is responsible for reviewing and approving the launch of such new products and services. Each new service and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new products and services in development prior to implementation.

(a) Credit risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, and treasury businesses. The Group has dedicated standards, policies and procedures in place to control and monitor risk from all such activities.

The Credit Risk Management ("CRM") function headed by the Chief Credit Officer who reported to Chief Risk Officer is mandated to provide centralised management of credit risk through:

- formulating credit policies on approval process, post disbursement monitoring, recovery process and large exposure;
- issuing guidelines on lending to specified market sectors, industries and products; the acceptability of specific classes of collateral or risk mitigations and valuation parameters for collateral;
- undertaking an independent review and objective assessment of credit risk for all commercial non-bank credit facilities in excess of designated amount prior to the facilities being committed to customers;
- controlling exposures to selected industries, counterparties, countries and portfolio types etc by setting limits;
- maintaining and developing credit risk rating/facility grading process to categorise exposures and facilitate focused management;
- reporting to senior executives and various committees on aspects of the Group loan portfolio;
- managing and directing credit-related systems initiatives; and
- providing advice and guidance to business units on various credit-related issues.

Impaired loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loans impairment allowance are made promptly where necessary and need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

Risk rating framework

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

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

Collateral and other credit enhancements

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

- in the personal sector, charges over the properties, securities, investment funds and deposits;
- in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery;
- in the commercial real estate sector, charges over the properties being financed.

Reposessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the balance sheet within "Other assets" at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The Group does not generally occupy reposessed properties for its business use.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured 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 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 32, 33, 35 and 36.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

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

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

| | Group | | Bank | |
|--|------------------|------------------|------------------|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Cash and balances with banks and other financial institutions | 44,411 | 22,086 | 41,062 | 18,461 |
| Placings with and advances to banks and other financial institutions | 110,564 | 104,551 | 52,131 | 65,624 |
| Trading assets | 26,047 | 66,591 | 25,224 | 65,282 |
| Financial assets designated at fair value | 4,440 | 4,927 | 148 | 174 |
| Derivative financial instruments | 5,593 | 5,050 | 5,026 | 4,916 |
| Advances to customers | 472,637 | 344,621 | 423,074 | 299,179 |
| Financial investments | 199,033 | 241,155 | 102,985 | 156,568 |
| Amounts due from subsidiaries | – | – | 93,445 | 87,360 |
| Other assets | 11,754 | 10,726 | 8,419 | 8,040 |
| Financial guarantees and other credit related contingent liabilities | 11,392 | 9,137 | 9,916 | 9,294 |
| Loan commitments and other credit related commitments | 347,019 | 295,084 | 314,108 | 280,093 |
| | 1,232,890 | 1,103,928 | 1,075,538 | 994,991 |

(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.

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”.

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Quality classification definitions:

- Strong: Exposures demonstrate a strong capacity to meet financial commitments, with low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.
- Medium: Exposures require closer monitoring, with satisfactory to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery process.
- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail accounts show longer delinquency periods of up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate through security realisation or other recovery processes.
- Impaired: Exposures have been assessed, individually or collectively, as impaired. The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL (“Expected loss”) grade, whereby in the higher quality grades the grading assignment will reflect the offsetting impact by credit risk mitigation in one form or another.

The Group’s policy in respect of impairment on loans and advances and debt securities is set out in note 4 on the financial statements. Analysis of impairment allowances as at 31 December 2010 and the movement of such allowances during the year are disclosed in note 35.

Granular risk rating scales:

The CRR (“Customer Risk Rating”) 10-grade scale maps to a more granular underlying 23-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

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

NOTES TO THE FINANCIAL STATEMENTS

61. 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 | | | | |
| 2010 | | | | | | | |
| Items in the course of collection from other banks | 4,589 | 84 | - | - | - | - | 4,673 |
| Trading assets: | | | | | | | |
| - treasury and eligible bills | 20,204 | - | - | - | - | - | 20,204 |
| - debt securities | 5,063 | 56 | - | - | - | - | 5,119 |
| - loans and advances to banks | 700 | - | - | - | - | - | 700 |
| - loans and advances to customers | 24 | - | - | - | - | - | 24 |
| | 25,991 | 56 | - | - | - | - | 26,047 |
| Financial assets designated at fair value: | | | | | | | |
| - treasury and eligible bills | - | - | - | - | - | - | - |
| - debt securities | 4,438 | 2 | - | - | - | - | 4,440 |
| - loans and advances to banks | - | - | - | - | - | - | - |
| - loans and advances to customers | - | - | - | - | - | - | - |
| | 4,438 | 2 | - | - | - | - | 4,440 |
| Derivatives | 4,235 | 1,284 | 74 | - | - | - | 5,593 |
| Loans and advances held at amortised cost: | | | | | | | |
| - loans and advances to banks | 135,797 | 13,077 | - | - | - | - | 148,874 |
| - loans and advances to customers | 271,974 | 194,139 | 2,990 | 3,380 | 1,990 | (1,836) | 472,637 |
| | 407,771 | 207,216 | 2,990 | 3,380 | 1,990 | (1,836) | 621,511 |
| Financial investments: | | | | | | | |
| - treasury and similar bills | 18,010 | - | - | - | - | - | 18,010 |
| - debt securities | 175,887 | 5,136 | - | - | - | - | 181,023 |
| | 193,897 | 5,136 | - | - | - | - | 199,033 |
| Other assets: | | | | | | | |
| - acceptances and endorsements | 1,034 | 2,688 | 29 | - | - | - | 3,751 |
| - other | 1,752 | 1,538 | 5 | 35 | - | - | 3,330 |
| | 2,786 | 4,226 | 34 | 35 | - | - | 7,081 |

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

| | Neither past due nor impaired | | | Group | | | Total |
|--|-------------------------------|---------|--------------|-----------------------|----------|-----------------------|---------|
| | Strong | Medium* | Sub-standard | Past due not impaired | Impaired | Impairment allowances | |
| 2009 | | | | | | | |
| Items in the course of collection from other banks | 4,343 | – | – | – | – | – | 4,343 |
| Trading assets: | | | | | | | |
| – treasury and eligible bills | 62,028 | – | – | – | – | – | 62,028 |
| – debt securities | 4,562 | – | – | – | – | – | 4,562 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | 1 | – | – | – | – | 1 |
| | 66,590 | 1 | – | – | – | – | 66,591 |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,841 | 86 | – | – | – | – | 4,927 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – | – |
| | 4,841 | 86 | – | – | – | – | 4,927 |
| Derivatives | 4,050 | 983 | 17 | – | – | – | 5,050 |
| Loans and advances held at amortised cost: | | | | | | | |
| – loans and advances to banks | 115,838 | 6,500 | – | – | – | – | 122,338 |
| – loans and advances to customers | 196,834 | 138,333 | 4,797 | 4,114 | 2,508 | (1,965) | 344,621 |
| | 312,672 | 144,833 | 4,797 | 4,114 | 2,508 | (1,965) | 466,959 |
| Financial investments: | | | | | | | |
| – treasury and similar bills | 53,973 | – | – | – | – | – | 53,973 |
| – debt securities | 177,926 | 9,256 | – | – | – | – | 187,182 |
| | 231,899 | 9,256 | – | – | – | – | 241,155 |
| Other assets: | | | | | | | |
| – acceptances and endorsements | 877 | 2,576 | 131 | – | – | – | 3,584 |
| – other | 1,792 | 968 | 34 | 5 | – | – | 2,799 |
| | 2,669 | 3,544 | 165 | 5 | – | – | 6,383 |

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

| | Bank | | | | | | Total |
|--|-------------------------------|----------------|------------------|-----------------------------|--------------|--------------------------|----------------|
| | Neither past due nor impaired | | | Past due not impaired | Impaired | Impairment allowances | |
| | Strong | Medium* | Sub- standard | | | | |
| 2010 | | | | | | | |
| Items in the course of collection from other banks | 4,589 | 84 | - | - | - | - | 4,673 |
| Trading assets: | | | | | | | |
| - treasury and eligible bills | 20,204 | - | - | - | - | - | 20,204 |
| - debt securities | 4,240 | 56 | - | - | - | - | 4,296 |
| - loans and advances to banks | 700 | - | - | - | - | - | 700 |
| - loans and advances to customers | 24 | - | - | - | - | - | 24 |
| | 25,168 | 56 | - | - | - | - | 25,224 |
| Financial assets designated at fair value: | | | | | | | |
| - treasury and eligible bills | - | - | - | - | - | - | - |
| - debt securities | 148 | - | - | - | - | - | 148 |
| - loans and advances to banks | - | - | - | - | - | - | - |
| - loans and advances to customers | - | - | - | - | - | - | - |
| | 148 | - | - | - | - | - | 148 |
| Derivatives | 3,744 | 1,220 | 62 | - | - | - | 5,026 |
| Loans and advances held at amortised cost: | | | | | | | |
| - loans and advances to banks | 80,171 | 7,165 | - | - | - | - | 87,336 |
| - loans and advances to customers | 247,256 | 171,341 | 1,984 | 2,463 | 1,462 | (1,432) | 423,074 |
| | 327,427 | 178,506 | 1,984 | 2,463 | 1,462 | (1,432) | 510,410 |
| Financial investments: | | | | | | | |
| - treasury and similar bills | 17,225 | - | - | - | - | - | 17,225 |
| - debt securities | 83,325 | 2,435 | - | - | - | - | 85,760 |
| | 100,550 | 2,435 | - | - | - | - | 102,985 |
| Other assets: | | | | | | | |
| - acceptances and endorsements | 681 | 1,666 | 16 | - | - | - | 2,363 |
| - other | 607 | 775 | - | 1 | - | - | 1,383 |
| | 1,288 | 2,441 | 16 | 1 | - | - | 3,746 |

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

| | Neither past due nor impaired | | | Bank | | Impairment allowances | Total |
|--|-------------------------------|---------|--------------|-----------------------|----------|-----------------------|---------|
| | Strong | Medium* | Sub-standard | Past due not impaired | Impaired | | |
| 2009 | | | | | | | |
| Items in the course of collection from other banks | 4,343 | – | – | – | – | – | 4,343 |
| Trading assets: | | | | | | | |
| – treasury and eligible bills | 62,028 | – | – | – | – | – | 62,028 |
| – debt securities | 3,253 | – | – | – | – | – | 3,253 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | 1 | – | – | – | – | 1 |
| | 65,281 | 1 | – | – | – | – | 65,282 |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – | – |
| – debt securities | 174 | – | – | – | – | – | 174 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – | – |
| | 174 | – | – | – | – | – | 174 |
| Derivatives | 3,930 | 971 | 15 | – | – | – | 4,916 |
| Loans and advances held at amortised cost: | | | | | | | |
| – loans and advances to banks | 76,150 | 3,856 | – | – | – | – | 80,006 |
| – loans and advances to customers | 170,878 | 122,500 | 2,779 | 2,924 | 1,761 | (1,663) | 299,179 |
| | 247,028 | 126,356 | 2,779 | 2,924 | 1,761 | (1,663) | 379,185 |
| Financial investments: | | | | | | | |
| – treasury and similar bills | 49,277 | – | – | – | – | – | 49,277 |
| – debt securities | 101,905 | 5,386 | – | – | – | – | 107,291 |
| | 151,182 | 5,386 | – | – | – | – | 156,568 |
| Other assets: | | | | | | | |
| – acceptances and endorsements | 763 | 1,641 | 31 | – | – | – | 2,435 |
| – other | 974 | 282 | 2 | 4 | – | – | 1,262 |
| | 1,737 | 1,923 | 33 | 4 | – | – | 3,697 |

* Includes HK\$1,623 million (2009: HK\$3,006 million) and HK\$283 million (2009: HK\$1,557 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2010, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

NOTES TO THE FINANCIAL STATEMENTS

61. 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 | | | | | Total |
|--|------------------|----------------|----------------|-----------------|------------------|--------------|
| | Up to 29 days | 30- 59 days | 60- 89 days | 90- 180 days | Over 180 days | |
| 2010 | | | | | | |
| Items in the course of collection from other banks | - | - | - | - | - | - |
| Trading assets: | | | | | | |
| – treasury and eligible bills | - | - | - | - | - | - |
| – debt securities | - | - | - | - | - | - |
| – loans and advances to banks | - | - | - | - | - | - |
| – loans and advances to customers | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Financial assets designated at fair value: | | | | | | |
| – treasury and eligible bills | - | - | - | - | - | - |
| – debt securities | - | - | - | - | - | - |
| – loans and advances to banks | - | - | - | - | - | - |
| – loans and advances to customers | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Derivatives | - | - | - | - | - | - |
| Loans and advances held at amortised cost: | | | | | | |
| – loans and advances to banks | - | - | - | - | - | - |
| – loans and advances to customers [#] | 2,892 | 419 | 51 | 13 | 5 | 3,380 |
| | 2,892 | 419 | 51 | 13 | 5 | 3,380 |
| Financial investments: | | | | | | |
| – treasury and similar bills | - | - | - | - | - | - |
| – debt securities | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Other assets: | | | | | | |
| – acceptances and endorsements | - | - | - | - | - | - |
| – other | 17 | 5 | 2 | 5 | 6 | 35 |
| | 17 | 5 | 2 | 5 | 6 | 35 |

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

| | Group | | | | | Total |
|---|------------------|----------------|----------------|-----------------|------------------|-------|
| | Up to 29 days | 30- 59 days | 60- 89 days | 90- 180 days | Over 180 days | |
| 2009 | | | | | | |
| 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 [#] | 3,432 | 588 | 83 | 11 | - | 4,114 |
| | 3,432 | 588 | 83 | 11 | - | 4,114 |
| Financial investments: | | | | | | |
| - treasury and similar bills | - | - | - | - | - | - |
| - debt securities | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Other assets: | | | | | | |
| - acceptances and endorsements | - | - | - | - | - | - |
| - other | 4 | 1 | - | - | - | 5 |
| | 4 | 1 | - | - | - | 5 |

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

| | Bank | | | | | Total |
|--|------------------|----------------|----------------|-----------------|------------------|--------------|
| | Up to 29 days | 30- 59 days | 60- 89 days | 90- 180 days | Over 180 days | |
| 2010 | | | | | | |
| Items in the course of collection from other banks | - | - | - | - | - | - |
| Trading assets: | | | | | | |
| – treasury and eligible bills | - | - | - | - | - | - |
| – debt securities | - | - | - | - | - | - |
| – loans and advances to banks | - | - | - | - | - | - |
| – loans and advances to customers | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Financial assets designated at fair value: | | | | | | |
| – treasury and eligible bills | - | - | - | - | - | - |
| – debt securities | - | - | - | - | - | - |
| – loans and advances to banks | - | - | - | - | - | - |
| – loans and advances to customers | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Derivatives | - | - | - | - | - | - |
| Loans and advances held at amortised cost: | | | | | | |
| – loans and advances to banks | - | - | - | - | - | - |
| – loans and advances to customers [#] | 2,173 | 236 | 39 | 13 | 2 | 2,463 |
| | 2,173 | 236 | 39 | 13 | 2 | 2,463 |
| Financial investments: | | | | | | |
| – treasury and similar bills | - | - | - | - | - | - |
| – debt securities | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Other assets: | | | | | | |
| – acceptances and endorsements | - | - | - | - | - | - |
| – other | 1 | - | - | - | - | 1 |
| | 1 | - | - | - | - | 1 |

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

| | Bank | | | | | Total |
|---|------------------|----------------|----------------|-----------------|------------------|-------|
| | Up to 29 days | 30- 59 days | 60- 89 days | 90- 180 days | Over 180 days | |
| 2009 | | | | | | |
| 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 [#] | 2,540 | 331 | 52 | 1 | - | 2,924 |
| | 2,540 | 331 | 52 | 1 | - | 2,924 |
| Financial investments: | | | | | | |
| - treasury and similar bills | - | - | - | - | - | - |
| - debt securities | - | - | - | - | - | - |
| | - | - | - | - | - | - |
| Other assets: | | | | | | |
| - acceptances and endorsements | - | - | - | - | - | - |
| - other | 3 | 1 | - | - | - | 4 |
| | 3 | 1 | - | - | - | 4 |

[#] The majority of the loans and advances to customers that are operating within revised terms following restructuring are excluded from this table.

Impaired loans and advances

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

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

Analyses of impairment allowances at 31 December 2010 and the movement of such allowances during the year are disclosed in note 35.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Renegotiated loans that would otherwise be past due or impaired

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

| | Group | | Bank | |
|---|------------|-------|------------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Renegotiated loans that would otherwise be past due or impaired | 695 | 1,110 | 424 | 801 |

(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 | |
|--------------------------------------|-----------|------|-----------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Nature of assets: | | | | |
| Residential properties | 24 | 19 | 11 | 12 |
| Commercial and industrial properties | – | – | – | – |
| Other | – | – | – | – |
| | 24 | 19 | 11 | 12 |

(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.

61. 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 | |
|--|-------|-------|
| | 2010 | 2009 |
| The Bank and its subsidiaries designated by the Hong Kong Monetary Authority | 38.1% | 48.1% |

The below tables are an analysis of undiscounted cash flows on the Group’s financial liabilities including future interest payments on the basis of their earliest possible contractual maturity.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (continued)

The balances in the below table will not agree with the balances in the balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and all future coupon payments (except for trading liabilities and trading derivatives). Also, loans commitments are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the “On demand” time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loans commitments expire without being drawn upon. The undiscounted cash flows potentially payable under loan commitments and financial guarantee are classified on the basis of the earliest date they can be called instead of behaviour maturity as previous reported. Accordingly, the comparative figures are restated to conform with current year presentation.

| | Group | | | | | Total |
|--|---------------------|--|---------------------------------------|-------------------------------------|-----------------|----------------|
| | Repayable on demand | Three months or less but not on demand | Over three months but within one year | Over one year but within five years | Over five years | |
| At 31 December 2010 | | | | | | |
| Current, savings and other deposit accounts | 536,442 | 116,288 | 29,956 | 1,660 | – | 684,346 |
| Deposits from banks | 6,387 | 9,084 | – | 117 | – | 15,588 |
| Financial liabilities designated at fair value | 2 | – | – | – | 455 | 457 |
| Trading liabilities | 42,581 | – | – | – | – | 42,581 |
| Derivative financial instruments | 3,709 | 104 | 400 | 616 | (18) | 4,811 |
| Certificates of deposit and other debt securities in issue | – | 553 | 135 | 2,489 | – | 3,177 |
| Other financial liabilities | 6,719 | 5,643 | 1,499 | 70 | 25 | 13,956 |
| Subordinated liabilities | – | 54 | 3,609 | 2,843 | 6,655 | 13,161 |
| | 595,840 | 131,726 | 35,599 | 7,795 | 7,117 | 778,077 |
| Commitments | 222,111 | 37,081 | 179 | 575 | – | 259,946 |
| Financial guarantee contracts | 4,094 | – | 2 | – | – | 4,096 |
| | 226,205 | 37,081 | 181 | 575 | – | 264,042 |
| At 31 December 2009 | | | | | | |
| Current, savings and other deposit accounts | 494,372 | 119,462 | 22,508 | 753 | – | 637,095 |
| Deposits from banks | 2,964 | 1,771 | 25 | 117 | – | 4,877 |
| Financial liabilities designated at fair value | 3 | 10 | 1,010 | – | 451 | 1,474 |
| Trading liabilities | 38,391 | – | – | – | – | 38,391 |
| Derivative financial instruments | 3,581 | 75 | 365 | 242 | (8) | 4,255 |
| Certificates of deposit and other debt securities in issue | – | 344 | 1,214 | 328 | – | 1,886 |
| Other financial liabilities | 5,881 | 4,935 | 1,103 | 114 | 116 | 12,149 |
| Subordinated liabilities | – | 12 | 3,547 | 5,846 | – | 9,405 |
| | 545,192 | 126,609 | 29,772 | 7,400 | 559 | 709,532 |
| Commitments | 182,134 | 27,781 | 82 | 183 | – | 210,180 |
| Financial guarantee contracts | 2,719 | 2 | 4 | 2 | – | 2,727 |
| | 184,853 | 27,783 | 86 | 185 | – | 212,907 |

61. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (continued)

| | Bank | | | | | Total |
|--|---------------------|--|---------------------------------------|-------------------------------------|-----------------|----------------|
| | Repayable on demand | Three months or less but not on demand | Over three months but within one year | Over one year but within five years | Over five years | |
| At 31 December 2010 | | | | | | |
| Current, savings and other deposit accounts | 526,177 | 105,993 | 16,276 | 1,106 | – | 649,552 |
| Deposits from banks | 6,386 | 9,084 | – | 117 | – | 15,587 |
| Financial liabilities designated at fair value | – | – | – | – | – | – |
| Trading liabilities | 30,106 | – | – | – | – | 30,106 |
| Derivative financial instruments | 3,803 | 91 | 280 | 381 | (21) | 4,534 |
| Certificates of deposit and other debt securities in issue | – | 553 | 135 | 2,489 | – | 3,177 |
| Amounts due to subsidiaries | 4,222 | 4,675 | 2 | – | – | 8,899 |
| Other financial liabilities | 6,596 | 4,514 | 770 | 1 | 910 | 12,791 |
| Subordinated liabilities | – | 54 | 3,609 | 2,843 | 6,655 | 13,161 |
| | 577,290 | 124,964 | 21,072 | 6,937 | 7,544 | 737,807 |
| Commitments | 190,235 | 36,455 | 75 | 1 | – | 226,766 |
| Financial guarantee contracts | 2,992 | – | 2 | – | – | 2,994 |
| | 193,227 | 36,455 | 77 | 1 | – | 229,760 |
| At 31 December 2009 | | | | | | |
| Current, savings and other deposit accounts | 486,023 | 112,668 | 13,207 | 403 | – | 612,301 |
| Deposits from banks | 2,963 | 1,365 | 25 | 117 | – | 4,470 |
| Financial liabilities designated at fair value | – | 10 | 1,010 | – | – | 1,020 |
| Trading liabilities | 35,071 | – | – | – | – | 35,071 |
| Derivative financial instruments | 3,572 | 71 | 324 | 217 | (8) | 4,176 |
| Certificates of deposit and other debt securities in issue | – | 344 | 1,214 | 328 | – | 1,886 |
| Amounts due to subsidiaries | 4,749 | 4,973 | 238 | – | – | 9,960 |
| Other financial liabilities | 5,794 | 4,053 | 646 | 50 | 909 | 11,452 |
| Subordinated liabilities | – | 12 | 3,547 | 5,846 | – | 9,405 |
| | 538,172 | 123,496 | 20,211 | 6,961 | 901 | 689,741 |
| Commitments | 169,270 | 26,463 | 69 | 2 | – | 195,804 |
| Financial guarantee contracts | 2,713 | 2 | 4 | 2 | – | 2,721 |
| | 171,983 | 26,465 | 73 | 4 | – | 198,525 |

(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.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

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

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

Value at risk ("VAR")

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR. 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 which include both end of day market movements and intra-day trading outcomes, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the Group would expect to see losses in excess of VAR only one per cent of the time over a 1-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

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

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

The Group's VAR, both trading and non-trading, for total positions and on individual risk portfolios during 2010 and 2009 are shown in the table below.

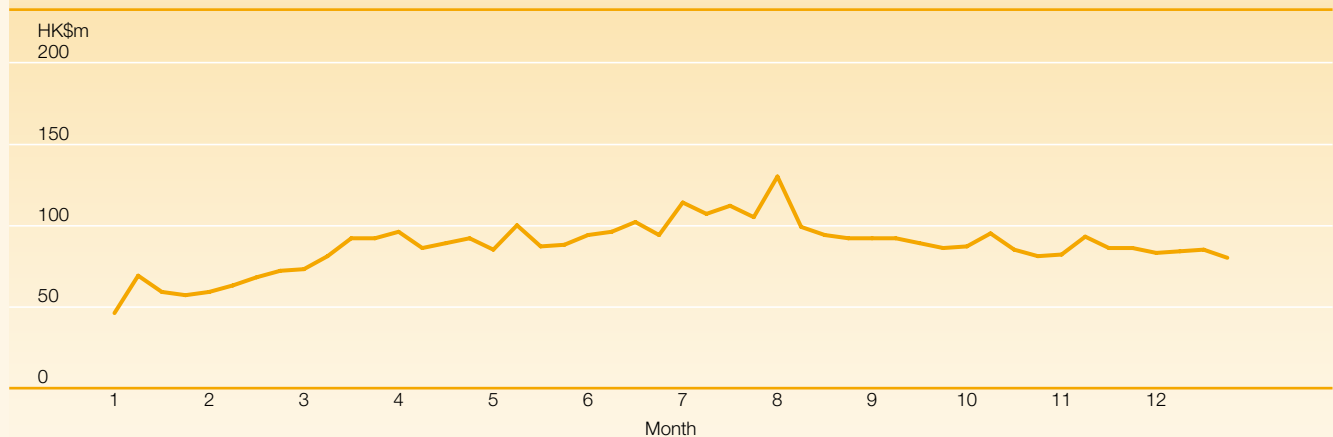
| | At 31 December 2010 | Minimum during the year | Maximum during the year | Average for the year |
|---|---------------------------|-------------------------------|-------------------------------|-------------------------|
| Total VAR | 69 | 53 | 149 | 99 |
| Total trading VAR | 9 | 5 | 25 | 10 |
| VAR for foreign exchange risk (trading) | 5 | 1 | 10 | 3 |
| VAR for interest rate risk: | | | | |
| – trading | 6 | 5 | 23 | 10 |
| – non-trading | 18 | 17 | 100 | 62 |

| | At 31 December 2009 | Minimum during the year | Maximum during the year | Average for the year |
|---|---------------------------|-------------------------------|-------------------------------|-------------------------|
| Total VAR | 76 | 46 | 130 | 86 |
| Total trading VAR | 6 | 6 | 20 | 10 |
| VAR for foreign exchange risk (trading) | 2 | 1 | 24 | 7 |
| VAR for interest rate risk: | | | | |
| – trading | 7 | 5 | 13 | 8 |
| – non-trading | 73 | 47 | 115 | 83 |

Total Value at Risk for 2010



Total Value at Risk for 2009



NOTES TO THE FINANCIAL STATEMENTS

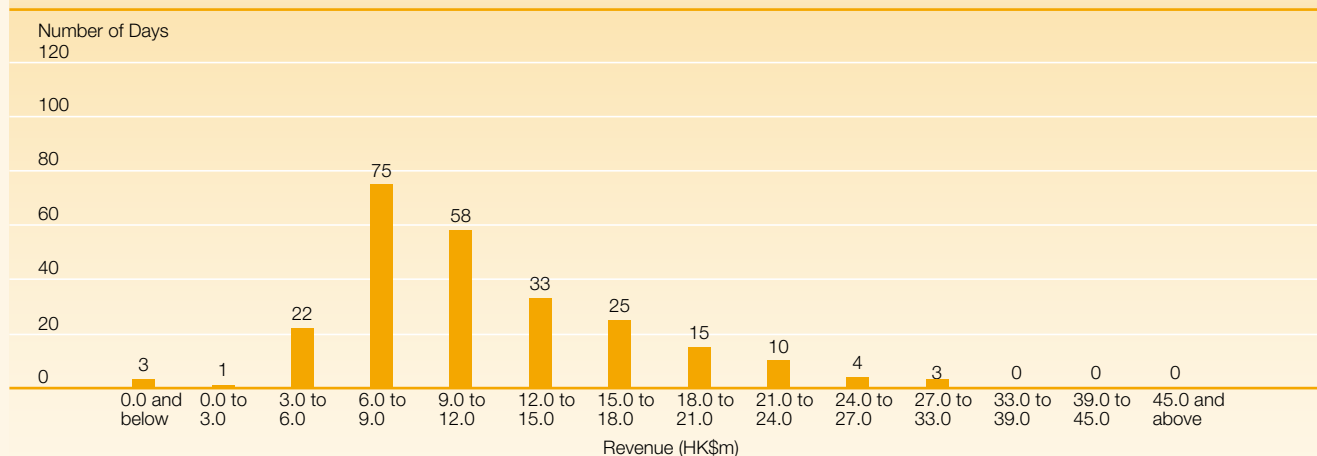
61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

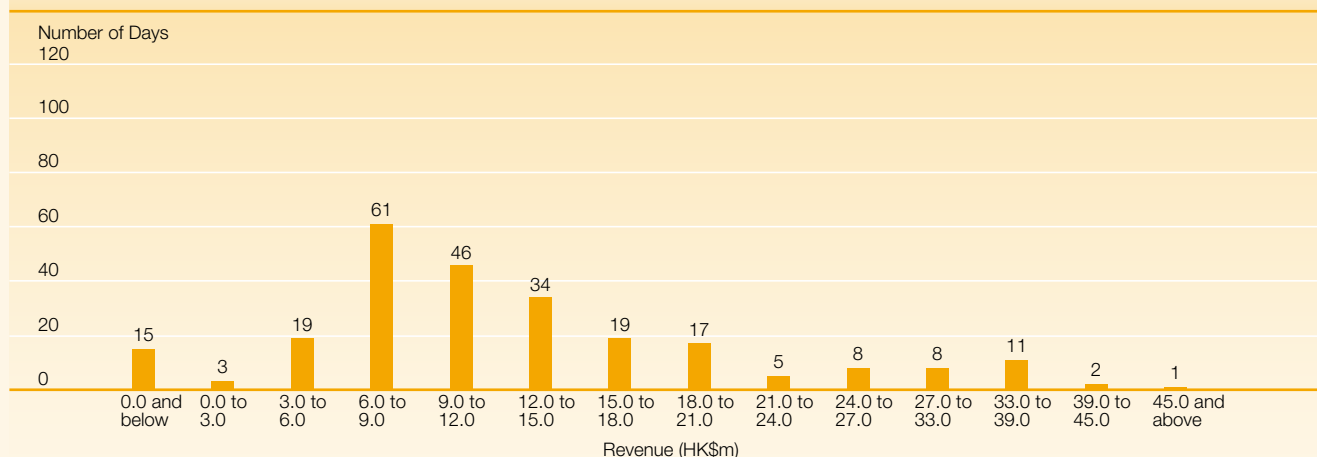
The average daily revenue earned from market risk-related treasury activities in 2010, including non-trading book net interest income and funding related to trading positions, was HK\$11 million (2009: HK\$12 million). The standard deviation of these daily revenues was HK\$6 million, compared with HK\$10 million for 2009.

An analysis of the frequency distribution of daily revenue shows that out of 249 trading days in 2010, losses were recorded on 3 days (2009: 15 days) and the maximum daily loss was HK\$35 million (2009: HK\$24 million). The most frequent result was a daily revenue of between HK\$6 million and HK\$18 million, with 191 occurrences (2009: 160 occurrences). The highest daily revenue was HK\$32 million (2009: HK\$62 million).

Daily Distribution of Market Risk Revenue for 2010



Daily Distribution of Market Risk Revenue for 2009



61. FINANCIAL RISK MANAGEMENT (continued)

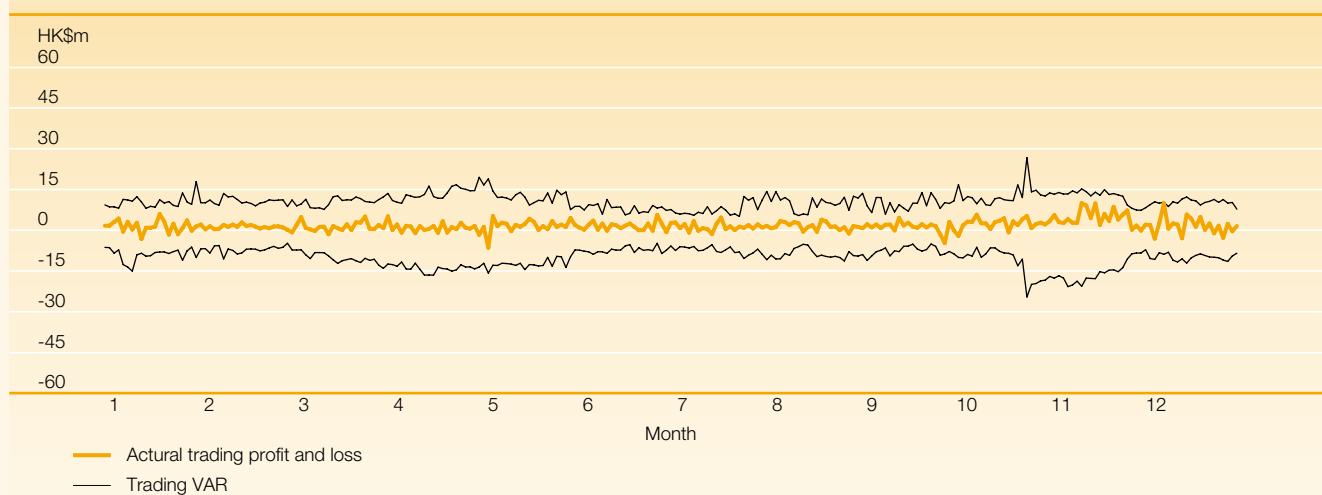
(c) Market risk (continued)

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

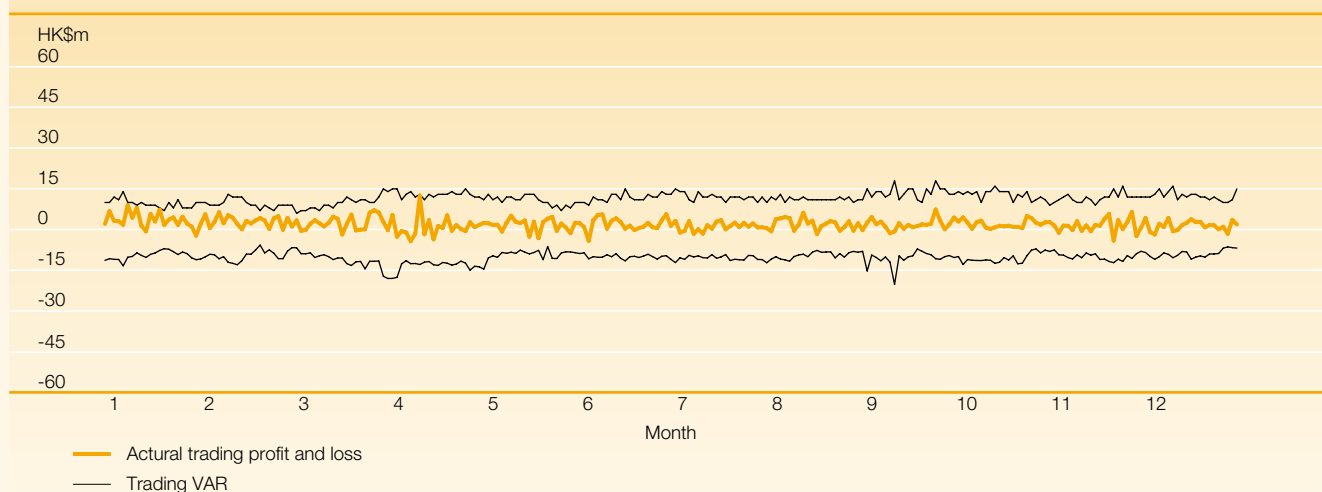
The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2010 and 2009 are shown in the table below.

A Comparison of Trading VAR with Actual Trading Profit and Loss for 2010



A Comparison of Trading VAR with Actual Trading Profit and Loss for 2009



NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios which include structural interest rate exposures. Treasury manages interest rate risks within the limits approved by the Risk Management Committee and under the monitoring of both ALCO and Risk Management Committee.

Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point ("PVBP") limits and option limits, and a list of permissible instruments authorised by the Risk Management Committee, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Structural interest rate risk arises from the 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 Risk Management Committee.

Net interest income

A principal part of the Group's management of interest rate risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

The table below sets out the impact on future net interest income of a 100 basis points parallel fall or rise in all-in yield curves at the beginning of year from 1 January 2011 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 2011.

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 2011 by HK\$1,303 million for 100 basis points case and by HK\$762 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\$1,706 million for 100 basis points case and by HK\$1,280 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and takes into account the change in pricing of retail products relative to change in market interest rates.

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Projected Net Interest Income

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

| | 100bp parallel increase | 100bp parallel decrease | 25bp increase at the beginning of each quarter | 25bp decrease at the beginning of each quarter |
|---|-------------------------------|-------------------------------|---|---|
| Change in 2011 projected net interest income | | | | |
| – HKD | 861 | (1,113) | 562 | (963) |
| – US\$ | 309 | (447) | 113 | (262) |
| – other | 133 | (146) | 87 | (55) |
| Total | 1,303 | (1,706) | 762 | (1,280) |
| Change in 2010 projected net interest income | | | | |
| – HKD | 1,737 | (1,949) | 993 | (1,426) |
| – US\$ | 214 | (95) | 72 | 143 |
| – other | 235 | (116) | 123 | 29 |
| Total | 2,186 | (2,160) | 1,188 | (1,254) |

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.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Sensitivity of reserves

The Group monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all-in yield curves. The table below describes the sensitivity to these movements at the balance sheet dates indicated below and the maximum and minimum month figures during the year then ended:

| | At 31 December 2010 | Maximum impact | Minimum impact |
|--|------------------------------------|---------------------------|---------------------------|
| + 100 basis points parallel move in all-in yield curves | (803) | (1,173) | (803) |
| As a percentage of shareholders' funds at 31 December 2010 (%) | (1.1) | (1.7) | (1.1) |
| – 100 basis points parallel move in all-in yield curves | 264 | 303 | 174 |
| As a percentage of shareholders' funds at 31 December 2010 (%) | 0.4 | 0.4 | 0.2 |

| | At 31 December 2009 | Maximum impact | Minimum impact |
|--|---------------------------|-------------------|-------------------|
| + 100 basis points parallel move in all-in yield curves | (975) | (996) | (729) |
| As a percentage of shareholders' funds at 31 December 2009 (%) | (1.7) | (1.7) | (1.3) |
| – 100 basis points parallel move in all-in yield curves | 975 | 996 | 729 |
| As a percentage of shareholders' funds at 31 December 2009 (%) | 1.7 | 1.7 | 1.3 |

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

Foreign exchange exposure

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

At 31 December 2010, the US dollar ("US\$"), Chinese renminbi ("RMB"), Pound Sterling ("GBP"), Japanese Yen ("JPY"), Euro ("EUR"), Canadian dollar ("CAD"), Swiss Francs ("CHF"), Australian dollar ("AUD"), New Zealand dollar ("NZD") and Gold ("GOL") were the currencies in which the Group had non-structural foreign currency positions that were not less than 10 per cent of the total net position in all foreign currencies. The Group also had a US\$ and RMB structural foreign currency position, which was not less than 10 percent of the total net structural position in all foreign currencies.

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Foreign exchange exposure (continued)

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

| | Group | | | | | | | | | | | |
|--|-----------|----------|----------|----------|----------|----------|-------|----------|----------|---------|--------------------------|--------------------------|
| | US\$ | RMB | GBP | JPY | EUR | CAD | CHF | AUD | NZD | GOL | Other foreign currencies | Total foreign currencies |
| 2010 | | | | | | | | | | | | |
| Non-structural position | | | | | | | | | | | | |
| Spot assets | 246,638 | 93,067 | 13,026 | 8,985 | 11,068 | 13,933 | 191 | 43,643 | 9,017 | 2,169 | 974 | 442,711 |
| Spot liabilities | (155,377) | (88,666) | (15,470) | (1,912) | (12,393) | (14,882) | (549) | (41,953) | (11,658) | (3,404) | (3,034) | (349,298) |
| Forward purchases | 228,982 | 72,661 | 7,130 | 8,932 | 3,735 | 2,431 | 1,347 | 8,340 | 3,909 | 2,919 | 3,423 | 343,809 |
| Forward sales | (319,494) | (77,799) | (4,810) | (16,151) | (2,497) | (1,449) | (964) | (9,885) | (1,341) | (1,559) | (1,359) | (437,308) |
| Net options position | 133 | (41) | - | (5) | (55) | (7) | - | (71) | 60 | - | - | 14 |
| Net long/(short) non-structural position | 882 | (778) | (124) | (151) | (142) | 26 | 25 | 74 | (13) | 125 | 4 | (72) |
| Structural position | 206 | 20,124 | - | - | - | - | - | - | - | - | 238 | 20,568 |
| 2009 | | | | | | | | | | | | |
| Non-structural position | | | | | | | | | | | | |
| Spot assets | 214,379 | 41,638 | 16,344 | 48,843 | 15,423 | 14,474 | 124 | 39,757 | 7,360 | 816 | 451 | 399,609 |
| Spot liabilities | (164,511) | (41,564) | (15,527) | (1,694) | (12,292) | (14,412) | (591) | (47,508) | (14,807) | (2,387) | (826) | (316,119) |
| Forward purchases | 169,349 | 29,483 | 2,215 | 3,728 | 6,885 | 1,607 | 832 | 14,293 | 9,586 | 2,430 | 764 | 241,172 |
| Forward sales | (219,453) | (29,603) | (2,995) | (50,915) | (10,103) | (1,680) | (371) | (6,532) | (2,083) | (851) | (490) | (325,076) |
| Net options position | (4) | - | - | 1 | (1) | (4) | 2 | 7 | 2 | - | - | 3 |
| Net (short)/long non-structural position | (240) | (46) | 37 | (37) | (88) | (15) | (4) | 17 | 58 | 8 | (101) | (411) |
| Structural position | 285 | 14,550 | - | - | - | - | - | - | - | - | 287 | 15,122 |
| Bank | | | | | | | | | | | | |
| | US\$ | RMB | GBP | JPY | EUR | CAD | CHF | AUD | NZD | GOL | Other foreign currencies | Total foreign currencies |
| 2010 | | | | | | | | | | | | |
| Non-structural position | | | | | | | | | | | | |
| Spot assets | 203,809 | 41,067 | 7,591 | 8,883 | 8,411 | 7,568 | 129 | 23,618 | 5,993 | 2,169 | 864 | 310,102 |
| Spot liabilities | (117,702) | (36,296) | (10,022) | (1,840) | (9,529) | (8,463) | (504) | (20,171) | (8,544) | (3,404) | (2,924) | (219,399) |
| Forward purchases | 205,281 | 59,923 | 7,130 | 8,695 | 3,550 | 2,377 | 1,347 | 6,433 | 3,813 | 2,919 | 3,423 | 304,891 |
| Forward sales | (292,023) | (64,330) | (4,762) | (15,805) | (2,467) | (1,449) | (948) | (9,782) | (1,341) | (1,559) | (1,359) | (395,825) |
| Net options position | 133 | (41) | - | (5) | (55) | (7) | - | (71) | 60 | - | - | 14 |
| Net (short)/long non-structural position | (502) | 323 | (63) | (72) | (90) | 26 | 24 | 27 | (19) | 125 | 4 | (217) |
| Structural position | 206 | 20,124 | - | - | - | - | - | - | - | - | 238 | 20,568 |
| 2009 | | | | | | | | | | | | |
| Non-structural position | | | | | | | | | | | | |
| Spot assets | 178,264 | 13,820 | 9,948 | 48,728 | 12,397 | 8,452 | 84 | 20,526 | 4,225 | 816 | 378 | 297,638 |
| Spot liabilities | (130,310) | (12,730) | (9,127) | (1,661) | (9,220) | (8,389) | (551) | (27,941) | (11,616) | (2,387) | (751) | (214,683) |
| Forward purchases | 165,452 | 27,274 | 2,188 | 3,640 | 6,815 | 1,607 | 832 | 13,944 | 9,530 | 2,430 | 764 | 234,476 |
| Forward sales | (215,240) | (27,146) | (2,971) | (50,738) | (10,078) | (1,680) | (371) | (6,527) | (2,083) | (851) | (490) | (318,175) |
| Net options position | (4) | - | - | 1 | (1) | (4) | 2 | 7 | 2 | - | - | 3 |
| Net (short)/long non-structural position | (1,838) | 1,218 | 38 | (30) | (87) | (14) | (4) | 9 | 58 | 8 | (99) | (741) |
| Structural position | 285 | 14,550 | - | - | - | - | - | - | - | - | 287 | 15,122 |

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Equities exposure

The Group's equities exposures in 2010 and 2009 are mainly in long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

(d) Insurance risk

Risk management objectives and policies for management of insurance risk

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

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

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

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

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

Asset/liability management

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

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

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

Balance sheet of insurance subsidiaries by type of contract

| | Life linked contracts ¹ | Life non-linked contracts ² | Non-life insurance ³ | Other assets ⁴ | Total |
|---|--|--|------------------------------------|------------------------------|--------|
| 2010 | | | | | |
| Financial assets: | | | | | |
| – financial assets designated at fair value | 237 | 6,586 | – | 142 | 6,965 |
| – derivatives | – | 161 | – | – | 161 |
| – financial investments | – | 53,591 | – | 3,339 | 56,930 |
| – other financial assets | 125 | 3,270 | 421 | 657 | 4,473 |
| Total financial assets | 362 | 63,608 | 421 | 4,138 | 68,529 |
| Reinsurance assets | – | 35 | 103 | 21 | 159 |
| Present value of in-force long-term insurance contracts | – | – | – | 4,593 | 4,593 |
| Other assets | – | 729 | 11 | 706 | 1,446 |
| Total assets | 362 | 64,372 | 535 | 9,458 | 74,727 |
| Liabilities under investment contracts designated at fair value | 136 | 321 | – | – | 457 |
| Liabilities under insurance contracts | 226 | 63,722 | 477 | – | 64,425 |
| Deferred tax | – | – | – | 733 | 733 |
| Other liabilities | – | – | 19 | 125 | 144 |
| Total liabilities | 362 | 64,043 | 496 | 858 | 65,759 |
| Shareholders' equity | – | – | – | 8,968 | 8,968 |
| Total liabilities and shareholders' equity | 362 | 64,043 | 496 | 9,826 | 74,727 |
| 2009 | | | | | |
| Financial assets: | | | | | |
| – financial assets designated at fair value | 217 | 4,441 | – | 616 | 5,274 |
| – derivatives | – | 78 | – | – | 78 |
| – financial investments | – | 46,791 | – | 2,329 | 49,120 |
| – other financial assets | 130 | 2,340 | 474 | 777 | 3,721 |
| Total financial assets | 347 | 53,650 | 474 | 3,722 | 58,193 |
| Reinsurance assets | – | 17 | 81 | 23 | 121 |
| Present value of in-force long-term insurance contracts | – | – | – | 3,466 | 3,466 |
| Other assets | – | 607 | 7 | 713 | 1,327 |
| Total assets | 347 | 54,274 | 562 | 7,924 | 63,107 |
| Liabilities under investment contracts designated at fair value | 121 | 332 | – | – | 453 |
| Liabilities under insurance contracts | 224 | 53,588 | 428 | – | 54,240 |
| Deferred tax | – | – | – | 533 | 533 |
| Other liabilities | – | – | – | 225 | 225 |
| Total liabilities | 345 | 53,920 | 428 | 758 | 55,451 |
| Shareholders' equity | – | – | – | 7,656 | 7,656 |
| Total liabilities and shareholders' equity | 345 | 53,920 | 428 | 8,414 | 63,107 |

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

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Underwriting strategy

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

Reinsurance strategy

The Group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. These reinsurance agreements transfer part of the risk and limit the exposure from each life insured. The amount of each risk retained depends on the Group's evaluation of the specific risk, subject in certain circumstances, to maximum limits based on characteristics of coverage. Under the terms of the reinsurance agreements, the reinsurer agrees to reimburse the ceded amount in the event the claim is paid. However, the Group remains liable to its policyholders with respect to ceded insurance if any reinsurer fails to meet the obligations it assumes. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The Group uses non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

Nature of risks covered

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

(i) Long-term insurance contracts – non-linked products

The basic feature of long-term non-linked insurance business is to provide guaranteed death benefit determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender benefit, guaranteed maturity benefit, 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. In practice the Group considers policyholders' reasonable expectations when setting bonus levels. It is the Group's intention to maintain a smooth dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable taken into account the overall experience on investments, claims, operating expenses and lapses.

(ii) Long-term insurance contracts – linked products

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

(iii) Long-term investment contracts – non-linked return guaranteed products

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

(iv) Long-term investment contracts – linked products

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

(v) Non-life insurance contracts

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

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Concentration of insurance risks

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

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

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

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

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities are therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. Details of the analysis of life insurance liabilities are disclosed in note 48. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

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

| | 2010 | 2009 |
|--------------------------------|------------|------------|
| Accident and health | 102 | 108 |
| Fire and other damage | 126 | 110 |
| Motor | 23 | 23 |
| Liability | 45 | 58 |
| Marine, aviation and transport | 21 | 19 |
| Other (non-life) | 27 | 11 |
| | 344 | 329 |

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.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

Financial assets held by insurance operations

| | Group | | | | Total |
|--|-----------------------|---------------------------|--------------------|--------------|--------|
| | Life linked contracts | Life non-linked contracts | Non-life insurance | Other assets | |
| 2010 | | | | | |
| Financial assets designated at fair value: | | | | | |
| – debt securities | – | 4,150 | – | 142 | 4,292 |
| – equity securities | 237 | 2,436 | – | – | 2,673 |
| | 237 | 6,586 | – | 142 | 6,965 |
| Financial investments | | | | | |
| Held-to-maturity: | | | | | |
| – debt securities | – | 53,591 | – | 2,710 | 56,301 |
| | – | 53,591 | – | 2,710 | 56,301 |
| Available-for-sale: | | | | | |
| – debt securities | – | – | – | 616 | 616 |
| – equity securities | – | – | – | 13 | 13 |
| | – | – | – | 629 | 629 |
| Derivatives | – | 161 | – | – | 161 |
| Other financial assets | 125 | 3,270 | 421 | 657 | 4,473 |
| | 362 | 63,608 | 421 | 4,138 | 68,529 |

| | Group | | | | Total |
|--|-----------------------|---------------------------|--------------------|--------------|--------|
| | Life linked contracts | Life non-linked contracts | Non-life insurance | Other assets | |
| 2009 | | | | | |
| Financial assets designated at fair value: | | | | | |
| – debt securities | – | 4,136 | – | 616 | 4,752 |
| – equity securities | 217 | 305 | – | – | 522 |
| | 217 | 4,441 | – | 616 | 5,274 |
| Financial investments | | | | | |
| Held-to-maturity: | | | | | |
| – debt securities | – | 46,791 | – | 1,878 | 48,669 |
| | – | 46,791 | – | 1,878 | 48,669 |
| Available-for-sale: | | | | | |
| – debt securities | – | – | – | 445 | 445 |
| – equity securities | – | – | – | 6 | 6 |
| | – | – | – | 451 | 451 |
| Derivatives | – | 78 | – | – | 78 |
| Other financial assets | 130 | 2,340 | 474 | 777 | 3,721 |
| | 347 | 53,650 | 474 | 3,722 | 58,193 |

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

The table demonstrates that for linked contracts, the Group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 0.5% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2010 (2009: 0.6%). The table also shows that approximately 89.3% of financial assets was invested in debt securities at 31 December 2010 (2009: 92.6%) with 3.9% (2009: 0.9%) invested in equity securities.

Market risk

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

Interest rate risk

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

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

An immediate and permanent movement in interest yield curves as at 31 December 2010 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:

| | 2010 | | 2009 | |
|--|-------------------------------|----------------------|-------------------------------|----------------------|
| | 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 | 239 | 229 | 205 | 197 |
| - 100 basis points shift in yield curves | (161) | (151) | (128) | (120) |

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 into account of any resultant changes in policyholder behaviour.

Equity risk

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

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

| | 2010 | | 2009 | |
|---------------------------------------|-------------------------------|----------------------|-------------------------------|----------------------|
| | 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 | 205 | 205 | 26 | 26 |
| 10 per cent decrease in equity prices | (205) | (205) | (26) | (26) |

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

Foreign currency risk

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

Credit risk

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

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

| | Neither past due nor impaired | | | Past due not impaired | Impaired | Impairment allowances | Total |
|---|-------------------------------|--------|--------------|-----------------------|----------|-----------------------|--------|
| | Strong | Medium | Sub-standard | | | | |
| 2010 | | | | | | | |
| Supporting liabilities under non-linked insurance and investment contracts | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,148 | 2 | – | – | – | – | 4,150 |
| | 4,148 | 2 | – | – | – | – | 4,150 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 52,271 | 1,320 | – | – | – | – | 53,591 |
| | 52,271 | 1,320 | – | – | – | – | 53,591 |
| Supporting shareholders funds | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 142 | – | – | – | – | – | 142 |
| | 142 | – | – | – | – | – | 142 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 3,282 | 44 | – | – | – | – | 3,326 |
| | 3,282 | 44 | – | – | – | – | 3,326 |
| Total | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,290 | 2 | – | – | – | – | 4,292 |
| | 4,290 | 2 | – | – | – | – | 4,292 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 55,553 | 1,364 | – | – | – | – | 56,917 |
| | 55,553 | 1,364 | – | – | – | – | 56,917 |

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

| | Neither past due nor impaired | | | Past due not impaired | Impaired | Impairment allowances | Total |
|---|-------------------------------|--------|------------------|-----------------------------|----------|--------------------------|--------|
| | Strong | Medium | Sub- standard | | | | |
| 2009 | | | | | | | |
| Supporting liabilities under non-linked insurance and investment contracts | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,051 | 85 | – | – | – | – | 4,136 |
| | 4,051 | 85 | – | – | – | – | 4,136 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 46,239 | 552 | – | – | – | – | 46,791 |
| | 46,239 | 552 | – | – | – | – | 46,791 |
| Supporting shareholders funds | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 616 | – | – | – | – | – | 616 |
| | 616 | – | – | – | – | – | 616 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 2,323 | – | – | – | – | – | 2,323 |
| | 2,323 | – | – | – | – | – | 2,323 |
| Total | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,667 | 85 | – | – | – | – | 4,752 |
| | 4,667 | 85 | – | – | – | – | 4,752 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 48,562 | 552 | – | – | – | – | 49,114 |
| | 48,562 | 552 | – | – | – | – | 49,114 |

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

Reinsurers' share of liabilities under insurance contracts

| | Neither past due nor impaired | | | Past due not impaired | Impaired | Impairment allowances | Total |
|--------------------------------|-------------------------------|--------|--------------|-----------------------|----------|-----------------------|-------|
| | Strong | Medium | Sub-standard | | | | |
| 2010 | | | | | | | |
| Linked insurance contracts | - | - | - | - | - | - | - |
| Non-linked insurance contracts | 108 | 30 | - | - | - | - | 138 |
| Total | 108 | 30 | - | - | - | - | 138 |
| Reinsurance Debtors | 7 | 3 | - | 11 | - | - | 21 |
| 2009 | | | | | | | |
| Linked insurance contracts | - | - | - | - | - | - | - |
| Non-linked insurance contracts | 82 | 16 | - | - | - | - | 98 |
| Total | 82 | 16 | - | - | - | - | 98 |
| Reinsurance Debtors | 7 | 2 | - | 13 | - | - | 22 |

Liquidity risk

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

The following table shows the expected maturity of insurance contract liabilities at balance sheet dates:

Expected maturity of insurance contract liabilities

| | Expected cash flows (undiscounted) | | | | Total |
|-----------------------------|------------------------------------|--------------------------------|----------------------------------|---------------|---------|
| | Within 1 year | Over 1 year but within 5 years | Over 5 years but within 15 years | Over 15 years | |
| 2010 | | | | | |
| Non-life insurance | 266 | 187 | 43 | - | 496 |
| Life insurance (non-linked) | 5,281 | 29,418 | 61,674 | 35,696 | 132,069 |
| Life insurance (linked) | 27 | 177 | 149 | 892 | 1,245 |
| | 5,574 | 29,782 | 61,866 | 36,588 | 133,810 |
| 2009 | | | | | |
| Non-life insurance | 249 | 160 | 33 | - | 442 |
| Life insurance (non-linked) | 3,985 | 26,231 | 56,760 | 32,549 | 119,525 |
| Life insurance (linked) | 28 | 183 | 158 | 973 | 1,342 |
| | 4,262 | 26,574 | 56,951 | 33,522 | 121,309 |

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Remaining contractual maturity of investment contract liabilities

| | Liabilities under investment contracts by insurance underwriting subsidiaries | | | Total |
|--|---|---------------------------------|-------------------------------|------------|
| | Linked investment contracts | Non-linked investment contracts | Investment contracts with DPF | |
| 2010 | | | | |
| Remaining contractual maturity: | | | | |
| – due within 1 year | 2 | – | – | 2 |
| – due over 1 year but within 5 years | – | – | – | – |
| – due over 5 years but within 10 years | – | – | – | – |
| – due over 10 years | – | – | – | – |
| – undated | 134 | 321 | – | 455 |
| | 136 | 321 | – | 457 |
| 2009 | | | | |
| Remaining contractual maturity: | | | | |
| – due within 1 year | 2 | – | – | 2 |
| – due over 1 year but within 5 years | – | – | – | – |
| – due over 5 years but within 10 years | – | – | – | – |
| – due over 10 years | – | – | – | – |
| – undated | 119 | 332 | – | 451 |
| | 121 | 332 | – | 453 |

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 2010 was HK\$4,593 million (2009: HK\$3,466 million). The present value of the shareholders’ interest in the profits expected to emerge from the book of in-force policies at balance sheet dates can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF at balance sheet dates of reasonably possible changes in the main economic and business assumptions:

| | 2010 | 2009 |
|--|-------|-------|
| + 100 basis points shift in risk-free rate | 635 | 548 |
| – 100 basis points shift in risk-free rate | (494) | (375) |
| + 100 basis points shift in risk discount rate | (196) | (181) |
| – 100 basis points shift in risk discount rate | 220 | 204 |
| + 100 basis points shift in expenses inflation | (18) | (15) |
| – 100 basis points shift in expenses inflation | 16 | 13 |
| + 100 basis points shift in lapse rate | 824 | 853 |
| – 100 basis points shift in lapse rate | (769) | (817) |

61. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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 into account of consequential changes in policyholder behaviour.

Non-economic assumptions

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

| | Impact on 2010 results | | Impact on 2009 results | |
|--|------------------------|------------|------------------------|------------|
| | Profit for the year | Net assets | Profit for the year | Net assets |
| 20 per cent increase in claims costs | (12) | (12) | (24) | (24) |
| 20 per cent decrease in claims costs | 12 | 12 | 24 | 24 |
| 10 per cent increase in mortality and/or morbidity rates | (27) | (27) | (22) | (22) |
| 10 per cent decrease in mortality and/or morbidity rates | 27 | 27 | 21 | 21 |
| 50 per cent increase in lapse rates | 520 | 520 | 535 | 535 |
| 50 per cent decrease in lapse rates | (531) | (531) | (549) | (549) |
| 10 per cent increase in expense rates | (40) | (40) | (36) | (36) |
| 10 per cent decrease in expense rates | 40 | 40 | 36 | 36 |

(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.

NOTES TO THE FINANCIAL STATEMENTS

61. FINANCIAL RISK MANAGEMENT (continued)

(e) Operational risk (continued)

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

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

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

(f) Capital management

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

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

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

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

Externally imposed capital requirements:

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

The Basel Committee on Banking Supervision has published a 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.

61. FINANCIAL RISK MANAGEMENT (continued)

(f) Capital management (continued)

With respect to Pillar One minimum capital requirements, Basel II provides three approaches, of increasing sophistication, to the calculation of credit risk regulatory capital. The most basic, the standardised approach, requires banks to use external credit ratings to determine risk weightings applied to rated counterparties, and groups other counterparties into broad categories and applies standardised risk weightings to these categories. In the next level, the foundation internal ratings-based approach, allows banks to calculate their credit risk regulatory capital requirement on the basis of their internal assessment of the probability that a counterparty will default ("PD"), but with quantification of exposure at default ("EAD") and loss given default 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 Hong Kong Monetary Authority approval, the Group has adopted the advanced internal ratings-based approach for the majority of its business with effect from 1 January 2009, with the remainder on standardised approach.

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

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

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

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

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

62. FAIR VALUE OF FINANCIAL INSTRUMENTS

(a) Determination of fair value

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

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

NOTES TO THE FINANCIAL STATEMENTS

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

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) Level 1: Quoted market price

Financial instruments with quoted prices for identical instruments in active markets.

(ii) Level 2: Valuation technique using observable inputs

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

(iii) Level 3: Valuation technique with significant non-observable inputs

Financial instruments valued using models where one or more significant inputs are not observable.

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

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

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.

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

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.

- Derivatives

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

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

- 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.

NOTES TO THE FINANCIAL STATEMENTS

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

Analysis of fair value determination

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

| | Group | | | | | |
|--|----------------------|-------------------------|--|-------------------|-----------------------------|---------|
| | Valuation techniques | | | Third party total | Amounts with HSBC entities* | Total |
| | quoted market price | using observable inputs | with significant non-observable inputs | | | |
| 2010 | | | | | | |
| Assets | | | | | | |
| Trading assets | 24,840 | 1,215 | – | 26,055 | – | 26,055 |
| Financial assets designated at fair value | 818 | 2,245 | 510 | 3,573 | 3,541 | 7,114 |
| Derivative financial instruments | 721 | 4,161 | 106 | 4,988 | 605 | 5,593 |
| Available-for-sale financial investments | 25,207 | 117,568 | 283 | 143,058 | – | 143,058 |
| Liabilities | | | | | | |
| Trading liabilities | 18,991 | 23,037 | 553 | 42,581 | – | 42,581 |
| Financial liabilities designated at fair value | – | 457 | – | 457 | – | 457 |
| Derivative financial instruments | 96 | 4,034 | – | 4,130 | 553 | 4,683 |
| 2009 | | | | | | |
| Assets | | | | | | |
| Trading assets | 64,476 | 2,121 | – | 66,597 | – | 66,597 |
| Financial assets designated at fair value | 216 | 1,192 | 696 | 2,104 | 3,346 | 5,450 |
| Derivative financial instruments | 511 | 4,156 | – | 4,667 | 383 | 5,050 |
| Available-for-sale financial investments | 59,895 | 132,490 | 448 | 192,833 | – | 192,833 |
| Liabilities | | | | | | |
| Trading liabilities | 12,932 | 24,703 | 756 | 38,391 | – | 38,391 |
| Financial liabilities designated at fair value | – | 1,456 | – | 1,456 | – | 1,456 |
| Derivative financial instruments | 92 | 2,845 | – | 2,937 | 1,314 | 4,251 |

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

| | Bank | | | | | |
|--|----------------------|-------------------------|--|-------------------|-----------------------------|---------|
| | Valuation techniques | | | Third party total | Amounts with HSBC entities* | Total |
| | quoted market price | using observable inputs | with significant non-observable inputs | | | |
| 2010 | | | | | | |
| Assets | | | | | | |
| Trading assets | 24,840 | 392 | – | 25,232 | – | 25,232 |
| Financial assets designated at fair value | – | 148 | – | 148 | – | 148 |
| Derivative financial instruments | 717 | 3,784 | – | 4,501 | 525 | 5,026 |
| Available-for-sale financial investments | 24,176 | 78,894 | 36 | 103,106 | – | 103,106 |
| Liabilities | | | | | | |
| Trading liabilities | 18,991 | 10,831 | 284 | 30,106 | – | 30,106 |
| Financial liabilities designated at fair value | – | – | – | – | – | – |
| Derivative financial instruments | 95 | 3,742 | – | 3,837 | 691 | 4,528 |
| 2009 | | | | | | |
| Assets | | | | | | |
| Trading assets | 64,476 | 812 | – | 65,288 | – | 65,288 |
| Financial assets designated at fair value | – | 174 | – | 174 | – | 174 |
| Derivative financial instruments | 510 | 4,115 | – | 4,625 | 291 | 4,916 |
| Available-for-sale financial investments | 55,446 | 101,236 | 33 | 156,715 | – | 156,715 |
| Liabilities | | | | | | |
| Trading liabilities | 12,932 | 21,537 | 602 | 35,071 | – | 35,071 |
| Financial liabilities designated at fair value | – | 1,003 | – | 1,003 | – | 1,003 |
| Derivative financial instruments | 92 | 2,765 | – | 2,857 | 1,323 | 4,180 |

* Included structured instrument and derivative contracts transacted with HSBC entities which were mainly classified within level 2 of the valuation hierarchy.

NOTES TO THE FINANCIAL STATEMENTS

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

| | Group | | | | | | |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|
| | Assets | | | | Liabilities | | |
| | Available- for-sale | Held for trading | Designated at fair value through profit or loss | Derivatives | Held for trading | Designated at fair value through profit or loss | Derivatives |
| At 1 January 2010 | 448 | – | 696 | – | 756 | – | – |
| Total gains or losses recognised in profit and loss | (1) | – | 47 | 14 | 14 | – | – |
| Total gains or losses recognised in other comprehensive income | 12 | – | – | – | – | – | – |
| Purchases | 20 | – | 165 | – | – | – | – |
| Issues/deposits taking | – | – | – | – | 1,528 | – | – |
| Sales | – | – | (21) | – | – | – | – |
| Settlements | (9) | – | (80) | 92 | (2,110) | – | – |
| Transfers out | (397) | – | (425) | – | (685) | – | – |
| Transfers in | 210 | – | 128 | – | 1,044 | – | – |
| Exchange adjustments | – | – | – | – | 6 | – | – |
| At 31 December 2010 | 283 | – | 510 | 106 | 553 | – | – |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date | 16 | – | 52 | 13 | 8 | – | – |

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

| | Group | | | | | | |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|
| | Assets | | | | Liabilities | | |
| | Available- for-sale | Held for trading | Designated at fair value through profit or loss | Derivatives | Held for trading | Designated at fair value through profit or loss | Derivatives |
| At 1 January 2009 | 137 | – | 217 | – | 2,338 | – | – |
| Total gains or losses recognised in profit and loss | (3) | – | 14 | – | 310 | – | – |
| Total gains or losses recognised in other comprehensive income | 1 | – | – | – | – | – | – |
| Purchases | 1 | – | 56 | – | – | – | – |
| Issues/deposits taking | – | – | – | – | 951 | – | – |
| Sales | (5) | – | (9) | – | – | – | – |
| Settlements | – | – | – | – | (1,629) | – | – |
| Transfers out | – | – | – | – | (1,211) | – | – |
| Transfers in | 317 | – | 418 | – | – | – | – |
| Exchange adjustments | – | – | – | – | (3) | – | – |
| At 31 December 2009 | 448 | – | 696 | – | 756 | – | – |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date | 10 | – | 14 | – | 326 | – | – |

NOTES TO THE FINANCIAL STATEMENTS

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

| | Bank | | | | | | |
|---|------------------------|---------------------|---|-------------|---------------------|---|-------------|
| | Assets | | | | Liabilities | | |
| | Available- for-sale | Held for trading | Designated at fair value through profit or loss | Derivatives | Held for trading | Designated at fair value through profit or loss | Derivatives |
| At 1 January 2010 | 33 | - | - | - | 602 | - | - |
| Total gains or losses recognised in profit and loss | - | - | - | - | 11 | - | - |
| Total gains or losses recognised in other comprehensive income | 3 | - | - | - | - | - | - |
| Purchases | - | - | - | - | - | - | - |
| Issues/deposits taking | - | - | - | - | 1,018 | - | - |
| Sales | - | - | - | - | - | - | - |
| Settlements | - | - | - | - | (1,662) | - | - |
| Transfers out | - | - | - | - | (685) | - | - |
| Transfers in | - | - | - | - | 1,000 | - | - |
| Exchange adjustments | - | - | - | - | - | - | - |
| At 31 December 2010 | 36 | - | - | - | 284 | - | - |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date | 5 | - | - | - | 9 | - | - |

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

| | Bank | | | | | | |
|--|--------------------|------------------|---|-------------|------------------|---|-------------|
| | Assets | | | | Liabilities | | |
| | Available-for-sale | Held for trading | Designated at fair value through profit or loss | Derivatives | Held for trading | Designated at fair value through profit or loss | Derivatives |
| At 1 January 2009 | 34 | – | – | – | 2,338 | – | – |
| Total gains or losses recognised in profit and loss | – | – | – | – | 309 | – | – |
| Total gains or losses recognised in other comprehensive income | (1) | – | – | – | – | – | – |
| Purchases | – | – | – | – | – | – | – |
| Issues/deposits taking | – | – | – | – | 798 | – | – |
| Sales | – | – | – | – | – | – | – |
| Settlements | – | – | – | – | (1,629) | – | – |
| Transfers out | – | – | – | – | (1,211) | – | – |
| Transfers in | – | – | – | – | – | – | – |
| Exchange adjustments | – | – | – | – | (3) | – | – |
| At 31 December 2009 | 33 | – | – | – | 602 | – | – |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date | 5 | – | – | – | 325 | – | – |

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

For held-for-trading liabilities, transfers into and out of Level 3 were primarily due to change in valuation observability of equity correlation during the year.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under “Trading income”.

The income statement line item “Net income/(expense) from financial instruments designated at fair value” captures fair value movements on all other financial instruments designated at fair value and related derivatives (including long-term subordinated notes issued).

Realised gains and losses from available-for-sale securities are presented under “Gains less losses from financial investments and fixed assets” in the income statement while unrealised gains and losses are presented in “Fair value changes taken to/(from) equity” within “Available-for-sale investment reserve” in other comprehensive income.

NOTES TO THE FINANCIAL STATEMENTS

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

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

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

| | Group | | | |
|---|-----------------------------------|-----------------------------|----------------------------|-----------------------------|
| | Reflected in profit/(loss) | | Reflected in equity | |
| | favourable changes | unfavourable changes | favourable changes | unfavourable changes |
| 2010 | | | | |
| Derivatives/trading assets/trading liabilities | 1 | (1) | – | – |
| Financial assets/liabilities designated at fair value | 51 | (51) | – | – |
| Available-for-sale financial investments | – | – | 28 | (28) |
| 2009 | | | | |
| Derivatives/trading assets/trading liabilities | – | – | – | – |
| Financial assets/liabilities designated at fair value | 70 | (70) | – | – |
| Available-for-sale financial investments | – | – | 45 | (45) |
| | | | | |
| | Bank | | | |
| | Reflected in profit/(loss) | | Reflected in equity | |
| | favourable changes | unfavourable changes | favourable changes | unfavourable changes |
| 2010 | | | | |
| Derivatives/trading assets/trading liabilities | – | – | – | – |
| Financial assets/liabilities designated at fair value | – | – | – | – |
| Available-for-sale financial investments | – | – | 4 | (4) |
| 2009 | | | | |
| Derivatives/trading assets/trading liabilities | – | – | – | – |
| Financial assets/liabilities designated at fair value | – | – | – | – |
| Available-for-sale financial investments | – | – | 3 | (3) |

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

Changes in fair value recorded in the income statement

The following table details changes in fair values recognised in 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 | |
|---|-------|------|------|------|
| | 2010 | 2009 | 2010 | 2009 |
| Recorded profit: | | | | |
| Derivatives/trading assets/trading liabilities | 28 | 310 | 11 | 309 |
| Financial assets/liabilities designated at fair value | 47 | 14 | – | – |

Fair value of financial instruments not carried at fair value

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

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

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

(i) Loans and advances to customers

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

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

NOTES TO THE FINANCIAL STATEMENTS

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

(ii) Financial investments

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

(iii) Deposits and customer accounts

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

(iv) Debt securities in issue and subordinated liabilities

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

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

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

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

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

Assets

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

Liabilities

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

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

62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(b) Fair value

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

| | Group | | | |
|--|-----------------|------------|-----------------|------------|
| | 2010 | | 2009 | |
| | Carrying amount | Fair value | Carrying amount | Fair value |
| Financial Assets | | | | |
| Placings with and advances to banks and other financial institutions | 110,564 | 110,570 | 104,551 | 104,551 |
| Advances to customers | 472,637 | 474,045 | 344,621 | 346,459 |
| Held-to-maturity debt securities | 56,301 | 58,327 | 48,669 | 49,805 |
| Financial Liabilities | | | | |
| Current, savings and other deposit accounts | 683,628 | 683,732 | 636,369 | 636,435 |
| Deposits from banks | 15,586 | 15,586 | 4,870 | 4,870 |
| Certificates of deposit and other debt securities in issue | 3,095 | 3,104 | 1,826 | 1,859 |
| Subordinated liabilities | 11,848 | 12,761 | 9,320 | 9,041 |

| | Bank | | | |
|--|-----------------|------------|-----------------|------------|
| | 2010 | | 2009 | |
| | Carrying amount | Fair value | Carrying amount | Fair value |
| Financial Assets | | | | |
| Placings with and advances to banks and other financial institutions | 52,131 | 52,136 | 65,624 | 65,624 |
| Advances to customers | 423,074 | 424,514 | 299,179 | 301,054 |
| Financial Liabilities | | | | |
| Current, savings and other deposit accounts | 649,144 | 649,249 | 612,014 | 612,080 |
| Deposits from banks | 15,585 | 15,585 | 4,469 | 4,469 |
| Certificates of deposit and other debt securities in issue | 3,095 | 3,104 | 1,826 | 1,859 |
| Subordinated liabilities | 11,848 | 12,761 | 9,320 | 9,041 |

63. COMPARATIVE FIGURES

As a result of the adoption of the amendments to HKAS 17 "Leases", certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2010.

64. IMMEDIATE AND ULTIMATE HOLDING COMPANIES

The immediate and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

65. APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 28 February 2011.

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF HANG SENG BANK LIMITED

(Incorporated in Hong Kong with limited liability)

We have audited the consolidated financial statements of Hang Seng Bank Limited ("the Bank") and its subsidiaries (together "the Group") set out on pages 98 to 249, which comprise the consolidated and the Bank balance sheets as at 31 December 2010, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information.

DIRECTORS' RESPONSIBILITY FOR THE CONSOLIDATED FINANCIAL STATEMENTS

The directors of the Bank are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. This report is made solely to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Bank and of the Group as at 31 December 2010 and of the Group's profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

KPMG

Certified Public Accountants

8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong

28 February 2011

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

These notes set out on pages 251 to 272 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 98 to 249. The consolidated financial statements and these supplementary notes taken together comply with the Banking (Disclosure) Rules (the "Disclosure Rules") made under section 60A of the Banking Ordinance.

1. BASIS OF PREPARATION

(a) Except where indicated otherwise, the financial information contained in these supplementary notes has been prepared on a consolidated basis in accordance with Hong Kong Financial Reporting Standards. Some parts of these supplementary notes, however, are required by the Disclosure Rules to be prepared on a different basis. In such cases, the Disclosure Rules require that certain information is prepared on a basis which excluded some of the subsidiaries of the Bank.

Further information regarding subsidiaries that are not included in the consolidation for regulatory purpose is set out in note 2 to the supplementary notes to the financial statements.

(b) The accounting policies applied in preparing these supplementary notes are the same as those applied in preparing the consolidated financial statements for the year ended 31 December 2010 as set out in note 4 to the financial statements.

2. CAPITAL ADEQUACY

(a) Capital adequacy ratios

The capital adequacy ratios as at 31 December 2010 are computed on the consolidated basis of the Bank and certain of its subsidiaries as specified by the Hong Kong Monetary Authority for its regulatory purposes, and are in accordance with the Banking (Capital) Rules ("the Capital Rules") of the Hong Kong Banking Ordinance.

From 1 January 2009, the Group has migrated to the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. The Group continued to use the standardised (operational risk) approach to calculate its operational risk. For market risk, an internal model approach is adopted for calculating general market risk, while standardised (market risk) approach is adopted for calculating specific interest rate risk and equity risk. There are no changes in the approaches used in 2010. In addition, there is no relevant capital shortfall in any of the Group's subsidiaries which are not included in its consolidation group for regulatory purposes.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

2. CAPITAL ADEQUACY (continued)

(a) Capital adequacy ratios (continued)

The capital base after deductions used in the calculation of capital adequacy ratios as at 31 December and reported to Hong Kong Monetary Authority is analysed as follows:

| | 2010 | 2009 |
|---|---------------|---------------|
| Core capital: | | |
| Paid-up ordinary share capital | 9,559 | 9,559 |
| – Reserves per balance sheet | 56,820 | 45,032 |
| – Unconsolidated subsidiaries | (6,268) | (5,251) |
| – Cash flow hedging reserve | (72) | (174) |
| – Regulatory reserve | (1,654) | (920) |
| – Reserves arising from revaluation of property and unrealized gains on available-for-sale equities and debt securities | (13,585) | (7,868) |
| – Own credit spread | – | (31) |
| Total reserves included in core capital | 35,241 | 30,788 |
| – Goodwill and intangible assets | (1,019) | (561) |
| – 50% of unconsolidated investments | (9,725) | (6,999) |
| – 50% of securitisation positions and other deductions | (158) | (331) |
| Deductions | (10,902) | (7,891) |
| Total core capital | 33,898 | 32,456 |
| Supplementary capital: | | |
| – Term subordinated debt | 11,848 | 10,354 |
| – Property revaluation reserves ¹ | 5,894 | 3,732 |
| – Available-for-sale investments revaluation reserves ² | 396 | 498 |
| – Regulatory reserve ³ | 182 | 101 |
| – Collective impairment allowances ³ | 77 | 81 |
| – Excess impairment allowances over expected losses ⁴ | 306 | – |
| Supplementary capital before deductions | 18,703 | 14,766 |
| – 50% of unconsolidated investments | (9,725) | (6,999) |
| – 50% per cent of securitisation positions and other deductions | (158) | (331) |
| Deductions | (9,883) | (7,330) |
| Total supplementary capital | 8,820 | 7,436 |
| Capital base⁵ | 42,718 | 39,892 |
| Risk-weighted assets | | |
| – credit risk | 274,969 | 212,434 |
| – market risk | 1,615 | 1,278 |
| – operational risk | 36,853 | 39,017 |
| | 313,437 | 252,729 |
| – Capital adequacy ratio ⁵ | 13.6% | 15.8% |
| – Core capital ratio ⁵ | 10.8% | 12.8% |
| Reserves and deductible items | | |
| Published reserves | 31,741 | 29,034 |
| Profit and loss account | 3,500 | 1,754 |
| Total reserves included in core capital⁵ | 35,241 | 30,788 |
| Total of items deductible 50% from core capital and 50% from supplementary capital | 19,766 | 14,660 |

2. CAPITAL ADEQUACY (continued)

(a) Capital adequacy ratios (continued)

- 1 Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with Banking (Capital) rules.
- 2 Includes adjustments made in accordance with Banking (Capital) rules.
- 3 Total regulatory reserve and collective impairment allowances are apportioned between the standardised approach and internal ratings-based approach in accordance with Banking (Capital) rules. Those apportioned to the standardised approach are included in supplementary capital. Those apportioned to the internal ratings-based approach are excluded from supplementary capital.
- 4 Excess impairment allowances over expected losses are applicable to non-securitisation exposures calculated by using the internal ratings-based approach.
- 5 The 2009 capital base, risk-weighted assets and capital ratios have not been restated for the effects of HKAS 17 "Leases".

(b) Basis of consolidation

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

Hang Seng Bank (Trustee) Limited
Hang Seng Bank Trustee International Limited
Hang Seng Futures Limited
Hang Seng General Insurance (Hong Kong) Company Limited
Hang Seng Insurance Company Limited
Hang Seng Insurance (Bahamas) Limited
Hang Seng Investment Management Limited
Hang Seng Investment Services Limited
Hang Seng Life Limited
Hang Seng (Nominee) Limited
Hang Seng Securities Limited

The Group operates subsidiaries in a number of countries and territories where capital will be governed by local rules and there may be restrictions on the transfer of regulatory capital and funds between members of the banking group.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

3. CREDIT RISK CAPITAL REQUIREMENTS

The table below shows the capital requirements for credit risk for each class and subclass of exposures as specified in the Capital Rules.

| | 2010 | 2009 |
|--|---------------|---------------|
| Subject to internal ratings-based approach | | |
| Sovereign exposures | 294 | 128 |
| Bank exposures | 2,592 | 2,270 |
| Corporate exposures | 13,538 | 9,943 |
| Residential mortgages to individuals and property-holding shell companies | 527 | 663 |
| Qualifying revolving retail exposures | 970 | 825 |
| Small business retail exposures | 9 | 8 |
| Other retail exposures to individuals | 295 | 340 |
| Other exposures | 1,184 | 969 |
| Securitisation exposures | – | – |
| Equity exposures | – | – |
| Total capital requirements for credit risk under internal ratings-based approach | 19,409 | 15,146 |
| Subject to standardised (credit risk) approach | | |
| On-balance sheet | | |
| Sovereign exposures | – | – |
| Public sector entity exposures | 174 | 89 |
| Multilateral development bank exposures | – | – |
| Bank exposures | 4 | – |
| Securities firm exposures | – | – |
| Corporate exposures | 938 | 312 |
| Collective investment scheme exposures | 4 | 4 |
| Cash items | – | – |
| Regulatory retail exposures | 128 | 152 |
| Residential mortgage loans | 671 | 701 |
| Other exposures which are not past due exposures | 354 | 399 |
| Past due exposures | 22 | 48 |
| Total capital requirements for on-balance sheet exposures | 2,295 | 1,705 |
| Off-balance sheet | | |
| Direct credit substitutes | 187 | 36 |
| Transaction-related contingencies | 3 | 2 |
| Trade-related contingencies | – | 6 |
| Forward asset purchases | 4 | 3 |
| Partly paid-up shares and securities | – | – |
| Forward deposits placed | – | – |
| Unconditionally cancellable commitments | – | – |
| Other commitments | 83 | 82 |
| Exchange rate contracts | 10 | 11 |
| Interest rate contracts | 1 | – |
| Equity contracts | 5 | 4 |
| OTC derivative transactions and credit derivative contracts subject to valid bilateral netting agreements | – | – |
| Other off-balance exposures which are not elsewhere specified | – | – |
| Total capital requirements for off-balance sheet exposures | 293 | 144 |
| Total capital requirements for credit risk under standardised (credit risk) approach | 2,588 | 1,849 |
| Total capital requirements for credit risk | 21,997 | 16,995 |

The capital requirement is made by multiplying the Group's risk-weighted amount derived from the relevant calculation approach by 8 per cent. It does not reflect the Group's actual regulatory capital.

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH

(a) The internal rating system

(i) Nature of exposures within each internal ratings-based (“IRB”) class

The Group adopted advanced IRB approach for the majority of its business with effect from 1 January 2009. The following exposures are subject to IRB approach:

- Corporate exposures include exposures to global large corporates, local large corporates, middle market corporates and small and medium-sized enterprises, non-bank financial institutions and specialised lending.
- Sovereign exposures include exposures to sovereign governments, central monetary institutions and relevant international organisations.
- Bank exposures include exposures to banks and regulated securities firms.
- Retail exposures include residential mortgages, qualifying revolving retail exposures, small business retail exposures and other retail exposures.
- Other exposures mainly include notes and coins, premises, plant and equipment and other fixed assets.

(ii) Structure of risk rating systems and control mechanisms

The Group’s exposure to credit risk arises from a wide range of asset classes, customers and product types. To measure and manage the risk in these exposures, both to individually assessed customers and to those aggregated into portfolios, the Group employs diverse risk rating systems and methodologies: judgmental, analytical, and hybrids of the two. The main characteristics of the Group’s credit risk rating systems are set out below.

A fundamental principle of the Group’s policy and approach is that analytical risk rating systems and scorecards are tools at the disposal of management, serving ultimately judgemental decisions for which individual approvers are accountable. In case of automated decision marking process, accountability rests with those responsible for the parameters built into those processes/systems and the controls surrounding their use. For individually assessed customers, the credit process provides for at least annual review of the facility granted. Review may be more frequent, as required by circumstances.

The Group adopts a set of standards that govern the process through which risk rating systems are developed, judged fit for purpose, approved and implemented, the conditions under which analytical risk model outcomes can be overridden by approvers and the process of model performance monitoring and reporting. The framework ensures an effective dialogue between business line and risk management, suitable independence of decision takers and a good understanding and robust challenge of senior management.

Analytical risk rating systems are not static and are subject to review and modification in light of the changing environment and the availability or quality of data. Processes are established to capture the relevant data for continuous model improvement.

(iii) Application of IRB parameters

The Group-wide credit risk rating framework incorporates probability of default (“PD”, representing the likelihood of a default event in a one-year horizon) of an obligor and loss severity expressed in terms of exposures at default (“EAD”, an estimate of exposures at time of default) and loss given default (“LGD”, the estimates of loss that the Group may incur in the event of default expressed as a percentage of EAD). These measures are used to calculate expected loss and capital requirements. They are also used in conjunction with other inputs to form rating assessments for the purpose of credit approval and for risk management decisions.

For corporate and bank exposures, PD models are developed based on historical loss data, combining financial statistics and expert inputs on various aspects such as industry environment, financial trend and quality assessment on the companies. PD model for sovereign exposures incorporates both quantitative and qualitative data from a wide range of reference sources on economic, political, financial and social conditions. For wholesale business (includes corporate, bank and sovereign exposures), obligor PD is estimated using a Customer Risk Rating of 23 grades (for bank and sovereign) or 22 grades (for corporate), of which 21 and 20 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. Credit score generated by a model and/or a scorecard for individual obligor is recommended to and reviewed by credit approver taking into account all relevant information to the risk rating determination.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(a) The internal rating system (continued)

(iii) Application of IRB parameters (continued)

LGD and EAD estimation for wholesale business is subject to Group framework of basic principles. EAD is estimated to a 12-month horizon and broadly represents the current exposure plus an estimate for future draw down on undrawn facilities and the crystallization of contingent exposures after default. LGD focuses on the facility and collateral structure which takes into account the priority/seniority of the facility, the type and value of the collateral and past experience on the type of counterparty, which is expressed as a percentage of EAD.

The Group uses supervisory slotting criteria approach in rating its regulatory specialised lending exposure. Under this approach, rating will be assigned based on the borrower and transaction characteristics.

For retail business including residential mortgage exposures, qualifying revolving retail exposures, small business retail exposures and other retail exposures, a wide range of application and behavioural models used in the management of retail portfolios has been supplemented to develop the credit models for measuring PD, EAD and LGD under the IRB approach. The PD models typically incorporates the characteristics of the products and the borrower's account behaviour.

EAD models are developed for retail revolving exposures to predict additional drawdown at the time of default, plus current outstanding balance. For non-revolving retail exposures such as residential mortgage, EAD is mainly estimated based on current outstanding balance.

LGD models for retail exposures are developed based on the Group's internal loss and default experience including recovery values for different types of collaterals for secured retail exposures such as residential mortgage; For unsecured retail exposures such as qualifying revolving retail exposures, LGD models are developed based on past recovery experiences, account behaviours and repayment ability.

(iv) Model governance

Model governance is under the Credit Risk Analytics Oversight Committee (CRAOC), whose responsibilities are to oversee the governance, including development, validation and monitoring of risk rating models. The CRAOC is chaired by the Chief Risk Officer and its memberships include heads of business groups and finance function.

Internal Audit conducts regular reviews of the risk rating model application by business groups.

(v) Use of internal ratings

While internal estimates derived from applying the IRB approach are employed in the calculation of risk-weighted exposure amounts for the purpose of determining regulatory capital requirements, they are also used in a multitude of contexts within risk management and business processes. Such uses continue to develop and become embedded as experience grows and the repository of quality data improves. They include:

- credit approval: authorities, including those for specific counterparty types and transactions, are delegated to officers and executives in the Group's credit risk function and business division involving lending activities using a risk-based approach, tiered relative to obligor customer risk rating;
- credit risk analytical tools: IRB measures are valuable tools deployed in the assessment of customer and portfolio risk; migration of customer risk rating becomes an important indicator in credit monitoring process;
- pricing: customer relationship managers apply a risk adjusted return on capital methodology in risk-weighted assets and profitability calculators;
- portfolio management: regular reports to Risk Management Committee, Audit Committee containing analyses of risk exposures employing IRB risk metrics, e.g. by customer segment and credit quality grade;
- economic capital: IRB risk measures are essential components of the credit risk economic capital model, which are evaluated in the capital adequacy assessment process of the Group; and
- stress testing: IRB risk measures are stressed to understand the sensitivities of the Group's capital and business plans under adverse economic environment.

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(a) The internal rating system (continued)

(vi) Credit risk mitigation

The Group's approach when granting credit facilities is on the basis of capacity to repay, rather than primarily rely on credit risk mitigation. Depending on a customer's standing and the type of product, facilities may be provided on unsecured basis. Nevertheless, mitigation of credit risk is an important aspect of effective management and takes in many forms.

The Group's general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Policies covering the acceptability, structuring, control and valuation with regard to different types of collateral security are established to ensure that they are supported by evidence and continue to fulfil their intended purpose.

The main types of recognised collateral taken by the Group are those as stated in section 80 of the Capital Rules, including (but not limited to) cash on deposit, gold bullion, equities listed in a main index and/or a recognised exchange, collective investment schemes, various recognised debt securities, residential, industrial and commercial property, etc.

The Group's policy provides that netting is only to be applied where it has the legal right to do so. Consistent with the Capital Rules, only bilateral netting arrangements are included for capital adequacy credit risk mitigation calculation.

In terms of the application within advanced IRB approach, credit risk mitigants are considered in two broad categories: first, those which reduce the intrinsic probability of default of an obligor and therefore operate as adjustments to PD estimation, and second, those which affect estimated recoverability of obligations and require adjustment of LGD. The first includes, for example, full parental or group company guarantees; the second, collateral security of various kinds such as cash, equity, properties, fixed assets such as motor vehicles, plant and machinery, stock and debtors, bank and sovereign guarantees, etc.

(b) Exposures subject to supervisory estimates

The following table indicates the exposure classes and the respective exposure amounts that are subject to supervisory estimates as at 31 December:

| | 2010 | 2009 |
|---------------------------|---------------|---------------|
| IRB Exposure Class | | |
| Sovereign exposures | – | – |
| Bank exposures | – | – |
| Corporate exposures | 28,609 | 19,468 |
| Total EAD | 28,609 | 19,468 |

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(c) Exposures by IRB calculation approach

The table below shows the Group's exposures:

| | Advanced IRB approach | Supervisory slotting criteria approach | Retail IRB approach | Specific risk-weight approach | Total exposures |
|---|-----------------------|--|---------------------|-------------------------------|-----------------|
| 2010 | | | | | |
| Sovereign exposures | 52,338 | – | – | – | 52,338 |
| Bank exposures | 229,460 | – | – | – | 229,460 |
| Corporate exposures | 263,358 | 28,609 | – | – | 291,967 |
| Retail exposures: | | | | | |
| – Residential mortgages to individuals and property-holding shell companies | – | – | 137,445 | – | 137,445 |
| – Qualifying revolving retail exposures | – | – | 60,551 | – | 60,551 |
| – Small business retail exposures | – | – | 4,100 | – | 4,100 |
| – Other retail exposures to individuals | – | – | 8,313 | – | 8,313 |
| Other exposures | – | – | – | 22,418 | 22,418 |
| | 545,156 | 28,609 | 210,409 | 22,418 | 806,592 |
| 2009 | | | | | |
| Sovereign exposures | 76,116 | – | – | – | 76,116 |
| Bank exposures | 209,757 | – | – | – | 209,757 |
| Corporate exposures | 187,790 | 19,468 | – | – | 207,258 |
| Retail exposures: | | | | | |
| – Residential mortgages to individuals and property-holding shell companies | – | – | 121,912 | – | 121,912 |
| – Qualifying revolving retail exposures | – | – | 50,321 | – | 50,321 |
| – Small business retail exposures | – | – | 3,398 | – | 3,398 |
| – Other retail exposures to individuals | – | – | 8,597 | – | 8,597 |
| Other exposures | – | – | – | 15,023 | 15,023 |
| | 473,663 | 19,468 | 184,228 | 15,023 | 692,382 |

(d) Exposures by credit risk mitigation used

The table below shows the Group's exposures (after the effect of any on-balance sheet or off-balance sheet recognised netting) which are covered by recognised guarantees after the application of haircuts required under the Capital Rules. These exposures exclude OTC derivative transactions.

| | 2010 | 2009 |
|---------------------|----------------|----------------|
| Portfolio | | |
| Bank exposures | 28,492 | 35,591 |
| Corporate exposures | 78,647 | 66,843 |
| Retail exposures | 16,314 | 15,722 |
| | 123,453 | 118,156 |

For the class of sovereign exposures, there were no exposures covered by recognised guarantees.

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(e) Risk assessment for exposures under IRB approach

The tables below detail the total EAD of sovereign, bank and corporate exposures by exposure-weighted average risk-weight, exposure-weighted average PD and exposure-weighted average LGD for each obligor grade as at 31 December.

(i) Sovereign, bank and corporate (other than specialised lending) exposures – analysis by obligor grade

The exposure of default disclosed below in respect of sovereign, bank and corporate exposures have taken into account the effect of recognised collateral and recognised guarantees.

| | 2010 | | | Exposure at default |
|--|--------------------------------|---------------------------------|---|---------------------|
| | Exposure-weighted average PD % | Exposure-weighted average LGD % | Exposure-weighted average risk-weight % | |
| Sovereign exposure | | | | |
| Minimal default risk | 0.01 | 10.38 | 1.03 | 33,968 |
| Low default risk | 0.07 | 44.84 | 18.12 | 18,370 |
| | | | | <u>52,338</u> |
| Bank exposure | | | | |
| Minimal default risk | 0.03 | 22.45 | 4.80 | 45,397 |
| Low default risk | 0.10 | 31.20 | 13.27 | 158,272 |
| Satisfactory default risk | 0.30 | 32.62 | 29.18 | 21,799 |
| Fair default risk | 1.33 | 34.52 | 64.42 | 3,133 |
| Moderate default risk | 2.65 | 33.38 | 81.29 | 434 |
| Significant default risk | 5.79 | 30.55 | 98.13 | 365 |
| High default risk | 12.70 | 46.37 | 209.15 | 60 |
| | | | | <u>229,460</u> |
| Corporate exposure (other than specialised lending) | | | | |
| Minimal default risk | 0.04 | 40.86 | 14.89 | 19,419 |
| Low default risk | 0.11 | 42.82 | 27.66 | 89,764 |
| Satisfactory default risk | 0.38 | 45.15 | 55.26 | 79,364 |
| Fair default risk | 1.29 | 42.29 | 88.19 | 32,163 |
| Moderate default risk | 2.97 | 39.94 | 112.23 | 36,637 |
| Significant default risk | 6.98 | 43.59 | 160.10 | 1,779 |
| High default risk | 12.54 | 41.58 | 192.26 | 1,674 |
| Special management | 19.31 | 35.92 | 187.67 | 547 |
| Default | 100.00 | 53.01 | – | 2,011 |
| | | | | <u>263,358</u> |

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(e) Risk assessment for exposures under IRB approach (continued)

(i) Sovereign, bank and corporate (other than specialised lending) exposures – analysis by obligor grade (continued)

| | 2009 | | | Exposure at default |
|--|--------------------------------|---------------------------------|---|---------------------|
| | Exposure-weighted average PD % | Exposure-weighted average LGD % | Exposure-weighted average risk-weight % | |
| Sovereign exposure | | | | |
| Minimal default risk | 0.01 | 10.08 | 0.93 | 68,919 |
| Low default risk | 0.06 | 44.60 | 13.30 | 7,197 |
| | | | | <u>76,116</u> |
| Bank exposure | | | | |
| Minimal default risk | 0.03 | 23.53 | 5.15 | 55,748 |
| Low default risk | 0.08 | 29.63 | 12.18 | 123,971 |
| Satisfactory default risk | 0.24 | 31.75 | 26.97 | 25,212 |
| Fair default risk | 1.02 | 42.32 | 74.49 | 4,620 |
| Moderate default risk | 2.58 | 31.18 | 73.69 | 136 |
| Significant default risk | 5.07 | 24.56 | 73.18 | 36 |
| High default risk | 12.83 | 20.53 | 92.89 | 34 |
| | | | | <u>209,757</u> |
| Corporate exposure (other than specialised lending) | | | | |
| Minimal default risk | 0.04 | 38.63 | 14.99 | 19,552 |
| Low default risk | 0.10 | 45.00 | 25.58 | 56,105 |
| Satisfactory default risk | 0.40 | 43.29 | 53.32 | 54,318 |
| Fair default risk | 1.22 | 42.79 | 87.93 | 26,202 |
| Moderate default risk | 2.99 | 40.86 | 116.44 | 20,468 |
| Significant default risk | 6.30 | 44.63 | 160.51 | 5,112 |
| High default risk | 12.74 | 49.13 | 235.09 | 2,431 |
| Special management | 26.51 | 41.82 | 214.06 | 1,364 |
| Default | 100.00 | 51.91 | – | 2,238 |
| | | | | <u>187,790</u> |

(ii) Corporate exposures (specialised lending) – analysis by supervisory rating grade

| | 2010 | | 2009 | |
|----------------------|---|----------------------|---|---------------------|
| | Exposure-weighted average risk-weight % | Exposure at default | Exposure-weighted average risk-weight % | Exposure at default |
| Obligor Grade | | | | |
| Strong | 66.15 | 22,532 | 64.32 | 14,460 |
| Good | 91.29 | 4,332 | 91.02 | 3,488 |
| Satisfactory | 121.90 | 1,745 | 121.90 | 1,520 |
| Weak | – | – | – | – |
| | | <u>28,609</u> | | <u>19,468</u> |

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(e) Risk assessment for exposures under IRB approach (continued)

(iii) Retail exposures – analysis by credit quality

The table below shows a breakdown of exposures (the EAD of on-balance sheet exposures and off-balance sheet exposures) on a pool basis by credit quality classification:

| | Residential mortgages | Qualifying revolving retail exposures | Small business retail exposures | Other retail exposures | Total exposures |
|--------------|-----------------------|---------------------------------------|---------------------------------|------------------------|-----------------|
| 2010 | | | | | |
| Strong | 136,621 | 51,821 | 4,085 | 6,319 | 198,846 |
| Medium | 557 | 8,434 | – | 1,912 | 10,903 |
| Sub-standard | – | 286 | – | 52 | 338 |
| Impaired | 267 | 10 | 15 | 30 | 322 |
| | 137,445 | 60,551 | 4,100 | 8,313 | 210,409 |
| 2009 | | | | | |
| Strong | 120,465 | 42,897 | 3,327 | 6,412 | 173,101 |
| Medium | 996 | 7,075 | 56 | 2,076 | 10,203 |
| Sub-standard | – | 336 | – | 79 | 415 |
| Impaired | 451 | 13 | 15 | 30 | 509 |
| | 121,912 | 50,321 | 3,398 | 8,597 | 184,228 |

(iv) Undrawn commitments

The table below shows the amount of undrawn commitments and exposure-weighted average EAD for sovereign, bank and corporate exposures as at 31 December 2010:

| | 2010 | | 2009 | |
|---------------------|---------------------|-------------------------------|---------------------|-------------------------------|
| | Undrawn commitments | Exposure-weighted average EAD | Undrawn commitments | Exposure-weighted average EAD |
| Sovereign exposures | – | – | – | – |
| Bank exposures | 738 | 378 | 803 | 303 |
| Corporate exposures | 109,653 | 39,456 | 81,348 | 32,029 |
| | 110,391 | 39,834 | 82,151 | 32,332 |

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(f) Analysis of actual loss and estimates

The table below shows the actual losses which represent the net charges (including write-offs and impairment loss allowances) made during the year.

| | 2010 | 2009 |
|-----------------------------|------------|------------|
| Exposure Class | | |
| Sovereign | – | – |
| Bank | (10) | 10 |
| Corporate | 346 | 413 |
| Residential mortgage | (45) | (59) |
| Qualifying revolving retail | 332 | 463 |
| Other retail | 51 | 131 |
| | 674 | 958 |

The actual loss in 2010 improved since overall economic conditions further improved in 2010.

The table below shows the expected loss which is the estimated future loss over a one-year time horizon for different exposure classes under IRB approach.

| | 31 December 2009 | 31 December 2008 |
|-----------------------------|---------------------|---------------------|
| Exposure Class | | |
| Sovereign | 3 | 2 |
| Bank | 77 | 191 |
| Corporate | 2,203 | 2,141 |
| Residential mortgage | 156 | 231 |
| Qualifying revolving retail | 347 | 301 |
| Other retail | 158 | 107 |
| | 2,944 | 2,973 |

It should be noted that actual loss and expected loss are measured and calculated using different methodologies which may not be directly comparable. The limitation arises mainly from the fundamental differences in the definition of “loss” under expected loss calculation which is derived based on regulatory rules and actual loss includes write-offs and impairment loss allowances.

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(f) Analysis of actual loss and estimates (continued)

The tables below set out the comparison of the predicted risk estimates of the Group's credit risk models against actual outcomes of the wholesale and retail exposures.

(i) Wholesale exposures

Risk estimates as at 31 December 2009 against actual outcome for the year 2010

| | PD | | LGD | | EAD | |
|--------------------|----------|--------------|----------|-------------|----------|-------------|
| | Actual % | Estimated* % | Actual % | Estimated % | Actual % | Estimated % |
| Sovereign exposure | – | 0.04 | – | 13.34 | – | 100.00 |
| Bank exposure | – | 0.71 | – | 28.55 | – | 98.22 |
| Corporate exposure | 0.23 | 1.54 | 34.95 | 44.75 | 80.22 | 79.08 |

* Remarks: Estimated PD has excluded default customers as of 31 Dec 2009

Risk estimates as at 31 December 2008 against actual outcome for the year 2009

| | PD | | LGD | | EAD | |
|--------------------|----------|-------------|----------|-------------|----------|-------------|
| | Actual % | Estimated % | Actual % | Estimated % | Actual % | Estimated % |
| Sovereign exposure | – | 0.07 | – | 15.95 | – | 100.00 |
| Bank exposure | – | 0.56 | 76.35 | 30.53 | 100.00 | 99.84 |
| Corporate exposure | 1.38 | 4.10 | 46.82 | 45.21 | 72.66 | 83.34 |

The actual PD rate is measured by using the number of obligor defaulted during the reporting period whereas the estimated PD rate is the long run average default rate estimated at the beginning of the reporting period. The PD estimated by internal model is calibrated to the Group's long run default experience. Hence, actual default rate in a particular year ("point-in-time") will typically differ from the estimated PD which is the "through the cycle" estimates as economies move above or below cyclical norms.

The predicted LGD is the exposure weighted average LGD for the portfolio, adjusted by a downturn factor, as of the beginning of the reporting period whereas the actual LGD is computed using the resolved default cases accumulated in 2010 which covers cases defaulted before 2010. No default and loss has been observed for Bank and Sovereign exposures during the reporting period.

The estimated EAD% represents the ratio of total model estimated exposure values to total limits for the portfolio at the beginning of the reporting period. The actual EAD% compares the realised EAD of the defaulted and resolved cases in 2010 against the limits 1 year prior to default.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

4. CREDIT RISK UNDER THE INTERNAL RATINGS-BASED APPROACH (continued)

(f) Analysis of actual loss and estimates (continued)

(ii) Retail exposures

Risk estimates as at 31 December 2009 against actual outcome for the year 2010

| | PD | | LGD | | EAD | |
|---|-------------|-----------------|-------------|----------------|-------------|----------------|
| | Actual % | Estimated* % | Actual % | Estimated % | Actual % | Estimated % |
| Residential mortgages to individuals and property-holding shell companies | 0.20 | 0.66 | 0.61 | 10.39 | 89.46 | 100.00 |
| Qualifying revolving retail exposures | 0.36 | 0.61 | 89.82 | 85.40 | 87.90 | 95.26 |
| Small business retail exposures | 0.40 | 0.60 | 0.29 | 11.58 | 93.31 | 100.00 |
| Other retail exposures to individuals | 1.79 | 2.60 | 63.99 | 63.43 | 68.69 | 93.97 |

* Remarks: Estimated PD has excluded default customers as of 31 Dec 2009

Risk estimates as at 31 December 2008 against actual outcome for the year 2009

| | PD | | LGD | | EAD | |
|---|-------------|----------------|-------------|----------------|-------------|----------------|
| | Actual % | Estimated % | Actual % | Estimated % | Actual % | Estimated % |
| Residential mortgages to individuals and property-holding shell companies | 0.34 | 1.68 | 3.34 | 11.24 | 93.33 | 100.00 |
| Qualifying revolving retail exposures | 0.70 | 0.73 | 89.56 | 86.17 | 89.35 | 85.00 |
| Small business retail exposures | 0.87 | 1.43 | 0.05 | 11.48 | 92.06 | 100.00 |
| Other retail exposures to individuals | 3.64 | 4.20 | 63.86 | 70.93 | 64.30 | 98.71 |

As there may be different portfolios reported under one retail asset class, portfolios with no default since model implementation are excluded from the estimated and actual comparison of the asset class concerned to eliminate distortion.

The actual and estimated PD rate are measured in the same ways as wholesale exposure.

The actual LGD for the retail exposures takes into account the 24-months recovery period and represents the realised LGD for cases defaulted during 2008 which were recovered within 24 months after default. The predicted LGD is the exposure weighted average LGD for the defaulted cases estimated prior to default. The actual LGD for qualifying revolving retail exposures in 2010 are slightly higher than the estimation since the recovery period covered the post-Financial Tsunami downturn period. The recent default data will be reflected in the review of internal models going forward.

The estimated EAD% represents the ratio of total model estimated EAD to total limits for cases defaulted during 2010 whereas the actual EAD% compares the exposure values of the cases defaulted in 2010 at the time of default against the maximum limit 1 year prior to default.

5. CREDIT RISK UNDER THE STANDARDISED (CREDIT RISK) APPROACH

(a) Ratings from External Credit Assessment Institutions (“ECAIs”)

The Group uses the following ECAIs to calculate its capital adequacy requirements under the standardised (credit risk) approach prescribed in the Capital Rules:

- Fitch Ratings
- Moody’s Investors Service
- Standard & Poor’s Ratings Services, and
- Rating and Investment Information, Inc.

Where exposures have been rated by the above-mentioned ECAIs, they are categorised under the following class of exposures:

- Sovereign exposures
- Public sector entity exposures
- Multilateral development bank exposures
- Bank exposures
- Securities firm exposures
- Corporate exposures
- Collective investment scheme exposures

The process used to map ECAIs issuer ratings or ECAIs issue specific ratings in the Group’s banking book is consistent with those prescribed in the Capital Rules.

(b) Credit risk mitigation

As stated in sections 98 and 99 of the Capital Rules, certain guarantees and credit derivative contracts are recognised for credit risk mitigation purposes. The main types of guarantees are from sovereigns, corporate and banks. With corporate guarantees, in order for it to be recognised as a credit risk mitigants, it must have a credit rating of A- or better by Standard & Poor’s Ratings Services, Fitch Ratings and Rating and Investment Information, Inc, or a credit rating of A3 or better by Moody’s Investors Service.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

5. CREDIT RISK UNDER THE STANDARDISED (CREDIT RISK) APPROACH (continued)

(c) Credit risk exposures under the standardised (credit risk) approach

| 2010 Class of exposures | Total exposures* | Exposures after recognised credit risk mitigation | | Risk-weighted amounts | | Total risk- weighted amounts | Total exposures covered by recognised collateral | Total exposures covered by recognised guarantees or recognised credit derivative contracts |
|---|---------------------|---|---------------|-----------------------|---------------|------------------------------------|--|---|
| | | Rated | Unrated | Rated | Unrated | | | |
| On-balance sheet | | | | | | | | |
| Sovereign | – | – | 1,147 | – | – | – | – | – |
| Public sector entity | 16,103 | 16,003 | 104 | 2,153 | 21 | 2,174 | – | – |
| Multilateral development bank | 21,761 | 21,761 | – | – | – | – | – | – |
| Bank | 185 | – | 185 | – | 46 | 46 | – | – |
| Securities firm | – | – | – | – | – | – | – | – |
| Corporate | 13,959 | 16 | 11,726 | 3 | 11,726 | 11,729 | 1,098 | 1,119 |
| Collective investment scheme | 53 | – | 53 | – | 53 | 53 | – | – |
| Cash items | – | – | – | – | – | – | – | – |
| Regulatory retail | 2,997 | – | 2,131 | – | 1,599 | 1,599 | 838 | 28 |
| Residential mortgage loan | 14,682 | – | 14,644 | – | 8,392 | 8,392 | 34 | 4 |
| Other exposures which are not past due exposures | 7,747 | – | 4,426 | – | 4,426 | 4,426 | 3,321 | – |
| Past due exposures | 188 | – | 188 | – | 272 | 272 | 11 | – |
| | 77,675 | 37,780 | 34,604 | 2,156 | 26,535 | 28,691 | 5,302 | 1,151 |
| Off-balance sheet | | | | | | | | |
| Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts | 3,637 | 19 | 3,457 | – | 3,471 | 3,471 | 161 | 3 |
| OTC derivative contracts | 224 | 2 | 222 | – | 211 | 211 | – | – |
| Credit derivative contracts | – | – | – | – | – | – | – | – |
| Other off-balance sheet exposures not elsewhere specified | – | – | – | – | – | – | – | – |
| | 3,861 | 21 | 3,679 | – | 3,682 | 3,682 | 161 | 3 |
| Total | 81,536 | 37,801 | 38,283 | 2,156 | 30,217 | 32,373 | 5,463 | 1,154 |
| Exposures deducted from capital base | – | – | – | – | – | – | – | – |

* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

5. CREDIT RISK UNDER THE STANDARDISED (CREDIT RISK) APPROACH (continued)

(c) Credit risk exposures under the standardised (credit risk) approach (continued)

| | Total exposures* | Exposures after recognised credit risk mitigation | | Risk-weighted amounts | | Total risk-weighted amounts | Total exposures covered by recognised collateral | Total exposures covered by recognised guarantees or recognised credit derivative contracts |
|---|------------------|---|---------|-----------------------|---------|-----------------------------|--|--|
| | | Rated | Unrated | Rated | Unrated | | | |
| 2009 | | | | | | | | |
| Class of exposures | | | | | | | | |
| On-balance sheet | | | | | | | | |
| Sovereign | - | - | 2,002 | - | - | - | - | - |
| Public sector entity | 14,882 | 14,327 | 69 | 1,107 | 14 | 1,121 | - | 490 |
| Multilateral development bank | 16,094 | 16,094 | - | - | - | - | - | - |
| Bank | 39 | - | 39 | - | 12 | 12 | - | - |
| Securities firm | - | - | - | - | - | - | - | - |
| Corporate | 11,974 | 397 | 3,502 | 198 | 3,701 | 3,899 | 6,644 | 1,431 |
| Collective investment scheme | 48 | - | 48 | - | 48 | 48 | - | - |
| Cash items | - | - | - | - | - | - | - | - |
| Regulatory retail | 2,721 | - | 2,529 | - | 1,896 | 1,896 | 111 | 81 |
| Residential mortgage loan | 14,256 | - | 14,239 | - | 8,753 | 8,753 | 13 | 4 |
| Other exposures which are not past due exposures | 5,435 | - | 4,987 | - | 4,987 | 4,987 | 448 | - |
| Past due exposures | 400 | - | 400 | - | 598 | 598 | 4 | - |
| | 65,849 | 30,818 | 27,815 | 1,305 | 20,009 | 21,314 | 7,220 | 2,006 |
| Off-balance sheet | | | | | | | | |
| Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts | 2,070 | 129 | 1,602 | 26 | 1,573 | 1,599 | 339 | 14 |
| OTC derivative contracts | 196 | 3 | 193 | 1 | 183 | 184 | - | - |
| Credit derivative contracts | - | - | - | - | - | - | - | - |
| Other off-balance sheet exposures not elsewhere specified | - | - | - | - | - | - | - | - |
| | 2,266 | 132 | 1,795 | 27 | 1,756 | 1,783 | 339 | 14 |
| Total | 68,115 | 30,950 | 29,610 | 1,332 | 21,765 | 23,097 | 7,559 | 2,020 |
| Exposures deducted from capital base | - | | | | | | | |

* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

6. COUNTERPARTY CREDIT RISK-RELATED EXPOSURES

(a) In respect of counterparty credit risk exposures which arises from over-the-counter (“OTC”) derivative transactions and repo-style transactions (referred as “relevant transaction”) hereunder, credit limit to counterparty credit risk arising from the relevant transaction is assigned, monitored and reported in accordance with the Group risk methodology. The credit limit established takes into account the gross contract amount and the future potential exposure measured on the basis of 95 percentile potential worst case loss estimates for the product involved. This method of calculating credit limit applies to all counterparties.

Credit equivalent amount and risk-weighted amount of relevant transaction is determined following the regulatory capital requirements. Risk-weighted amount is calculated in accordance with the counterparty risk weighting as per internal ratings-based approach/standardised (credit risk) approach under the Capital Rules.

The policy for secured collateral on derivatives is guided by the Group’s internal Best Practice Guidelines ensuring the due-diligence necessary to fully understand the effectiveness of netting and collateralisation by jurisdiction, counterparty, product and agreement type is fully assessed and that the due-diligence standards are high and consistently applied. The Group’s policies for establishing provisions are discussed in note 4(f) – Loan impairment.

(b) Counterparty credit risk exposures

The following tables show the counterparty credit risk exposures under the internal-ratings based approach and standardised (credit risk) approach. There was no outstanding repo-style transactions and credit derivative contracts at 31 December 2010 (2009: Nil).

(i) Counterparty credit risk exposures under the internal-ratings based approach

| | 2010 | 2009 |
|---|--------------|--------|
| OTC derivative transactions: | | |
| Gross total positive fair value which are not repo-style transactions | 4,589 | 4,398 |
| Credit equivalent amount | 6,799 | 10,135 |
| Value of recognised collateral by type: | | |
| Debt securities | – | – |
| Others | – | – |
| | – | – |
| Credit equivalent amount or net credit exposures net of recognised collateral held | 6,799 | 10,135 |
| Risk-weighted amount | 2,657 | 1,499 |
| Notional amount of recognised credit derivative contracts which provide credit protection | – | – |

(ii) Counterparty credit risk exposures under the standardised (credit risk) approach

| | 2010 | 2009 |
|---|------------|------|
| OTC derivative transactions: | | |
| Gross total positive fair value which are not repo-style transactions | 98 | 119 |
| Credit equivalent amount | 224 | 196 |
| Value of recognised collateral by type: | | |
| Debt securities | – | – |
| Others | – | – |
| | – | – |
| Credit equivalent amount or net credit exposures net of recognised collateral held | 224 | 196 |
| Risk-weighted amount | 211 | 184 |
| Notional amount of recognised credit derivative contracts which provide credit protection | – | – |

6. COUNTERPARTY CREDIT RISK-RELATED EXPOSURES (continued)

(c) Major classes of exposures by counterparty type

(i) Major classes of exposures under the internal ratings-based approach by counterparty type

| | 2010 | | | 2009 | | |
|------------------------|-----------------|--------------------------|----------------------|-----------------|--------------------------|----------------------|
| | Contract amount | Credit equivalent amount | Risk-weighted amount | Contract amount | Credit equivalent amount | Risk-weighted amount |
| Sovereign | - | - | - | - | - | - |
| Public sector entities | - | - | - | - | - | - |
| Banks | 703,961 | 4,212 | 521 | 582,150 | 9,081 | 878 |
| Corporates | 125,370 | 2,587 | 2,136 | 37,478 | 1,054 | 621 |
| | 829,331 | 6,799 | 2,657 | 619,628 | 10,135 | 1,499 |

(ii) Major classes of exposures under the standardised (credit risk) approach by counterparty type

| | 2010 | | | 2009 | | |
|------------------------|-----------------|--------------------------|----------------------|-----------------|--------------------------|----------------------|
| | Contract amount | Credit equivalent amount | Risk-weighted amount | Contract amount | Credit equivalent amount | Risk-weighted amount |
| Sovereign | - | - | - | - | - | - |
| Public sector entities | 39 | 2 | - | 438 | 3 | 1 |
| Banks | - | - | - | - | - | - |
| Corporates | 9,414 | 222 | 211 | 3,212 | 193 | 183 |
| | 9,453 | 224 | 211 | 3,650 | 196 | 184 |

7. ASSET SECURITISATION

There was no asset securitisation for which the Group is an originating institution or an investing institution at 31 December 2010 (2009: Nil).

8. MARKET RISK

The Hong Kong Monetary Authority has granted approval under section 18(2)(a) and 18(5) of the Capital Rules for the Group to use the internal models approach to calculate its market risk for foreign exchange risk and general interest rate risk. Standardised approach is used for the calculation of specific interest rate risk, equity risk and commodity risk.

| | 2010 | 2009 |
|--|------------|------|
| Market risk calculated by: | | |
| - Internal models approach: | | |
| - foreign exchange exposures and general interest rate exposures | 118 | 91 |
| - Standardised approach: | | |
| - specific interest rate exposures | 10 | 10 |
| - equity exposures | 1 | 1 |
| Total capital charge for market risk | 129 | 102 |

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

9. OPERATIONAL RISK

The Hong Kong Monetary Authority has granted approval under section 25(2) of the Capital Rules for the Group to use the standardised approach to calculate its operational risk.

| | 2010 | 2009 |
|-------------------------------------|-------|-------|
| Capital charge for operational risk | 2,948 | 3,121 |

10. EQUITY EXPOSURES IN BANKING BOOK

Investments in equity shares which are intended to be held on a continuing basis, but which do not comprise investments in associates, jointly controlled entities or subsidiaries, are classified as available-for-sale securities and are reported in the balance sheet as "Financial investments". Available-for-sale securities are measured at fair value as described in notes 4(g)(iii) and 4(n) on the financial statements. Included within this category are investments made by the Group for strategic purposes, which are subject to additional internal procedures and approvals to ensure that the investment is in accordance with the Group's strategy and to ensure compliance with all relevant regulatory and legal restrictions. In some cases, additional investments may be made later such that the investee becomes an associate, jointly controlled entity or subsidiary, at which point the investment is reclassified in accordance with the Group's accounting policies.

| | 2010 | 2009 |
|--|------|------|
| Cumulative realised gains on disposal | 10 | 161 |
| Unrealised gains: | | |
| – recognised in reserve but not through the income statement | 188 | 199 |
| – deducted from the supplementary capital | – | – |

11. DISCLOSURE FOR SELECTED EXPOSURE

(a) Holding of debt securities issued by Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation

The table below shows the Group's exposures to the senior debt securities (AAA rated) issued by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

| | Gross principal | Fair value |
|----------------------------|-----------------|------------|
| At 31 December 2010 | 37 | 38 |
| At 31 December 2009 | 45 | 47 |

The Group did not hold any asset-backed securities, mortgage-backed securities and collateralised debt obligations.

(b) Involvement with Special Purpose Entities (SPEs)

From time to time, the Group enters into certain transactions with customers in the ordinary course of business which involve the establishment of SPEs. The use of SPEs is not a significant part of the Group's activities and the Group is not reliant on SPEs for any material part of its business operations or profitability.

12. ANALYSIS OF GROSS ADVANCES TO CUSTOMERS BY CATEGORIES BASED ON INTERNAL CLASSIFICATION USED BY THE GROUP

Gross advances, impaired advances, individually assessed and collectively assessed loan impairment allowances, the amount of new impairment allowances charged to income statement, and the amount of impaired loans and advances written off during the year in respect of industry sectors which constitute not less than 10 per cent of gross advances to customers are analysed as follows:

| | Group | | | | | |
|--|----------------|-------------------|--|--|---------------------------|--------------------------------------|
| | Gross advances | Impaired advances | Individually assessed loan impairment allowances | Collectively assessed loan impairment allowances | New impairment allowances | Advances written off during the year |
| 2010 | | | | | | |
| Residential mortgages | 135,515 | 149 | – | (55) | 1 | 1 |
| Commercial, industrial and international trade | 119,841 | 1,536 | (1,086) | (506) | 447 | 100 |
| Other property-related lending | 94,060 | 84 | (23) | (36) | 22 | 66 |
| 2009 | | | | | | |
| Residential mortgages | 116,746 | 308 | (5) | (87) | 2 | 2 |
| Commercial, industrial and international trade | 61,676 | 1,615 | (972) | (484) | 520 | 384 |
| Other property-related lending | 63,166 | 256 | (70) | (76) | 25 | 2 |

13. NON-BANK MAINLAND EXPOSURES

The analysis of non-bank Mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the Hong Kong Monetary Authority under the Banking (Disclosure) Rules with reference to the Hong Kong Monetary Authority return for non-bank Mainland exposures, which includes the Mainland exposures extended by the Bank and its overseas branches and overseas subsidiaries only.

| | On-balance sheet exposure | Off-balance sheet exposure | Total exposures | Individually assessed allowances |
|--|---------------------------|----------------------------|-----------------|----------------------------------|
| 2010 | | | | |
| Mainland entities | 20,940 | 6,036 | 26,976 | – |
| Companies and individuals outside Mainland where the credit is granted for use in Mainland | 9,177 | 2,278 | 11,455 | 31 |
| Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure | 738 | 28 | 766 | – |
| | 30,855 | 8,342 | 39,197 | 31 |
| Exposures incurred by the Bank's mainland subsidiary | 36,318 | 40,837 | 77,155 | 229 |
| | 67,173 | 49,179 | 116,352 | 260 |
| 2009 | | | | |
| Mainland entities | 9,241 | 1,911 | 11,152 | – |
| Companies and individuals outside Mainland where the credit is granted for use in Mainland | 6,644 | 2,653 | 9,297 | 50 |
| Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure | 45 | – | 45 | – |
| | 15,930 | 4,564 | 20,494 | 50 |
| Exposures incurred by the Bank's mainland subsidiary | 28,038 | 10,095 | 38,133 | 183 |
| | 43,968 | 14,659 | 58,627 | 233 |

SUPPLEMENTARY NOTES TO THE FINANCIAL STATEMENTS (UNAUDITED)

14. CROSS-BORDER CLAIMS

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

| | Banks & other financial institutions | Public sector entities | Sovereign & other | Total |
|-----------------------------------|---|---------------------------------------|----------------------------------|----------------|
| 2010 | | | | |
| Asia-Pacific excluding Hong Kong: | | | | |
| – China | 75,515 | – | 23,467 | 98,982 |
| – Japan | 4,750 | – | 5,174 | 9,924 |
| – Other | 24,331 | 1,506 | 8,886 | 34,723 |
| | 104,596 | 1,506 | 37,527 | 143,629 |
| The Americas: | | | | |
| – United States | 40,199 | 38 | 5,405 | 45,642 |
| – Other | 2,975 | 1,458 | 12,920 | 17,353 |
| | 43,174 | 1,496 | 18,325 | 62,995 |
| Europe: | | | | |
| – United Kingdom | 24,954 | – | 1,523 | 26,477 |
| – Other | 41,492 | 6,671 | 9,949 | 58,112 |
| | 66,446 | 6,671 | 11,472 | 84,589 |
| 2009 | | | | |
| Asia-Pacific excluding Hong Kong: | | | | |
| – China | 24,034 | – | 16,124 | 40,158 |
| – Japan | 8,320 | – | 45,952 | 54,272 |
| – Other | 37,436 | 589 | 8,140 | 46,165 |
| | 69,790 | 589 | 70,216 | 140,595 |
| The Americas: | | | | |
| – United States | 39,941 | 45 | 10,259 | 50,245 |
| – Other | 4,762 | 694 | 13,005 | 18,461 |
| | 44,703 | 739 | 23,264 | 68,706 |
| Europe: | | | | |
| – United Kingdom | 37,510 | – | 4,066 | 41,576 |
| – Other | 47,799 | 12,454 | 7,990 | 68,243 |
| | 85,309 | 12,454 | 12,056 | 109,819 |

ANALYSIS OF SHAREHOLDERS

| As at 31 December 2010 | Shareholders | | Shares of HK\$5 each | |
|----------------------------------|--------------|---------------------|----------------------|---------------------|
| | Number | Percentage of total | Number in millions | Percentage of total |
| Number of shares held | | | | |
| 1 – 500 | 6,506 | 33.18 | 1.6 | 0.08 |
| 501 – 2,000 | 6,247 | 31.84 | 7.6 | 0.40 |
| 2,001 – 5,000 | 3,271 | 16.68 | 11.2 | 0.59 |
| 5,001 – 20,000 | 2,733 | 13.94 | 27.9 | 1.46 |
| 20,001 – 50,000 | 549 | 2.80 | 17.1 | 0.89 |
| 50,001 – 100,000 | 168 | 0.86 | 12.3 | 0.64 |
| 100,001 – 200,000 | 77 | 0.39 | 10.9 | 0.57 |
| Over 200,000 | 61 | 0.31 | 1,823.2 | 95.37 |
| | 19,612 | 100.00 | 1,911.8 | 100.00 |
| Geographical Distribution | | | | |
| Hong Kong | 19,260 | 98.21 | 1,908.4 | 99.82 |
| Malaysia | 70 | 0.36 | 0.5 | 0.03 |
| Singapore | 47 | 0.24 | 2.0 | 0.11 |
| Macau | 31 | 0.16 | 0.1 | 0.01 |
| Canada | 61 | 0.31 | 0.2 | 0.01 |
| United Kingdom | 36 | 0.18 | 0.1 | 0.00 |
| United States of America | 39 | 0.20 | 0.3 | 0.01 |
| Australia | 37 | 0.19 | 0.1 | 0.00 |
| Others | 31 | 0.15 | 0.1 | 0.01 |
| | 19,612 | 100.00 | 1,911.8 | 100.00 |

SUBSIDIARIES*

Everlasting International Limited
Fulcher Enterprises Company Limited
Full Wealth Investment Limited
Hang Seng Asset Management Pte Ltd
Hang Seng Bank (Bahamas) Limited
Hang Seng Bank (China) Limited
Hang Seng Bank (Trustee) Limited
Hang Seng Bank Trustee International Limited
Hang Seng Bullion Company Limited
Hang Seng Credit Limited
Hang Seng Credit (Bahamas) Limited
Hang Seng Data Services Limited
Hang Seng Finance Limited
Hang Seng Finance (Bahamas) Limited
Hang Seng Financial Information Limited
Hang Seng Futures Limited
Hang Seng General Insurance (Hong Kong) Company Limited
Hang Seng Indexes Company Limited
Hang Seng Insurance Company Limited
Hang Seng Insurance (Bahamas) Limited
Hang Seng Investment Management Limited
Hang Seng Investment Services Limited
Hang Seng Life Limited
Hang Seng (Nominee) Limited
Hang Seng Real Estate Management Limited
Hang Seng Security Management Limited
Hang Seng Securities Limited
Haseba Investment Company Limited
Hayden Lake Limited
High Time Investments Limited
HSI International Limited
Imenson Limited
Mightyway Investments Limited
Silver Jubilee Limited
Yan Nin Development Company Limited

* As defined in Section 2 of Hong Kong Companies Ordinance.

CORPORATE INFORMATION AND CALENDAR

CORPORATE INFORMATION

Honorary Senior Advisor to the Bank

The Honourable Lee Quo-Wei GBM, JP

BOARD OF DIRECTORS

Chairman

Raymond K F Ch'ien GBS, CBE, JP

Vice-Chairman

Margaret Leung JP

Directors

John C C Chan GBS, JP

Marvin K T Cheung GBS, OBE, JP

L Y Chiang

Jenkin Hui

Sarah C Legg

William W Leung BBS, JP

Eric K C Li GBS, OBE, JP

Vincent H S Lo GBS, JP

Mark S McCombe OBE

Dorothy K Y P Sit

Richard Y S Tang BBS, JP

Peter T S Wong JP

Michael W K Wu

Secretary

C C Li

REGISTERED OFFICE

83 Des Voeux Road Central, Hong Kong

Telephone: (852) 2198 1111

Facsimile: (852) 2868 4047

Telex: 73311 73323

SWIFT: HASE HK HH

Website: www.hangseng.com

STOCK CODE

The Stock Exchange of Hong Kong Limited: 11

REGISTRAR

Computershare Hong Kong Investor Services Limited

Shops 1712-1716, 17th Floor, Hopewell Centre

183 Queen's Road East, Wanchai, Hong Kong

DEPOSITARY *

The Bank of New York Mellon

BNY Mellon Shareowner Services

PO Box 358516

Pittsburgh, PA 15252-8516, USA

Telephone: 1-201-680-6825

Toll free (domestic): 1-888-BNY-ADRS

Website: www.bnymellon.com/shareowner

Email: shrrelations@bnymellon.com

* The Bank offers investors in the United States a Sponsored Level-1 American Depositary Receipts Programme through The Bank of New York Mellon.

ANNUAL REPORT 2010

This Annual Report 2010 in both English and Chinese is now available in printed form and on the Bank's website (www.hangseng.com) and the website of Hong Kong Exchanges and Clearing Limited ("HKEX") (www.hkexnews.hk).

Shareholders who:

- A) browse this Annual Report 2010 on the Bank's website and wish to receive a printed copy; or
- B) receive this Annual Report 2010 in either English or Chinese and wish to receive a printed copy in the other language version,

may send a request form, which can be obtained from the Bank's Registrar or downloaded from the Bank's website (www.hangseng.com) or HKEX's website (www.hkexnews.hk), to the Bank's Registrar:

Computershare Hong Kong Investor Services Limited

17M Floor, Hopewell Centre

183 Queen's Road East

Wanchai, Hong Kong

Facsimile: (852) 2529 6087

Email: hangseng@computershare.com.hk

If shareholders who have chosen (or are deemed to have chosen) to read this Annual Report 2010 on the Bank's website have difficulty in reading or gaining access to this Annual Report 2010 via the Bank's website for any reason, the Bank will promptly send this Annual Report 2010 in printed form free of charge upon the shareholders' request.

Shareholders may change their choice of means of receipt or language of the Bank's future corporate communications at any time, free of charge, by giving the Bank c/o the Bank's Registrar reasonable notice in writing or by email to hangseng@computershare.com.hk.

CORPORATE INFORMATION AND CALENDAR

CALENDAR

2010 Full Year Results

Announcement date 28 February 2011

2010 Fourth Interim Dividend*

Announcement date 28 February 2011

Book close and record date 15 March 2011

Payment date 30 March 2011

2010 Annual Report

to be posted to shareholders in late March 2011

Annual General Meeting

to be held on 13 May 2011

2011 Half Year Results

Announcement date 1 August 2011

2011 Interim Report

to be posted to shareholders in late August 2011

Proposed dates for 2011:

2011 First Interim Dividend

Announcement date 3 May 2011

Book close and record date 19 May 2011

Payment date 2 June 2011

2011 Second Interim Dividend

Announcement date 1 August 2011

Book close and record date 17 August 2011

Payment date 1 September 2011

2011 Third Interim Dividend

Announcement date 7 November 2011

Book close and record date 23 November 2011

Payment date 8 December 2011

2011 Full Year Results

Announcement date 27 February 2012

2011 Fourth Interim Dividend

Announcement date 27 February 2012

Book close and record date 14 March 2012

Payment date 29 March 2012

* The Register of Shareholders of the Bank will be closed on Tuesday, 15 March 2011, during which no transfer of shares can be registered. To qualify for the fourth interim dividend, all transfers, accompanied by the relevant share certificates, must be lodged with the Bank's Registrar, Computershare Hong Kong Investor Services Limited, at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, for registration not later than 4:30 pm on Monday, 14 March 2011. The fourth interim dividend will be payable on Wednesday, 30 March 2011 to shareholders on the Register of Shareholders of the Bank on Tuesday, 15 March 2011. Shares of the Bank will be traded ex-dividend as from Friday, 11 March 2011.

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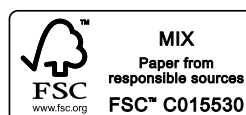
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HANG SENG BANK

HANG SENG BANK LIMITED

83 Des Voeux Road Central, Hong Kong

Member HSBC Group