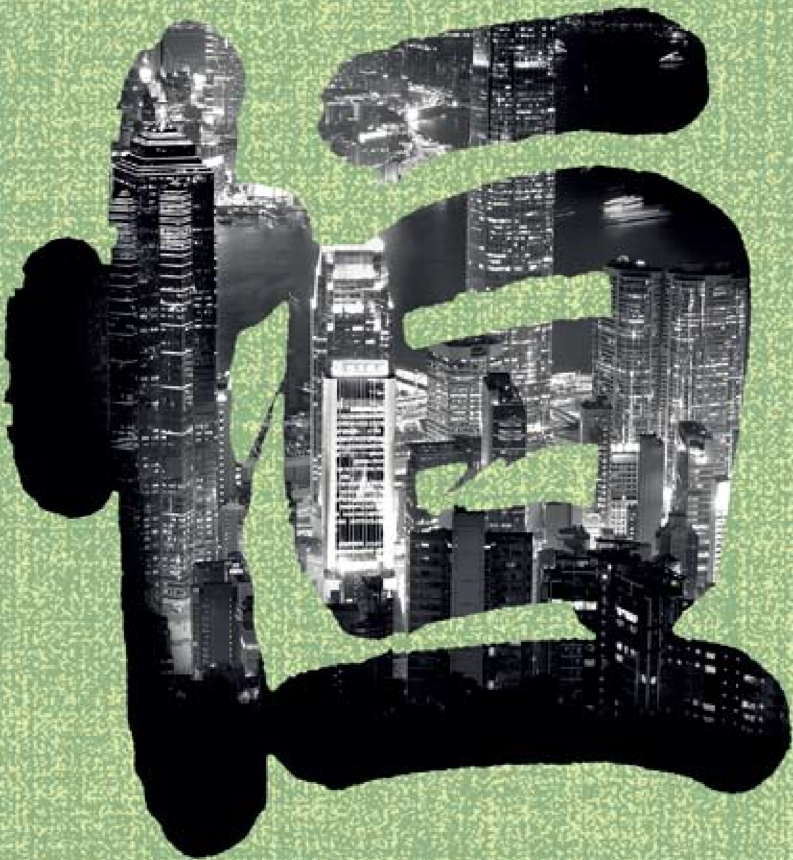
HANG SENG BANK

ANNUAL REPORT 2012



TRUE TO OUR ROOTS

同心同根

Contents

* 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.

Founded in 1933, Hang Seng Bank is one of Hong Kong's largest listed companies and among the 50 largest listed banks in the world in terms of market capitalisation (HK$226.9bn as at the end of December 2012).

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

Established in 2007 and headquartered in Shanghai, wholly owned mainland China subsidiary Hang Seng Bank (China) Limited operates a network of 46 outlets in Beijing, Shanghai, Guangzhou, Shenzhen, Dongguan, Fuzhou, Nanjing, Hangzhou, Ningbo, Tianjin, Kunming, Foshan, Zhongshan, Huizhou, Xiamen, Zhuhai and Jiangmen.

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

80 Years of Service Excellence
用心服務八十年

RATINGS

HANG SENG BANK

MOODY'S INVESTORS SERVICE

Long-term Bank Deposit local and foreign currency Aa2	**Short-term Bank Deposit** local and foreign currency Prime-1
Bank Financial Strength B	**Outlook** Stable

STANDARD & POOR'S

Long-term Counterparty Credit local and foreign currency AA-	**Short-term Counterparty Credit** local and foreign currency A-1+
Outlook Stable	

HANG SENG BANK (CHINA) LIMITED

MOODY'S INVESTORS SERVICE

Long-term Bank Deposit local and foreign currency A3	**Short-term Bank Deposit** local and foreign currency Prime-2
Bank Financial Strength D-	**Outlook** Stable

STANDARD & POOR'S

Long-term Counterparty Credit local and foreign currency AA-	**Short-term Counterparty Credit** local and foreign currency A-1+
Outlook Stable	

Results in Brief

FOR THE YEAR

Operating profit excluding loan impairment charges

15,992 HK$m

2011 : 14,621 HK$m

↗ 9%

Operating profit

15,606 HK$m

2011 : 14,181 HK$m

↗ 10%

Profit before tax

22,113 HK$m

2011 : 19,255 HK$m
(restated)

↗ 15%

Profit attributable to shareholders

19,426 HK$m

2011 : 16,885 HK$m
(restated)

↗ 15%

Earnings per share

10.16 HK$

2011 : 8.83 HK$
(restated)

↗ 15.1%

Dividends per share

5.30 HK$

2011 : 5.20 HK$

↗ 1.9%

AT YEAR-END

Shareholders' funds

92,323 HK$m

2011 : 79,634 HK$m
(restated)

↗ 16%

Total assets

1,077,096 HK$m

2011 : 975,665 HK$m
(restated)

↗ 10%

RATIOS FOR THE YEAR

Return on average shareholders' funds

22.9%

2011 : 22.7%
(restated)

Cost efficiency ratio

34.4%

2011 : 35.0%

Average liquidity ratio

36.9%

2011 : 33.6%

RATIOS AT YEAR-END

Capital adequacy ratio*

14.0%

2011 : 14.3%

Core capital ratio*

12.2%

2011 : 11.6%

* Capital ratios at 31 December 2012 were compiled in accordance with the Banking (Capital) Rules (the "Capital Rules") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II. The Bank used the advanced internal ratings-based 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

	2008 (restated)	2009 (restated)	2010 (restated)	2011 (restated)	2012
FOR THE YEAR	HK$bn	HK$bn	HK$bn	HK$bn	HK$bn
Operating profit	13.6	13.2	14.1	14.2	**15.6**
Profit before tax	15.7	15.4	17.4	19.3	**22.1**
Profit attributable to shareholders	13.9	13.2	15.0	16.9	**19.4**
AT YEAR-END	HK$bn	HK$bn	HK$bn	HK$bn	HK$bn
Shareholders' funds	55.5	62.7	70.7	79.6	**92.3**
Issued and paid up capital	9.6	9.6	9.6	9.6	**9.6**
Total assets	766.2	830.8	917.1	975.7	**1,077.1**
Total liabilities	710.7	768.1	846.4	896.0	**984.8**
PER SHARE	HK$	HK$	HK$	HK$	HK$
Earnings per share	7.29	6.90	7.85	8.83	**10.16**
Dividends per share	6.30	5.20	5.20	5.20	**5.30**
RATIOS	%	%	%	%	%
Post-tax return on average shareholders' funds	24.1	22.7	22.7	22.7	**22.9**
Post-tax return on average total assets	1.8	1.7	1.7	1.8	**1.9**
Capital adequacy ratio*	12.5	15.8	13.6	14.3	**14.0**
Core capital ratio*	9.5	12.8	10.8	11.6	**12.2**
Cost efficiency ratio	29.6	32.6	33.7	35.0	**34.4**

* Capital ratios at 31 December 2012 were compiled in accordance with the Banking (Capital) Rules (the "Capital Rules") under section 98A of the Hong Kong Banking Ordinance for the implementation of Basel II. The Bank used the advanced internal ratings-based 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.

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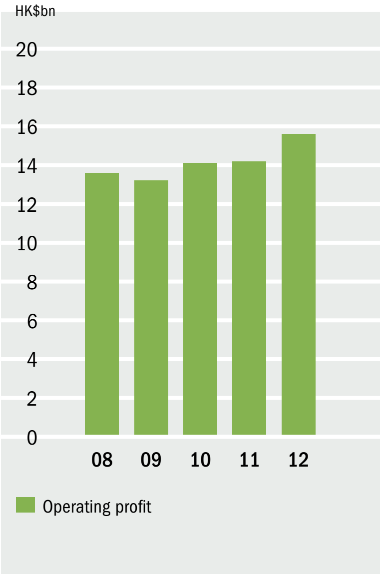
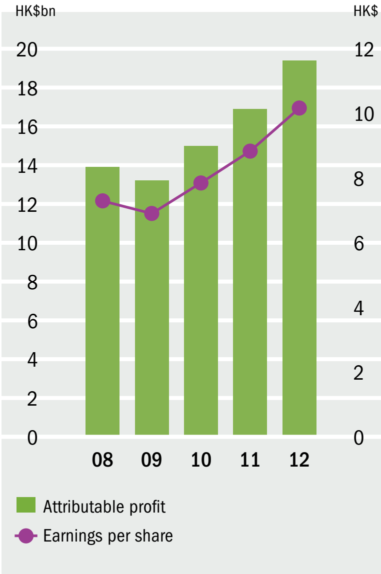
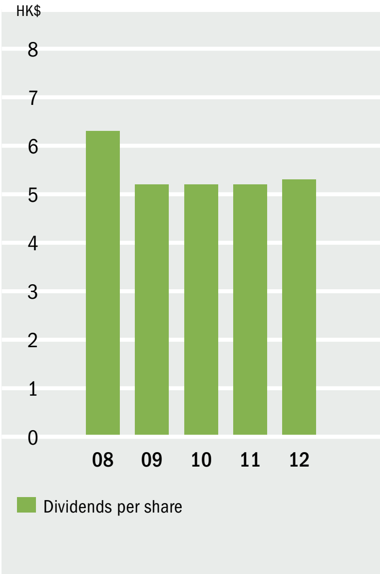
Results



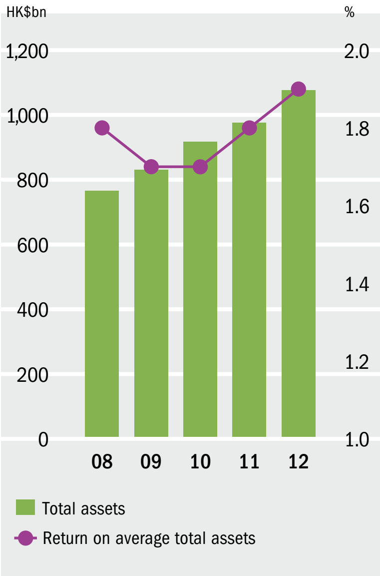
Attributable Profit and Earnings per Share



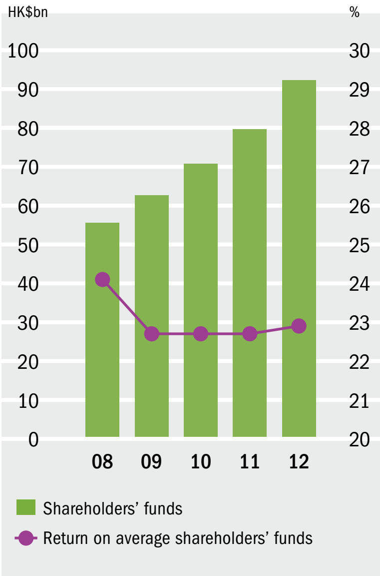
Dividends per Share



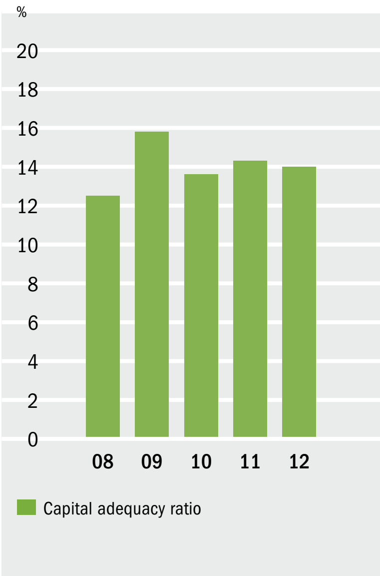
Total Assets and Return on Average Total Assets



Shareholders' Funds and Return on Average Shareholders' Funds



Capital Adequacy Ratio



Chairman's Statement

Amid continuing uncertainty in the global economic environment, Hang Seng remained focused on its long-term strategy for enhancing its position as the leading domestic bank in Hong Kong and achieved good results in 2012.

Our excellent time-to-market capabilities, extensive distribution network and solid financial fundamentals were effective in supporting customers facing challenging market conditions while strengthening our platform for growth.

Assisted by our trusted brand, we increased our penetration of market segments with good long-term business potential and won more clients among target groups with the timely launch of new wealth management and trade-related products. The resulting increase in the customer base helped drive solid growth in deposits.

Innovative services and our tightly interconnected network across Hong Kong and mainland China enhanced our position as a preferred bank in the rapidly developing cross-border trade and renminbi-related sectors.

We continued to expand Hang Seng Bank (China) Limited's service proposition by adding outlets and leveraging our strong Hong Kong franchise – leading to increases in the number of customers and deposits.

Profit attributable to shareholders rose by 15% to HK$19,426m. Earnings per share were up 15% at HK$10.16.

Return on average shareholders' funds was 22.9%, compared with 22.7% in 2011.

The Directors have declared a fourth interim dividend of HK$2.00 per share. This brings the total distribution for 2012 to HK$5.30 per share – up from HK$5.20 in 2011. We remain committed to a dividend policy that strikes a good balance between annual distributions and investment in future growth.

Economic Outlook

Concerns over the continuing financial difficulties in the eurozone and the US fiscal cliff in the second half of 2012 put significant downward pressure on international economic activity.

Weak global export demand constrained Hong Kong's externally oriented economy, resulting in total GDP growth of just 1% for the first three quarters of the year – the lowest level since 2009. Buoyed by investment in large-scale public projects, the favourable employment market and vibrant property sector, robust consumer and investment spending cushioned the impact of subdued international trade, driving a solid rebound in economic expansion during the fourth quarter, resulting in overall growth of 1.4% in 2012.

GDP growth on the Mainland was 7.8% in 2012 – the slowest rate since 1999. External conditions remain a significant obstacle, but Central Government investment in infrastructure and other stimulus measures are driving domestic sector activity. Recent signs indicate that the economy may have bottomed out. GDP growth in the fourth quarter was 7.9% – up from 7.4% in the preceding quarter. We expect further recovery to 8% in 2013, given the moderating effects of global economic headwinds and government concerns over speculation in the property sector.

With the eurozone debt crisis still unresolved and the fragile state of economic recovery in the US, challenging operating conditions will persist in 2013. However, the Mainland is likely to maintain a steady pace of growth. Increasing economic integration in the Greater China region and Hong Kong's continuing development as a leading centre for offshore renminbi financial services will boost business expansion.

We will take full advantage of these opportunities by further leveraging our competitive strengths – including our well-respected brand, diverse range of service channels and excellent cross-border capabilities – to enhance our strong position in key areas of business and acquire new customers to support sustainable growth.

On behalf of the Board, I would like to thank staff at all levels for their hard work, commitment and contribution. I also wish to express the Bank's sincere appreciation to our customers and shareholders for their long-standing support.

This year sees Hang Seng reach its 80th anniversary. As we celebrate this major milestone, we are more determined than ever to uphold our core principles and build on the good progress we have made in our dedicated efforts to provide increasing value for shareholders.

Raymond K.F. Ch'ien

Raymond Ch'ien
Chairman
Hong Kong, 4 March 2013

Chief Executive's Report

Under challenging operating conditions, Hang Seng achieved resilient results in 2012 while investing in our core businesses to drive sustainable growth. Profit attributable to shareholders increased by 15% on the prior year with return on equity reaching 22.9%.

Our balanced growth strategy drove double-digit increases in both deposits and lending, while effective funding cost management contributed to the widening of our net interest margin to 1.85%.

Successful revenue diversification and product cross-sell initiatives contributed to an 8% increase in non-funds income. We achieved revenue growth in life insurance and retail investment fund sales of 49% and 25% respectively, and our overall wealth management income grew by 14%.

Our cost efficiency ratio improved by 0.6 percentage points to 34.4% as a result of revenue growing faster than operating expenses.

The credit quality of our loan portfolio remained sound, with a reduction in loan impairment charges.

Leveraging our good China connectivity and product development strength, we continued to lead the market with innovative offshore renminbi products, including the first renminbi-denominated gold exchange-traded fund to be introduced to the market.

In mainland China, Hang Seng Bank (China) Limited continued to invest in network expansion and leverage the deepening connectivity between the Mainland and Hong Kong. We opened seven new outlets and enhanced cross-border business referral mechanisms. We also established the first joint venture securities investment advisory company in Guangdong province under the Closer Economic Partnership Arrangement (CEPA).

Profit before tax was up 15% at HK$22,113m, reflecting an increase in return from Industrial Bank Co., Ltd. and the disposal gain arising from the sale of our general insurance business in July.

Operating profit rose by 10% to HK$15,606m compared with 2011. Operating profit excluding loan impairment charges increased by 9% to HK$15,992m.

Following our continuing investment for business expansion, operating expenses rose by 6% to HK$8,389m, due mainly to increases in staff compensation and benefits, increased marketing expenditure, and higher rental and depreciation costs.

With the 8% rise in net operating income before loan impairment charges outpacing the increase in operating expenses, our cost efficiency ratio improved to 34.4% – down 0.6 percentage points compared with 2011.

Financial Performance

Total assets grew by HK$101bn, or 10%, to reach HK$1,077bn. Customer advances were up HK$56bn, or 12%, at HK$536bn, due mainly to increases in corporate and commercial lending and residential mortgage loans. Success with acquiring new personal and business customers in target segments helped drive the HK$76bn, or 10%, rise in customer deposits (including certificates of deposit and other debt securities in issue) to HK$819bn.

The return on average total assets was 1.9% – up 0.1 percentage point year on year.

The expansion in customer deposits and lending underpinned a 4% rise in average interest-earning assets. Improved deposit and loan spreads and increased return on the life insurance investment funds portfolio drove the 8% growth in net interest income to HK$16,946m. Net interest margin was 1.85% – an increase of seven basis points.

Net fee income rose by 5% to HK$5,086m. Growth in fee-related revenue from retail investment fund sales as well as credit card, insurance agency and trade-related services business more than offset the drop in fee income from stock broking and related services.

Trading income was up 15% at HK$2,063m. We recorded a net revenue gain from securities, derivatives and other trading activities compared with a net loss in 2011. Increased net income from funding swaps supported the 8% growth in foreign exchange income.

Loan impairment charges were down HK$54m, or 12%, at HK$386m. Loan impairment charges in the second half of 2012 fell by 45% compared with the first half.

Effective credit risk management ensured we maintained good asset quality, resulting in an eight-basis-point improvement in impaired loans as a percentage of gross advances to 0.25%.

Our share of profits from associates rose by 33%, driven largely by the increase in contribution from Industrial Bank. On 8 January, we announced that we will no longer account for Industrial Bank as an associate following its completion of a private placement on 7 January. We will now recognise our holding as a financial investment and will therefore not account for our proportionate share of results and net assets.

On a Basel II basis, our capital adequacy ratio at 31 December 2012 was 14.0%, compared with 14.3% a year earlier. Our core capital ratio was up 0.6 percentage points at 12.2%.

Positioning For Growth

While global macroeconomic uncertainties will persist in 2013, we expect stable economic growth on the Mainland and favourable policy development under CEPA and the Qianhai initiatives. Hong Kong's economy will be underpinned by firm domestic consumption, strong trade and capital flows from the Mainland, and will continue to benefit from initiatives to further promote the internationalisation of the renminbi.

As the leading domestic bank in Hong Kong supported by a strong brand, extensive branch network and a loyal customer base, Hang Seng is well positioned to benefit from China's economic transformation. We will maintain balanced growth in our core businesses, invest in our branch network, delivery channels and product propositions to increase target customer intake and drive wealth management revenues. We will increase connectivity to maximise cross-border opportunities from the closer integration of the Mainland and Hong Kong economies.

In 2013, Hang Seng celebrates its 80th anniversary. Throughout our history, we have upheld the principles of service excellence, integrity and sound business management established by our founders.

Our success over the years rests in large part on the professionalism and passion of our people. I wish to thank them for their ongoing drive and dedication in working to grow our business and ensure we provide a premium service. I would also like to thank our customers for continuing to place their trust in us.

True to our roots, we remain committed to the community we serve through ongoing support for sports promotion, education and care for the aged and disabled, partnering with charitable organisations, and engaging staff volunteers.

We will adhere to a high standard of corporate governance while embracing a proactive approach to business and client management to deliver quality and sustainable growth in the best interests of customers and shareholders.

Rose Lee
Vice-Chairman and Chief Executive
Hong Kong, 4 March 2013

Management Discussion and Analysis

TRUE TO OUR ROOTS

同根 | 同心

This year's theme reflects the close relationship Hang Seng has established with our communities over the past 80 years. In our growth from a small money-changer to Hong Kong's leading domestic bank, values such as professionalism, passion and taking a prudent-yet-progressive approach have earned us the trust of more than 3 million customers. As the mainland China and Hong Kong economies become increasingly integrated, we are well placed to meet the cross-border banking needs of our clients. Remaining true to our roots, we will continue to champion service excellence and work hand-in-hand with our stakeholders as we live up to our name as the 'ever-growing' bank.

Business in Hong Kong

Hang Seng's customer-led business strategy continued to serve us well in a competitive operating environment. With our operational strengths, we deepened existing relationships and established new ones, combining innovation with integrity to deliver service excellence.

Best Domestic Bank in Hong Kong
(for 13th consecutive year)
The Asset

Hong Kong Domestic Cash Management Bank of the Year
Asian Banking and Finance

Hong Kong Domestic Trade Finance Bank of the Year
Asian Banking and Finance

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

This reinforced our leading position for traditional banking services and enhanced our foothold in areas with significant potential for long-term growth.

Our comprehensive range of trade-related services and new renminbi-denominated products proved effective in growing the customer base, particularly among affluent clients and mainland China personal and business customers with cross-border financial needs. Customer deposits, including certificates of deposit and other debt securities in issue, increased by 10.2% to HK$818.8bn.

Leveraging our balance sheet strength, we used our in-depth market and customer knowledge to identify good opportunities to expand lending, resulting in an 8.4% rise in customer advances to HK$423.8bn.

In July, we sold our wholly owned general insurance subsidiary, Hang Seng General Insurance (Hong Kong) Company Limited, allowing us to focus on enhancing the franchise for Hang Seng-branded life insurance solutions while continuing to offer customers a wide array of general insurance products through an exclusive distribution agreement.

Retail Banking and Wealth Management

Retail Banking and Wealth Management achieved a 22.0% increase in profit before tax to HK$7,939m. Excluding the effects of the general insurance disposal gain, profit before tax was up 19.1%. Operating profit excluding loan impairment charges rose by 16.2% to HK$7,836m.

Net interest income rose by 10.6% to HK$8,761m, reflecting increases in deposits, unsecured lending and insurance business. Good growth in wealth management revenue helped drive an 8.8% rise in non-interest income to HK$3,822m.

Continued expansion of the deposits base remained key to our strategy for sustainable growth. Backed by our strong brand, diverse wealth management product portfolio and comprehensive network of service delivery channels, we stepped up efforts to attract new customers and tap new sources of funds. Our broad-ranging actions generated good results, with a 9.1% increase in deposits. The larger deposits base provided additional support for the expansion of lending, which grew by 11.5%.

With our continuing initiatives to acquire quality customers, the numbers of Prestige Banking and Preferred Banking clients increased by 10.7% and 8.3% respectively compared with a year earlier. We developed more mechanisms for strengthening customer relationships, including the implementation of a new wealth management cross-selling structure targeting residential mortgage clients. To enhance the customer experience and attract affluent clients, we developed a new Prestige and Preferred Banking Centre design concept and completed its implementation at a number of our outlets in 2012. We will open more Prestige and Preferred Banking Centres at strategic locations in the years ahead.

We used technology to improve efficiency while providing customers with greater choice and convenience as to where, when and how they manage their financial needs. At 31 December 2012, the number of Personal e-Banking clients had increased by 9.5% compared with the end of 2011.

MILESTONES

Helping customers achieve home ownership with higher returns

As part of our initiatives to help more people achieve their home ownership dreams, in March we launched the Hang Seng RMB/HKD Mortgage-Link Account – Hong Kong's first such dual-currency mortgage plan. RMB/HKD Mortgage-Link Account customers enjoy a preferential interest rate on renminbi and Hong Kong dollar savings that is equal to their mortgage loan interest rate, helping them to more easily offset their mortgage interest expenses. Offering instant access to savings for greater financial flexibility, the account also addresses the growing demand for renminbi-denominated wealth management solutions and further enriches our value-added residential mortgage service.

New mobile device-based services increased our appeal among younger and tech-savvy customer segments. In November, we announced plans to develop an innovative contactless payment channel to provide customers with a fast and secure way to make retail payments using their mobile phones.

Our strong capabilities across multiple high-tech platforms were recognised with a 'Best Business (Application)' Gold Award at the Hong Kong Computer Society's Hong Kong ICT Awards 2012.

Our pioneering initiatives in the rapidly developing market for renminbi-related financial services helped us attract more business from affluent Mainland individuals with cross-border and offshore financial services needs.

We recorded a number of firsts – launching the first renminbi/Hong Kong dollar dual-currency-linked mortgage account and the first renminbi-denominated gold exchange-traded fund (ETF). In August, we became one of the first banks in Hong Kong to offer personal renminbi services to non-Hong Kong residents.

Our continuing efforts to exceed customer expectations through service excellence saw us crowned 'Best Domestic Bank' in Hong Kong for the 13th consecutive year in *The Asset's* Triple A Country Awards.

Wealth management

In uncertain economic conditions, customers continued to rely on our trusted brand and personalised service approach. We worked hard to reward their loyalty, using our expanding range of investment and insurance offerings to provide tailor-made wealth management solutions.

Wealth management income grew by 18.6% to HK$5,328m.

Income from life insurance business increased by 51.4% to HK$2,833m. Leveraging our extensive distribution network, we launched products with innovative features to increase our penetration rates in strategically important customer segments.

Annualised life insurance new premiums rose by 13.3% to HK$2,765m. Total life insurance policies in force grew by 8.7% and proactive management of the life insurance funds investment portfolio resulted in an increased return. Successful new products – including a new retirement solution that aligns with Hong Kong's aging population trend and our first insurance policy to be denominated in renminbi – broadened our range of insurance offerings to keep pace with the changing needs of customers.

Compared with the unfavourable investment performance in 2011, the increase in property investment and favourable investment return on securities helped us improve investment income.

Investment services income was down 4.0% at HK$2,339m. We grew the number of securities accounts, but reduced stock market activity led to a 26.2% decline in investment revenue from stock broking and related services. With subdued investor sentiment, our time-to-market advantage and more gold-related investment options helped maintain business flows. Innovative products contributed to rises in retail investment fund income and turnover of 35.7% and 73.7% respectively, and helped us increase our penetration rate for investment fund business among Prestige Banking clients.

In February, we were named 'Best Local Private Bank in Hong Kong' for the third consecutive year and the best local provider of 'Super Affluent, Net-worth-specific Services' by *Euromoney*.

MILESTONES

Helping SMEs to flourish

Small and medium-sized enterprises embody the Hong Kong 'can-do' spirit and play an important part in our city's economic success. Two new Business Banking Centres and the launch of a Business Mobile Banking platform in 2012 are providing more convenient access to our services – just part of our ongoing efforts to ensure Hong Kong's home-grown businesses continue to flourish.

Consumer finance

We maintained good momentum in the active residential mortgage sector, achieving a 16.4% rise in residential mortgage lending to individuals. We used our value-added service proposition, including the dual currency Hang Seng RMB/HKD Mortgage-Link Account that offers enhanced returns on renminbi savings, to attract target customers. Despite keen market competition, we retained our market share in terms of new mortgage registrations compared with a year earlier.

Total operating income from unsecured lending grew by 7.2% to HK$3,478m.

Effective cross-selling strategies along with the growing customer base underpinned a 5.1% rise in the number of credit cards in issue. Card spending and receivables were up by 10.7% and 9.8% respectively, supporting an 8.0% increase in revenue from credit card business.

The personal loans balance rose by 11.2% compared with a year earlier.

Corporate and Commercial Banking

Corporate and Commercial Banking achieved good growth in asset portfolios and non-funds fee income streams to record a 27.3% increase in profit before tax to HK$5,878m. Excluding the effects of the general insurance disposal gain, profit before tax was up by 23.7%. Operating profit excluding loan impairment charges rose by 17.4% to HK$5,660m.

Net interest income rose by 15.6% to HK$5,289m, underpinned largely by increases in deposits and lending, which both grew by 10.4%. Non-interest income was up 6.2% at HK$2,101m.

We stepped up initiatives to acquire new customers, capitalising on the close connectivity of Hang Seng's Hong Kong and Mainland operations, particularly in southern China, and our network of Mainland strategic alliances. We strengthened the referral pipeline and leveraged our comprehensive suite of trade-related products and services to provide end-to-end financial solutions for customers engaged in cross-border business.

Two new Business Banking Centres, the launch of our Business Mobile Banking platform and a Mainland toll-free direct hotline facilitated access to our services for small and medium-sized enterprise (SME) customers. At the end of 2012, the number of Business e-Banking customers was up 21.1% compared with a year earlier.

We developed new marketing initiatives, including a television commercial campaign for our SME Business Loan. In February, we received the 'Excellent Brand of SME Loan Services' award in Metro Finance's HK Leaders Choice Brand Awards 2012. In May, the Hong Kong General Chamber of Small and Medium Business recognised us as an 'SME's Best Partner' for the seventh consecutive year.

Our efforts drove a 12.8% increase in the customer base. We gained further momentum among Mainland companies, which represented 45.7% of newly acquired customers in the second half of 2012, compared with 34.2% in the first half of the year. Year on year, the number of renminbi accounts was up 25.1%.

The seal, a traditional sign of authenticity, is echoed in modern-day Quick Response (QR) codes. In using the latest technology, our modes of service delivery may change, but our emphasis on providing strong customer assurance remains the same – represented here by the Chinese character for 'trust'.

MILESTONES

Using technology to enhance financial management choice

We employ new technology to provide customers with a growing range of choices for fast, convenient and secure financial management. With Hong Kong consumers each carrying an average of two mobile phones, in November we announced our plans to launch an innovative new mobile phone-based contactless payment channel. Utilising near-field communication (NFC) technology, the service will enable customers to make purchases through their credit card accounts using their NFC-enabled mobile phones at retail payment terminals equipped with contactless readers.

Customers down the generations have relied on our trusted brand for wealth management services. From individual clients to large corporations, we provide financial peace of mind with investment and insurance solutions that are tailored to fit their needs.

Enhancements to our relationship management strategy and improved balance sheet strength supported the expansion of lending in a broad range of industry sectors. We maintained good credit quality.

We made solid progress with diversifying the lending portfolio in terms of loan type, increasing our participation in structured finance and syndicated lending. We ranked as the number two mandated arranger in Hong Kong and Macau in 2012 based on the number of transactions.

Over HK$3.7bn in loan facilities were approved under the SME Financing Guarantee Scheme in the seven months following the Hong Kong Government's introduction of the 80% guarantee protection in June 2012.

At 31 December 2012, renminbi lending had increased by 213.9% compared with a year earlier.

The extended reach of our service delivery network generated new opportunities for client contact. Net fee income was up 18.5% at HK$1,566m, reflecting successful efforts to boost fee revenue from non-funds business. Our strong cross-border capabilities helped drive a 5.4% increase in fee income from trade-related services and a 29.9% rise in revenue from remittance fees.

In August, we were named 'Hong Kong Domestic Cash Management Bank of the Year' and 'Hong Kong Domestic Trade Finance Bank of the Year' by *Asian Banking and Finance*.

Treasury

Treasury recorded a 5.9% decline in profit before tax to HK$2,364m.

Net interest income decreased by 11.3% to HK$1,676m. The low interest rate environment and flattened yield curves offered few opportunities for yield enhancement and constrained re-pricing levels as balance sheet management portfolios matured.

Non-interest income rose by 12.1% to HK$960m.

Trading income increased by 12.5% to HK$988m. With rising customer demand for renminbi-denominated products, we reinforced our position as a market leader with the development and launch of new offerings – including the Hang Seng RMB Gold ETF – helping drive solid growth in option trading income from structured products. Along with faster growth in gross interest income from funding swaps, this more than offset the decline in income from securities and other trading.

Leveraging our trusted brand, we expanded our range of physical gold investment products with the launch of 10oz and 100g Hang Seng Gold Bars with a Chinese New Year Dragon motif. Building on the success of these new products, we introduced God of Wealth-themed bars in the same weights in February 2013.

MILESTONES

Uniting tradition and innovation to serve wealth management needs

We continue to blend innovation and integrity in expanding our portfolio of wealth management products to meet customer needs. Uniting recent rising demand for renminbi-related investments with the long-established investor interest in gold, in February we launched the Hang Seng RMB Gold Exchange-traded Fund (ETF) – the first fund of its kind to be launched to the market and the first renminbi-denominated ETF of any kind in Hong Kong.

Leveraging the strength of our trusted brand, we introduced Dragon-themed 10oz and 100g Hang Seng Gold Bars in January to enhance choice for customers interested in physical gold. In early 2013, we further extended our offerings with God of Wealth-themed bars in the same weights.

Hang Seng Indexes

Widely recognised as the leading compiler of indexes covering Hong Kong and the Mainland, wholly owned subsidiary Hang Seng Indexes Company Limited continued to enhance its profile in 2012, expanding and enriching its service offerings with the launch of new indexes, the licensing of new index-linked funds and new derivatives products.

In June, Hang Seng Indexes launched the Hang Seng Equal Weighted Index and the Hang Seng China Enterprises Equal Weighted Index – which have the same constituents as the Hang Seng Index (HSI) and the Hang Seng China Enterprises Index (H-shares Index) respectively – to offer the market a broader range of investment strategy options. In contrast to the HSI and H-shares Index, which use a freefloat-adjusted market capitalisation weighted methodology, the new indexes use an equal-weighted methodology under which the weightings of individual stocks are all set to equal at market close on the rebalancing date. This approach results in a different industry sector exposure, providing investors with an alternative way to assess the overall performance and risk-return characteristics of companies included in the HSI and the H-shares Index.

In December, the Hang Seng High Dividend Yield Index was launched to track the performance of high-yield stocks and real estate investment trusts which have demonstrated a stable dividend payment record. The index provides a benchmark for investors interested in a less volatile investment portfolio.

New milestones were reached on the Mainland. In June, licences were issued for the first two Mainland ETFs tracking Hong Kong stocks to be linked to the HSI and the H-shares Index respectively. The ETF linked to the HSI was listed on the Shenzhen Stock Exchange and the ETF linked to the H-shares Index was listed on the Shanghai Stock Exchange. A month earlier, the first index fund linked to the Hang Seng China A Industry Top Index was launched on the Mainland – the first Mainland licensing of a fund linked to a Hang Seng Indexes A-share index.

Other developments in 2012 included the commencement of futures trading in Hong Kong based on the HSI Volatility Index and the listing of two ETFs linked to the HSCEI Short Index and the HSCEI Leveraged Index on the Tokyo Stock Exchange.

Hang Seng Indexes now compiles 323 publicly available indexes – 51 real-time and 272 daily indexes – under 62 different index series. This includes six cross-border series offering six real-time and 40 daily indexes. In addition to the Hang Seng Family of Indexes, the company also compiles customised indexes to serve the specific needs of various clients.

The total number of futures and options contracts traded on the HSI and the H-shares Index in 2012 was over 54 million. At 31 December 2012, the total assets of ETFs tracking all indexes in the Hang Seng Family of Indexes was over US$16bn.

Best Local Private Bank in Hong Kong
Euromoney

Best for Super Affluent, Net-worth-specific Services
Euromoney

Trusted Brands Gold Award – Bank (Hong Kong)
Reader's Digest

Trusted Brands Gold Award – Credit Card Issuing Bank (Hong Kong)
Reader's Digest

The Best Corporate Governance Bank of Asia
21st Century Business Herald

Over the past eight decades, we have grown with Hong Kong – embracing change while always upholding our core principles. Just as our globally recognised Hang Seng Index tracks stock movements, we closely monitor market developments to anticipate customer needs as part of our strategy to continually exceed their expectations.

MILESTONES

Supporting the development of Mainland financial markets

Providing support for the development of financial products in mainland China is one important way in which Hang Seng Indexes continues to break new ground in meeting the needs of the investment community. In June, Hang Seng Indexes licensed the first two Mainland exchange-traded funds tracking Hong Kong stocks to be linked to its indexes – the Hang Seng Index and Hang Seng China Enterprises Index respectively. The two funds were issued on the Mainland in August.

Business on the Mainland

We expanded the scope and reach of our mainland China business in 2012, capitalising on the close integration of our Hong Kong and Mainland operations and an increasing awareness of our unique brand strengths. We strategically deployed resources to increase our presence in regions with good long-term growth potential and further enrich our premium service proposition.

The slower pace of economic activity led to greater competition in the operating environment as foreign banks stepped up efforts to maintain revenue flows and market share. We differentiated ourselves from our peers through quality service delivery – providing tailor-made wealth management and trade-related financial solutions to meet the diverse needs of customers.

We progressed with our plan for organic growth through our wholly owned Mainland subsidiary bank, Hang Seng Bank (China) Limited, balancing prudent risk and cost management with investment in our network and human resources. Along with additional staff training and an enhanced product portfolio, the opening of seven new outlets and a 6.3% increase in headcount have strengthened our ability to capitalise on future business opportunities and reach more customers.

We further leveraged our network of strategic alliances and established new ones to offer a wider range of wealth management products and more convenient access to services. Improvements to cross-border customer referral mechanisms provided a valuable source of new business, particularly among corporate and commercial customers.

These efforts drove a 12.6% increase in Hang Seng China's customer base, strengthening our deposits acquisition pipeline and balance sheet.

Net interest income grew by 9%.

Deposits rose by 12.7% and lending increased by 15.5%. We continued to emphasise credit quality over loan portfolio size, focusing on clients offering good potential for generating additional income streams through wealth management and trade services.

We made solid progress with expanding and diversifying non-interest income.

Hang Seng China's total operating income increased by 8.5%, underpinned by the rise in net interest income. Operating expenses increased by 15.3%, due largely to investments in long-term business growth. Together with a net loan impairment charge compared with a net release in 2011, this led to a 28.8% decline in operating profit.

MILESTONES

Hang Seng China opened a new branch in Xiamen in March

Establishing authority as investment advisory services leader

In March, wholly owned subsidiary Hang Seng Securities received approval to establish an investment advisory services joint venture in partnership with Guangzhou Securities Company in Guangdong province under CEPA. In July, Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company became the first such company to commence operations. Compiling analysis reports on securities and securities-related products and conducting market research, the company contributes to the development of the Mainland investment market while building our reputation as a trusted provider of investment-related advice.

Sharing a common cultural heritage, Hong Kong and the Mainland have developed strong economic ties. Backed by our integrated network of outlets and strategic alliances, we provide a premium service that is playing a valuable role in helping customers meet their financial management needs while enhancing the links between Hong Kong and other parts of China.

Business on the Mainland

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

Including the share of profit from Mainland strategic partners, profit before tax from our Mainland business grew by 29.6%, contributing 24.5% of Hang Seng's total profit before tax compared with 21.7% in 2011.

Services

Our expanding network of outlets and strategic alliances provided new opportunities to reach customers in key segments. Targeted brand-building initiatives led to wider recognition of our Greater China experience and expertise, reinforcing our position as a leading provider of wealth management, trade and renminbi-related financial solutions among foreign banks.

In November, our commitment to exceeding the expectations of customers was independently recognised by *Money Weekly*, which awarded us the accolade of 'Most Respected Foreign Bank'.

With a particular focus on affluent individuals, Retail Banking and Wealth Management enhanced its diverse range of investment and insurance offerings, leveraging in part on the product development and time-to-market strengths of our Hong Kong operations and closer collaboration with domestic and foreign insurance companies.

Our personalised and professional approach in assisting customers at different life stages with managing their financial needs in uncertain economic conditions helped drive a 13.3% increase in the customer base, with a 15.5% rise in Prestige Banking clients.

Our series of 'Easy Touch' investment products – which offer enhanced yield investment opportunities with partial capital protection – was recognised as a 'China Top Ten Wealth Management Product' by *Money Weekly*.

In challenging operating conditions for many companies, our cross-border strength and trade-related services helped customers maintain business flows.

We launched new trade and supply chain-related products and services, including renminbi-denominated domestic documentary credits and a new type of renminbi bank-accepted draft offering enhanced terms. More key-person insurance products facilitated better continuity planning for customers while strengthening our reputation for providing one-stop financial solutions.

Leveraging the strong connectivity between our Mainland and Hong Kong operations, we built new momentum in cross-border referrals and collaborations. Facilitated by

our document verification arrangement and innovative video-conferencing channel, we recorded good year-on-year growth in new account openings by Hong Kong-based commercial customers. Overall, the number of Corporate and Commercial Banking clients rose by 2.9%.

In October, we received an award for 'Best Cross Border Trade Settlement' from *China CFO*.

Network

At the end of 2012, Hang Seng China had 46 outlets – 12 branches and 34 sub-branches – in 17 Mainland cities.

In addition to a new branch in Xiamen and sub-branch openings in Beijing Kerry Centre, Tianjin Binhai and Tianjin Jinmen, we established three more cross-city sub-branches in Guangdong – one each in Shunde, Zhuhai and Jiangmen – bringing Hang Seng China's network in the province to 21 outlets in eight cities.

Hang Seng China now operates 63 ATMs and our customers can also 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 to expose potential new customers to our brand.

Other steps to enhance service delivery and support increased sales via self-directed channels included new investment in our online platform.

We continued to benefit from the extended reach provided by our relationships with strategic partners. With our complementary sets of strengths and expertise, our close collaboration with Industrial Bank – particularly in the areas of customer referrals and branch-level initiatives – generated win-win outcomes.

Hang Seng's wholly owned subsidiary, Hang Seng Securities Limited, partnered with Guangzhou Securities Company Limited to open the first joint venture securities investment advisory company to be established in Guangdong under Supplement VI to the Closer Economic Partnership Arrangement (CEPA). Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company Limited, which commenced operations in July 2012, enhances our Mainland service scope and will promote our position as a key Greater China financial services provider.

Future Growth

We will continue with our focused strategy for sustainable growth, targeting regions and market segments that enable us to take advantage of our competitive strengths and actively pursue new business opportunities.

We will make more investments in our infrastructure, systems and people, reinforce internal and external cross-referral channels, and use our premium services and brand-building activities to acquire more customers and further penetrate our existing client base while achieving greater operational efficiency.

The acquisition of deposits will remain central to our strategy for strengthening our platform for long-term business expansion.

A growing number of Mainland businesses and affluent clients are looking for new investment opportunities domestically and in Hong Kong. Leveraging our time-to-market advantage, we will launch more wealth management products and services to meet the needs of these customers.

Backed by the interconnectedness of our Hong Kong and Mainland operations and comprehensive range of trade-related services, our growing market coverage in Guangdong sees us well placed to capture an increasing share of cross-border business. We will capitalise on the rapidly expanding opportunities provided by CEPA and other Central Government initiatives while playing our part in promoting closer economic ties in the southern China region.

2012 Most Respected Foreign Bank in China
Money Week

Best Cross Border Trade Settlement Award
CFO World

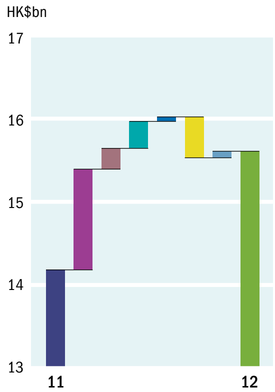
Most Popular Foreign Bank of the Year
Hexun

Best Foreign Wealth Management Service of the Year
National Business Daily

Most Competitive Award for Financial Innovation of the Year - International Category
Nanfang Daily

Financial Review

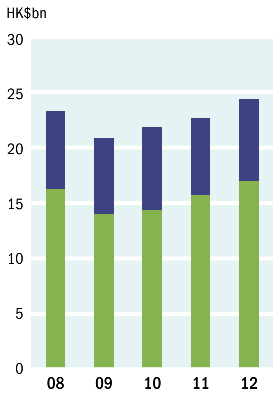
Operating Profit Analysis



	HK$m
2011 Operating profit	14,181
Changes due to:	
Net interest income	1,210
Net fee income	250
Other operating income	324
Loan impairment charges	54
Operating expenses	(491)
Impairment loss on intangible assets	78
2012 Operating profit	15,606

Net Operating Income

(Before loan impairment charges)



Net operating income
Non-interest income
Net interest income

Financial Performance

Income Statement

Summary of Financial Performance

Figures in HK$m	2012	2011 (restated)
Total operating income	36,616	34,207
Operating expenses	8,389	7,898
Operating profit after loan impairment charges	15,606	14,181
Profit before tax	22,113	19,255
Profit attributable to shareholders	19,426	16,885
Earnings per share (in HK$)	10.16	8.83

Hang Seng Bank Limited ("the Bank") and its subsidiaries ("the Group") reported a profit attributable to shareholders of HK$19,426m for 2012, up 15.0% compared with 2011. Earnings per share were up by 15.1% to HK$10.16. Profit attributable to shareholders for the second half of 2012 increased by HK$822m, or 8.8%, compared with the first half.

Operating profit excluding loan impairment charges grew by HK$1,371m, or 9.4%, to HK$15,992m.

This was underpinned by asset and deposit growth, increases in both net interest income and non-interest income, partly offset by the rise in operating expenses.

Net interest income rose by HK$1,210m, or 7.7%, driven by the 3.5% increase in average interest-earning assets and an improvement in the net interest margin.

The increase in interest-earning assets reflected the Bank's continued efforts to strengthen its asset and liability management and maintain a balanced growth strategy to expand its average loans and deposits.

Net interest margin rose by seven basis points to 1.85% and net interest spread increased by five basis points to 1.73%. Liability spreads have improved reflecting the increased value of core funding while asset spreads have narrowed as a result of the increase in cost of funds. The offshore renminbi business yield was higher through improved renminbi fund deployment from the low-yielding local clearing bank and fiduciary account to renminbi commercial lending and other financial instruments in light of the developments of the renminbi business in Hong Kong and the availability of a greater variety of renminbi denominated liquid assets. The Group continued to grow and manage its life insurance investment funds portfolio and grew its interest income by 8.9% compared with last year. However, Treasury balance sheet management income was negatively affected as the yield curve continued to flatten under the prolonged low interest rate environment. The contribution from net free funds was two basis points higher, at 0.12%.

Figures in HK$m	2012	2011
Net interest income/(expense) arising from:		
– financial assets and liabilities that are not at fair value through profit and loss	18,162	16,525
– trading assets and liabilities	(1,268)	(848)
– financial instruments designated at fair value	52	59
	16,946	15,736
Average interest-earning assets	917,236	886,156
Net interest spread	1.73%	1.68%
Net interest margin	1.85%	1.78%

Net interest income in the second half of 2012 grew by HK$374m, or 4.5%, compared with the first half, due mainly to a 4.1% increase in average interest earning assets and more days in the second half.

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

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

Figures in HK$m	2012	2011
– Net interest income and expense reported as "Net interest income"		
Interest income	21,537	19,535
Interest expense	(3,375)	(3,010)
Net interest income	18,162	16,525
– Net interest income and expense reported as "Net trading income"	(1,268)	(848)
– Net interest income and expense reported as "Net income from financial instruments designated at fair value"	52	59
Average interest-earning assets	865,876	840,064
Net interest spread	2.00%	1.89%
Net interest margin	2.10%	1.97%

Net fee income increased by HK$250m, or 5.2%, to HK$5,086m compared with 2011.

With the increased demand for wealth management products, the Bank continued to launch new retail investment funds to meet different investor risk appetites and the growing demand for renminbi wealth management products, and saw income from retail investment funds increase by 24.9%.

Insurance-related fee income rose by 51.7%, benefiting from the increase in non-life insurance products distribution commission in the second half of the year as a result of the disposal of the general insurance manufacturing business to a third party insurance service provider. This increase was offset by a corresponding fall in non-life insurance underwriting profit in the second half of the year.

The Bank's effective marketing campaigns saw fee income from the credit card business grow by 11.3%, driven by the increase of 11.1% in cardholder spending and 5.4% in the number of cards in circulation. Credit facilities fee income rose significantly by 40.7%, due mainly to higher fees from increased corporate lending.

Fees from remittances and trade-related service income increased by 10.3% and 18.0% respectively as the Bank successfully captured opportunities from the increased trade activities and the expansion of renminbi cross-border trade settlement volumes.

However, these increases were offset by a 26.8% reduction in stockbroking and related services income, reflecting lower stock market turnover in the difficult market condition.

Compared with the first half of 2012, net fee income in the second half increased by HK$270m, or 11.2%, due mainly to the increases in income from the sales of retail investment funds, card, trade and insurance-related services.

Trading income rose by HK$267m, or 14.9%, to HK$2,063m.

Foreign exchange income rose by HK$143m, or 7.8%, driven by increased customer activity and higher demand for foreign exchange-linked structured products, notably in renminbi products, as well as the increase in net income from funding swaps*. These were partly offset by lower demand for renminbi denominated derivatives products linked with trade financing and reduced position taking for balance sheet management.

Income from securities, derivatives and other trading activities recorded net income of HK$77m compared with a net loss of HK$47m last year. This was primarily due to higher gains on equity options backing a life endowment product, which benefited from a favourable movement in the underlying equity indices, which was offset by a corresponding increase in "net insurance claims incurred and movement in policyholder liabilities". The unfavourable market interest rate movement also impacted the interest rate derivatives and debt securities trading income. Income from the sale of equity-linked structured products also registered lower income when compared with last year.

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

Net income from financial instruments designated at fair value recorded a revaluation gain of HK$376m, compared with a revaluation loss of HK$160m in 2011.

This was mainly due to the fair value changes of assets held by the life insurance business, as a result of favourable equity market conditions. To the extent that this fair value gain was attributed to policyholders of unit-linked life insurance policies, there was a corresponding increase in "net insurance claims incurred and movement in policyholders' liabilities".

Net earned insurance premiums fell by HK$114m, or 1.0%. Net insurance claims incurred and movement in policyholders' liabilities rose by HK$625m, or 5.4%.

Analysis of income from wealth management business

Figures in HK$m	2012	2011 (restated)
Investment income:		
– retail investment funds	1,130	905
– structured investment products*	952	940
– private banking service fee**	123	173
– stockbroking and related services	941	1,285
– margin trading and others	142	134
	3,288	3,437
Insurance income:		
– life insurance	3,016	2,018
– general insurance and others	310	364
	3,326	2,382
Total	6,614	5,819

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

The Bank continued to grow wealth management income, recording a rise of 13.7% to HK$6,614m when compared with 2011.

Investment income decreased by 4.3%, with income from stockbroking and related services falling by 26.8% as stock market volumes remain muted.

The Bank continued to make progress in offering a wide variety of investment funds to meet the changing risk appetites of investors under the low interest rate environment. These included funds from Hang Seng Investment Management and other providers. The first renminbi-denominated gold exchange-traded fund ("ETF") which caters for the growing demand for renminbi wealth management products was launched in 2012. Under the volatile equity market, investors shifted to fixed rate and lower risk bond funds which led to a 24.9% growth in the Bank's retail investment funds income.

Figures in HK$m	2012	2011
Life insurance:		
– net interest income and fee income	2,845	2,576
– investment returns on life insurance funds/share of associate's profit	761	(361)
– net earned insurance premiums	10,774	10,723
– net insurance claims incurred and movement in policyholders' liabilities*	(12,179)	(11,515)
– movement in present value of in-force long-term insurance business	815	595
	3,016	2,018
General insurance and others	310	364
Total	3,326	2,382

* Including premium and investment reserves

Insurance income increased strongly by HK$944m, or 39.6% to HK$3,326m, due mainly to the 49.5% increase in life insurance income, as a result of strong investment returns, higher insurance sales and movement in present value of in-force long-term insurance business. Hang Seng continued to launch new products catering for customers' investment and protection needs. This included the launch of the "SavourLife Annuity Life Insurance Plan". Total policies in-force and total annualised new premium at 31 December 2012 rose by 8.6% and 13.1% respectively year-on-year.

Net interest income and fee income from the life insurance funds investment portfolio rose by 10.4%, due mainly to growth in the size of the life insurance investment portfolio, which held bond investments as its major assets. Investment returns on life insurance funds improved strongly, recording a profit of HK$761m compared with a loss of HK$361m last year, reflecting changes in the fair value of assets held by the life insurance business, and benefited from the positive movements of equity markets and the upward commercial property market in 2012. To the extent that this fair value gain was attributed to policyholders of unit-linked life insurance policies, there was a corresponding increase in "net insurance claims incurred and movement in policyholders' liabilities".

The movement in present value of in-force long-term insurance business ("PVIF") increased strongly by 37%, due mainly to the combined effect of higher life insurance sales and more favourable market conditions.

General insurance business income decreased by 14.8% to HK$310m following the completion of the disposal of our general insurance manufacturing business to a third party insurance service provider in the second half of 2012 for a cash consideration of approximately HK$1,550m. The Bank recognised a disposal gain of HK$355m on this transaction. Subsequent to the disposal of general insurance manufacturing business, there will be an increase in non-life insurance products distribution commission with a corresponding decrease in non-life insurance underwriting profit.

Operating expenses rose by HK$491m, or 6.2%, to HK$8,389m.

The increase reflected the Bank's continued investments to support long-term business growth and capture business opportunities while maintaining carefully cost control and operational efficiency. Excluding the Mainland business, operating expenses rose by 4.7%.

Employee compensation and benefits increased by HK$249m, or 6.4%. Salaries and other related costs increased by 6.6%, reflecting the annual salary increment as a result of wage inflation. General and administrative expenses were up 5.8%, mainly due to the increase in marketing expenditure as more branding and promotional activities were conducted to support business growth. Rental expenses rose as a result of increased rents for branches in Hong Kong and new branches on the Mainland. Depreciation charges rose by 8.9%, reflecting higher depreciation charges on business premises following the upward property revaluation in Hong Kong.

Full time equivalent staff numbers by region

	2012	2011
Hong Kong	7,732	7,993
Mainland	1,883	1,772
Others	65	69
Total	9,680	9,834

At 31 December 2012, the Group's number of full-time equivalent staff decreased by 154 compared with the end of 2011.

With the increase in net operating income before loan impairment charges outpacing the growth in operating expenses, the cost efficiency ratio declined by 0.6 percentage points to 34.4%, compared with 35.0% for 2011. The Bank continues to focus on improving operational efficiency while maintaining growth momentum.

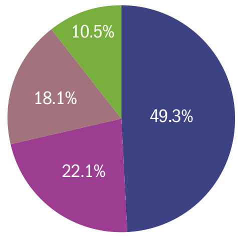
Operating profit rose by HK$1,425m, or 10.0%, to HK$15,606m after accounting for the decrease in **loan impairment charges**.

Loan impairment charges decreased by HK$54m, or 12.3%, to HK$386m compared with a year earlier.

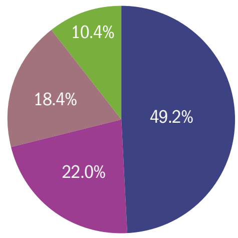
Figures in HK$m	2012	2011
Net charge for impairment of loans and advances to customers:		
Individually assessed impairment allowances:		
– new allowances	(294)	(359)
– releases	224	221
– recoveries	13	35
	(57)	(103)
Net charge for collectively assessed impairment allowances	(329)	(337)
Net charge for loan impairment	(386)	(440)

Operating Expenses

2012



2011



- Employee compensation and benefits
- Other operating expenses
- Premises and equipment
- Depreciation and amortisation

Overall credit quality was relatively stable and the Bank will remain cautious on the credit outlook.

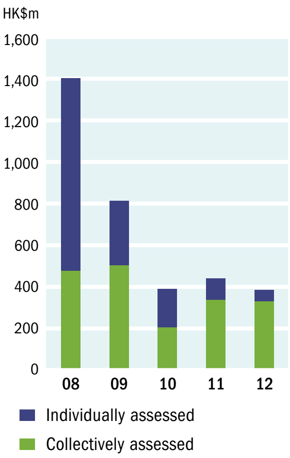
Individually assessed impairment charges fell by HK$46m, or 44.7%, reflecting lower charges for corporate and commercial banking customers for Hong Kong operations in 2012, despite higher charges for Mainland operations due to the downgrading of certain commercial banking customers.

Collectively assessed charges fell by HK$8m, or 2.4%. Higher charges on credit card and personal loan portfolios were recorded, which reflected growth in the portfolios. Impairment allowances for loans not individually identified as impaired recorded a net release compared with a net charge in 2011, mainly due to improved historical loss rates.

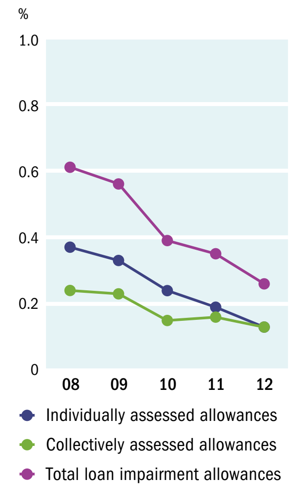
Total loan impairment allowances as a percentage of gross loans and advances to customers are as follows:

	At 31 December 2012 %	At 31 December 2011 %
Loan impairment allowances:		
– individually assessed	**0.13**	0.19
– collectively assessed	**0.13**	0.16
Total loan impairment allowances	**0.26**	0.35

Loan Impairment Charges



Loan Impairment Allowances as a Percentage of Gross Loans and Advances to Customers



Profit before tax recorded growth of 14.8% to HK$22,113m after taking into account a HK$355m increase in **gain on disposal of a subsidiary**, reflecting the gain of HK$355m from the disposal of the Group's general insurance manufacturing business; a 21.8% (or HK$216m) fall in **net surplus on property revaluation**; and a 33.5% (or HK$1,349m) increase in **share of profits from associates**, mainly from Industrial Bank Co., Ltd. ("Industrial Bank") on the back of strong growth in its customer lending and higher fee-based income. On 7 January 2013, Industrial Bank completed a private placement of additional share capital to a number of third parties, thereby diluting the Group's equity holding from 12.8% to 10.9%. As a result of this and other factors, the Group considers it is no longer in a position to exercise significant influence over Industrial Bank and ceased to account for the investment as an associate from that date. For the financial year ended 31 December 2012, the Group's interest in Industrial Bank was recognised using the equity method based on the Industrial Bank's financial statement made up to 30 September 2012 in accordance with the Group's accounting policy. The Group will not equity account for its interest in Industrial Bank from 7 January 2013.

Gains less losses from financial investments and fixed assets fell by HK$55m, or 110%, compared with 2011.

Net surplus on property revaluation fell by 21.8% to HK$776m.

Figures in HK$m	2012	2011
Surplus of revaluation on investment properties	**742**	982
Surplus of revaluation on assets held for sale	**34**	8
Reversal of revaluation deficit on premises	**–**	2
	776	992

The Group's premises and investment properties were revalued at 30 November 2012 and updated for any material changes at 31 December 2012 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$2,222m which was credited to the premises revaluation reserve. A revaluation gain of HK$742m on investment properties was recognised through the income statement. The related deferred tax provision for Group premises was HK$360m.

The revaluation exercise also covered properties held for sale and a revaluation gain of HK$34m related to the investment property was recognised through the income statement.

Segmental Analysis

The table below sets out the profit before tax contributed by the business segments for the years stated.

Figures in HK$m	Hong Kong & other businesses: Retail Banking and Wealth Management	Corporate and Commercial Banking	Treasury	Other	Total	Mainland China business	Total
Year ended 31 December 2012							
Profit before tax	**7,939**	**5,878**	**2,364**	**509**	**16,690**	**5,423**	**22,113**
Share of profit before tax	**35.9%**	**26.6%**	**10.7%**	**2.3%**	**75.5%**	**24.5%**	**100.0%**
Share of profit before tax as a % of Hong Kong & other businesses	**47.6%**	**35.2%**	**14.2%**	**3.0%**	**100.0%**		
Year ended 31 December 2011 (restated)							
Profit before tax	6,509	4,616	2,512	1,433	15,070	4,185	19,255
Share of profit before tax	33.8%	24.0%	13.0%	7.5%	78.3%	21.7%	100.0%
Share of profit before tax as a % of Hong Kong & other businesses	43.2%	30.6%	16.7%	9.5%	100.0%		

Retail Banking and Wealth Management ("RBWM") in Hong Kong reported profit before tax of HK$7,939m in 2012, representing a 22.0% year-on-year increase. Excluding the general insurance business disposal gain, profit before tax was up 19.1%.

Net interest income reached HK$8,761m in 2012, representing a 10.6% year-on-year increase, which was mainly attributable to growth in deposit balances driven by the expansion in affluent customers, as well as the growth of unsecured lending and insurance businesses.

Year-on-year, total loans and deposits increased by 11.5% and 9.1% respectively. Mortgages as one of the core businesses, achieved good momentum throughout 2012, through offering innovative products including the Hang Seng Renminbi / Hong Kong Dollar Mortgage-Link launched in March 2012, a professional one-stop service and flexible sales channels to our customers. Amidst strong competition and the tightening of government measures on mortgage lending, our mortgage business maintained third position in the market, with our market share in terms of new mortgage registrations reaching 18.7% in 2012, representing a 6.2% year-on-year increase. The personal loans portfolio was also up 11.2% year-on-year.

Non-interest income grew by HK$309m to HK$3,822m while overall wealth management income grew by 18.6% to HK$5,328m.

Total operating income from the credit card business recorded year-on-year growth of 8.0% in 2012, supported by a high quality credit card customer base and effective marketing campaigns. Total cards in force reached 2.34 million, representing year-on-year growth of 5.1% and we were the third largest card issuer of VISA and MasterCard as of December 2012. Card spending and card receivables grew robustly by 10.7% and 9.8% year-on-year respectively.

The insurance business achieved a strong performance in 2012 with operating income increased by 45.5% year-on-year, underpinned by proactive management of investment assets, strong distribution and promotion efforts and an effective product diversification strategy. In 2012, we broadened our product suite by launching the SavourLife Annuity Life Insurance Plan, ProsperDragon Renminbi Life Insurance Plan and SurgicalGuard Refundable Life Insurance Plan, thereby attracting new customer segments as well as new sources of income. As a result, annualised life insurance new premiums grew by 13.3% and total life insurance policies in-force rose by 8.7% compared with last year.

Global market uncertainties, particularly from the second quarter onwards, adversely affected investor sentiment. Income from investment business decreased 4.0% compared with last year, primarily from lower securities brokerage. However, with our time-to-market investment solutions catering for customer needs, income and sales turnover of investment funds recorded encouraging growth of 35.7% and 73.7% respectively. New Hang Seng retail investment fund products, including the first renminbi-denominated gold exchange-traded fund ("ETF"), reinforced our reputation as a wealth management leader and a renminbi services pioneer. We have continued to build momentum in our investment fund business into this year. To provide diversified wealth management products to suit customers' needs, we launched the Hang Seng Gold Linked Deposits in January 2013 to meet the increased demand in gold investment products.

As a result of our continued effort to acquire quality customers, the numbers of Prestige and Preferred Banking customers increased by 10.7% and 8.3% respectively compared with 2011. To enhance the customer experience by providing modern environment and to attract affluent customers, a new Prestige and Preferred Banking Centre design concept has been introduced and a total of six Prestige and Preferred Banking Centres have already been opened. We have plans to open more Prestige and Preferred Banking Centres at strategic locations in the coming years.

Service excellence had always been our strength and we continued to receive recognition in the banking industry. We were named by The Asset as the "Best Domestic Bank in Hong Kong" for the 13th consecutive year in 2012. For the third consecutive year, Euromoney named the Bank as "Best Local Private Bank in Hong Kong" in the Private Banking Survey 2012 based on the assessment of business performance and peer nominations. We were also awarded the Reader's Digest "Trusted Brands GOLD Award" in the Bank category and the Credit Card Issuing Bank category in Hong Kong for the third consecutive year in 2012.

Corporate and Commercial Banking ("CNC") in Hong Kong achieved a 27.3% growth in profit before tax to HK$5,878m. Excluding the general insurance business disposal gain, profit before tax was up 23.7%.

Net interest income grew by 15.6% to HK$5,289m when compared with last year. CNC continued to provide customers with new and renewed facilities while adjusting pricing in line with the credit environment.

Year-on-year, total loans and deposits both grew by 10.4%. The growth in deposits was underpinned by a 21.4% increase in current and saving account deposit balances primarily contributed by new commercial customers.

Non-interest income rose by HK$123m to HK$2,101m. Net fee income reported a growth of 18.5%, which was driven by solid growth in a wide range of non-funds income streams – including remittances, trade, factoring and syndication loan facility fees. Income from corporate wealth management business was HK$634m, representing 8.5% of CNC's net operating income.

The momentum of quality commercial customer acquisition has accelerated in 2012 and the CNC customer base has increased by 12.8% in 2012. Mainland companies represented 45.7% of newly acquired customers in the second half of 2012 – compared with 34.2% in the first half of 2012.

Renminbi business remained one of our key strategic priorities. The number of renminbi accounts was up 25.1% in 2012 and CNC successfully made renminbi loans and will continue to explore such opportunities to achieve more balanced and sustainable growth. As at 31 December 2012, the size of the renminbi lending was three times of a year earlier.

In August 2012, CNC launched a new TV commercial to emphasise the edges of Hang Seng SME Business Loan – "Speed, Ease and Professional Service". This has reinforced Hang Seng's progressive image. Hang Seng was awarded "Excellent Brand of SME Loan Services – Hong Kong Leaders Choice Brand Awards 2012" by Metro Finance.

Network expansion and channel enhancements continued to be one of our key objectives. To strengthen our support to Mainland and Hong Kong corporates with cross-border business needs, two new Business Banking Centres were opened in the second half of 2012. Furthermore, Business Mobile Banking was launched in September 2012 to enhance customer convenience.

Focusing on structured finance and syndicated loans also contributed to our success. According to Thomson Reuters LPC, we ranked second in terms of number of deals and third in terms of deal volume in the Mandated Arranger League Table for Hong Kong and Macau Syndicated Loans in 2012.

In 2012, Hang Seng was awarded "Hong Kong Domestic Trade Finance Bank of the Year" and "Hong Kong Domestic Cash Management Bank of the Year" by Asian Banking and Finance. CNC would continue to leverage on the solid Hong Kong platform and loyal customer base to provide trade, cash management and wealth management solutions to corporate and commercial customers in Greater China.

CNC will continue to capitalise on her core strengths – customer-focused strategies and propositions, industry-specialised relationship teams, time-to-market and product innovations.

Treasury ("TRY") in Hong Kong recorded a 5.9% decrease in profit before tax to HK$2,364m and a 5.4% decline in operating profit excluding loan impairment charges to HK$2,363m.

Net interest income decreased by 11.3% to HK$1,676m. With the low interest rate environment and flattened yield curves, there were few opportunities for yield enhancement. Further, as balance sheet management portfolios matured, they could only be re-priced at prevailing rates which were relatively low.

Non-interest income grew by HK$104m to HK$960m. Total trading income increased by HK$110m, or 12.5%, to HK$988m. Option income from structured products achieved encouraging growth, boosted in part by rising demand for renminbi-denominated products following further liberalisation of renminbi business in Hong Kong. Faster growth in gross interest income from funding swaps also contributed to the increase. However, these increases were partly offset by a decline in income from securities and other trading.

Front-line channels (including e-Banking) and trading systems were enhanced to facilitate straight-through processing, enabling better position management. To reinforce our brand in gold-related business, the Hang Seng Gold Bar (physical gold product) and renminbi-denominated gold ETF were launched. Treasury will continue to position itself to capture yield enhancement opportunities by investing in Hong Kong and Mainland bonds and riding on yield curves of selected currencies. As the renminbi market in Hong Kong evolves, Treasury will continue to develop renminbi-denominated hedging and investment products to meet customer needs as well as explore new business opportunities for cross-selling treasury products with other customer groups.

Mainland China business

Hang Seng Bank (China) Limited ("Hang Seng China") expanded the scope and reach of our Mainland Chinese business in 2012, capitalising on the close integration of our Hong Kong and Mainland operations and an increasing awareness of our unique brand strengths. Hang Seng China strategically deployed resources to improve our foothold in regions with good long-term growth potential and further enrich our premium service proposition.

Hang Seng China opened one branch and six sub-branches, bringing the network to 46 outlets in 17 cities. Leveraging the favourable policies under CEPA, these new openings included three cross-city sub-branches in Guangdong province where we now have 21 outlets.

The operating environment in China was challenging in 2012 due to slower domestic economic growth and weakened external demand. The People's Bank of China has kept interest rates and the deposit reserve ratio unchanged since 6 July 2012 while using reverse repurchase agreements to maintain liquidity. The upper deviation to standard deposit rates and lower deviation to base lending rates were both widened, paving the way to further interest rate liberalisation. The competition for deposits and wealth management products was keen as foreign banks stepped up efforts to maintain revenue flows and market share.

Despite all the challenges, Hang Seng China has focused on growth of the portfolio, expansion of the customer base as well as diversification of revenue sources through differentiated business propositions for target customer segments and by exploiting opportunities in cross-selling and providing cross-border services between the Mainland and Hong Kong.

As a result, Hang Seng China maintained growth momentum. At 31 December 2012, the total number of Mainland customers (including both Corporate and Commercial Banking and Retail Banking and Wealth Management customers) rose by 12.6%, in which the total number of Prestige Banking customers increased by 15.5% over December 2011.

	As reported	Constant currency*
Year ended 31 December 2012 compared with 31 December 2011		
Total operating income	8.5%	6.6%
Operating profit	-28.8%	-29.8%
At 31 December 2012 compared with 31 December 2011		
Gross loans and advances to customers	15.5%	15.5%
Customer deposits	12.7%	12.7%

Total operating income grew by 8.5%, supported mainly by growth in net interest income, driven by growth in loans and advances to customers of 15.5%. Total deposits were 12.7% higher. Hang Seng China continued to emphasise credit quality over loan portfolio size, focusing on clients offering good potential for generating additional income streams through wealth management and trade services. Operating expenses increased by 15.3%, due largely to investments in long-term business growth. Together with a net loan impairment charge compared with a net release in 2011, this led to a 28.8% decline in operating profit.

The Bank worked closely with Industrial Bank and captured collaboration opportunities in various business areas during the year.

During the first quarter of 2012, Hang Seng Securities Limited ("Hang Seng Securities"), a wholly owned subsidiary of the Bank, and Guangzhou Securities Company Limited ("Guangzhou Securities"), a member of the Yue Xiu Group, received approval from the China Securities Regulatory Commission to establish a joint venture, Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company Limited ("Guangzhou GuangZheng Hang Seng Securities"). The joint venture commenced business in the third quarter of the year and became the first joint venture securities investment advisory company in Guangdong province under Supplement VI to the Mainland and Hong Kong Closer Economic Partnership Arrangement ("CEPA"). The joint venture aims at becoming a showcase for cross-border securities investment advisory cooperation under CEPA by leveraging the strengths of both partners, and thus supporting the Bank's further business expansion in the Mainland.

Including the share of profit from Mainland associates, our mainland China business contributed 24.5% of total profit before tax, compared with 21.7% in last year, as a result of the strong growth in the Group's share of Industrial Bank's profit.

* Constant currency comparatives for 2011 referred to in the tables above are computed by translating into Hong Kong dollars the functional currency (renminbi) of Hang Seng's mainland China business:
– the income statement for 2011 at the average rates of exchange for 2012; and
– the balance sheet at 31 December 2011 at the prevailing rates of exchange on 31 December 2012.

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 2012, economic profit was HK$12,938m, an increase of HK$2,421m, or 23.0%, compared with 2011. Return on invested capital rose by HK$2,857m.

	2012 HK$m	%	2011 HK$m (restated)	%
Average invested capital	71,583		62,837	
Return on invested capital*	19,070	26.7	16,213	25.8
Cost of capital	(6,132)	(8.6)	(5,696)	(9.1)
Economic profit	12,938	18.1	10,517	16.7

* 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.

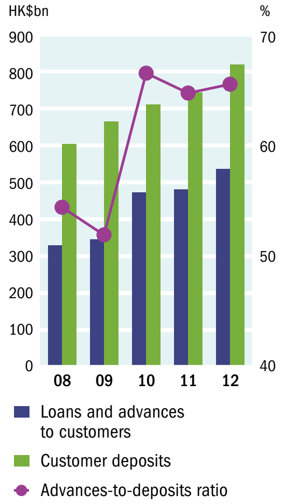
Balance sheet

Total assets rose by HK$101.4bn, or 10.4%, to HK$1,077.1bn. The Group continued to strengthen its asset and liability management and maintained a balanced growth strategy on loans and deposits. Loans and advances to customers increased by HK$55.6bn, or 11.6%, to HK$536.2bn, with growth in the commercial and corporate lending businesses, largely in mainland China. Residential mortgages grew as the Bank regained momentum in the year and reinforced its strong position in the residential mortgage sector and gained market share on the back of the active property market. Trade finance lending declined, due mainly to the maturing of certain cross border documentary credit loans during the year more than offsetting the growth in other trade finance loan products. Leveraging the strong connectivity between Hong Kong and mainland China operations, the Bank grew its Mainland lending during the year, driven mainly by renminbi loans. The Group remained vigilant in assessing credit risk in increasing lending on the Mainland. Customer deposits, including certificates of deposit and other debt securities in issue, increased by HK$75.6bn, or 10.2%, to HK$818.8bn. At 31 December 2012, the advances-to-deposits ratio was 65.5%, compared with 64.7% at 31 December 2011. Financial investments increased by 21.1% and trading assets decreased by 46.4%, reflecting the deployment of the commercial surplus to higher quality financial investments.

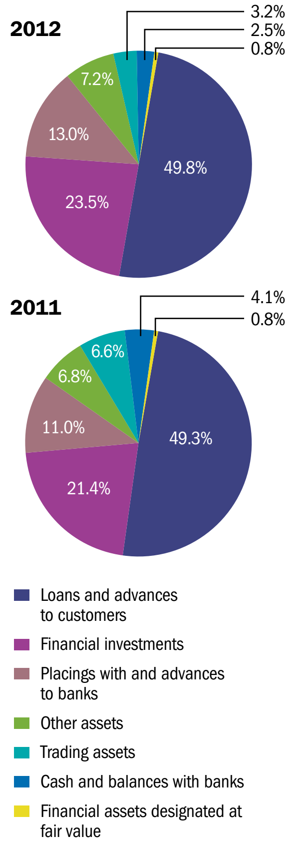
Assets Deployment

Figures in HK$m	2012	%	2011 (restated)	%
Cash and balances with banks	27,082	2.5	39,533	4.1
Placings with and advances to banks	140,382	13.0	107,742	11.0
Trading assets	34,399	3.2	64,171	6.6
Financial assets designated at fair value	8,343	0.8	8,096	0.8
Loans and advances to customers	536,162	49.8	480,574	49.3
Financial investments	253,408	23.5	209,190	21.4
Other assets	77,320	7.2	66,359	6.8
Total assets	1,077,096	100.0	975,665	100.0

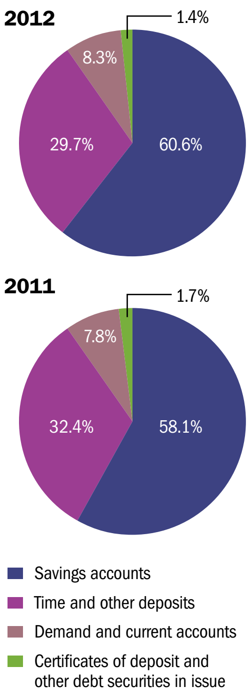
Loans and Advances to Customers and Customer Deposits



Assets Deployment



Customer Deposits



Loans and Advances to Customers

At 31 December 2012, gross loans and advances to customers were up HK$55.3bn, or 11.5%, at HK$537.6bn compared with the end of 2011.

Loans for use in Hong Kong increased by HK$34.9bn, or 10.2%. Lending to industrial, commercial and financial sectors grew by 8.8%. Lending to the property development and investment sectors remained active and grew by 4.2% and 3.0% respectively, supported by a buoyant commercial property market during the year. With strong customer relationships, active participation in Hong Kong Government-organised schemes, and enhanced service capabilities, the Bank continued to support customers in growing their businesses, with 42.9% growth in the wholesale and retail trade sector and 15.9% in manufacturing sector.

Lending to individuals increased by 12.0% compared with last year-end. As the property market remained active, residential mortgage lending to individuals rose by 16.4%, as a result of the Bank's aim to be a preferred mortgage bank that provides comprehensive mortgage services despite strong market competition. Credit card loans and advances grew by 9.9% supported by the rise of 5.4% in the number of cards in circulation and an 11.1% increase in cardholder spending.

Trade finance declined by 4.0% against last year-end as certain cross border documentary credit loans matured during 2012, partly offset by the growth in other trade finance loan products.

Loans for use outside Hong Kong rose by 24.5%, compared with the end of 2011, driven largely by lending on the Mainland. The Mainland loan portfolio increased by 15.5% to HK$51.6bn, underpinned by the expansion of renminbi lending to corporate borrowers. The Group remained vigilant in assessing credit risk in increasing lending on the Mainland.

Customer Deposits

With the Bank's successful effort in acquiring new customers in target segments, customer deposits, including current, savings and other deposit accounts and certificates of deposit and other debt securities in issue, increased by HK$75.6bn, or 10.2%, to HK$818.8bn at 31 December 2012. Higher growth was recorded in Hong Kong dollar currency deposits. Structured deposits increased as instruments with yield enhancement features gained popularity. Deposits in Hang Seng China also rose by 12.7%, driven mainly by renminbi deposits.

Subordinated Liabilities

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

Shareholders' funds

Figures in HK$m	At 31 December 2012	At 31 December 2011 (restated)
Share capital	9,559	9,559
Retained profits	59,683	49,519
Premises revaluation reserve	13,790	12,280
Cash flow hedging reserve	17	6
Available-for-sale investment reserve		
– on debt securities	(57)	(756)
– on equity securities	284	195
Capital redemption reserve	99	99
Other reserves	5,124	5,099
Total reserves	78,940	66,442
	88,499	76,001
Proposed dividends	3,824	3,633
Shareholders' funds	92,323	79,634
Return on average shareholders' funds	22.9%	22.7%

Shareholders' funds (excluding proposed dividends) grew by HK$12,498m, or 16.4%, to HK$88,499m at 31 December 2012. Retained profits rose by HK$10,164m, mainly reflecting growth as a result of the 2012 profit after the appropriation of interim dividends during the year. The premises revaluation reserve increased by HK$1,510m, or 12.3%, on the back of the buoyant property market during the year.

The available-for-sale investment reserve for debt securities recorded a deficit of HK$57m compared with a deficit of HK$756m at the end of 2011, reflecting the decrease in the Group's share of associate's available-for-sale investment reserve deficit as a result of the interest rate movement and the narrowing of credit spreads of debt securities of the Group's investment portfolios. 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 22.9%, compared with 22.7% for 2011.

Excluding the redemption of all the US$300m floating rate subordinated notes due 2017 at par on 6 July 2012, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's securities during 2012.

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 62 "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.

Corporate Responsibility

Our commitment to core values such as excellence, integrity and innovation extend beyond the provision of banking and financial services into our actions as a responsible corporate citizen. We are determined to 'walk the talk' in supporting sustainable development as we strive to achieve international standards in the things we do.

We lead by example in continually working to improve our own sustainability performance as we encourage our staff, customers, suppliers and the general public to do the same through our procurement and financing policies as well as internal and external stakeholder engagement activities.

Long-term partnerships, lasting positive change

We contribute to social and environmental betterment by building long-term relationships with local community partners. We collectively continue to grow as we work together to promote lasting positive change.

1987
The Community Chest of Hong Kong

1991
Hong Kong Table Tennis Association

1994
Hang Seng Bank Help the Police Fight Youth Crime Competition

1995
Tertiary education institutes in Hong Kong

1996
Hang Seng Athlete Incentive Awards Scheme

1999
Ming Pao Student Reporter Programme

1999
Universities in mainland China

Our deep community roots are reflected in the long-term partnerships we have established with local organisations and institutions that are working to improve well-being and make a positive difference.

Our sustainability initiatives have earned us international recognition. We rank among Corporate Knights' 'Global 100 Most Sustainable Corporations in the World' – the only Hong Kong company to hold such distinction.

In 2011, we became the first local bank in Hong Kong to be included as a constituent stock of the Dow Jones Sustainability Asia Pacific Index, which provides a benchmark for best-in-class corporate sustainability performance of companies in the Asia Pacific region, and we have been a constituent member of the FTSE4Good Global Index for 11 consecutive years.

In a concrete move to implement sustainability best practices, we are also the first local Hong Kong bank to attain an A+ Global Reporting Initiative Sustainability Reporting Guidelines rating – the top grade available – for our 2011 online Corporate Responsibility Report.

Our people are more than just employees – they are the ambassadors and relationship builders of our business. In addition to supporting their professional development through an extensive range of training and skills programmes, we organised two staff CSR forums in 2012 to promote awareness of key social and environmental issues and encourage greater engagement through experience sharing.

Support for education and youth development is the cornerstone of our long-established commitment to promoting community betterment. By encouraging the attainment of knowledge and the adoption of positive life values, we are helping today's young people grow into well-rounded leaders of tomorrow.

MAJOR EVENTS

Nurturing positive life values among young people

Over 260,000 young people took part in the Hang Seng Bank – Help the Police Fight Youth Crime Competition in 2012 – an all-time high for this biennial event. Organised in partnership with the Hong Kong Police since 1994, the 2012 theme of this crime prevention programme was 'Power of Friends' with the aims of promoting greater awareness and positive action to combat drug use, theft and bullying.

We used sports and recreational activities to foster good team spirit among colleagues – including the six sports competitions held under the Hang Seng Cup. A family fun day formed part of our efforts to help employees enjoy a good work-life balance. Including staff family members and friends, over 21,000 people took part in Bank-arranged sporting events in 2012.

Deep Community Roots

We have given out over HK$224m in donations and sponsorships in the past decade – including HK$21.5m in 2012 – to support a broad range of community development initiatives.

For 25 years, we have worked hand-in-hand with The Community Chest of Hong Kong, which provides funding for 153 local charities, raising more than HK$60m. We have supported The Chest's Dress Casual Day since 1997, matching staff donations on a dollar-for-dollar basis – resulting in over HK$13m in support.

Our e-Donation service makes it easier for customers to offer assistance to those in need, with about HK$2m in donations benefiting over 60 charitable organisations in Hong Kong in 2012. Since 2001, more than HK$23m has been donated via this convenient and secure channel.

In line with our emphasis on serving from the heart, our staff regularly give their time to support worthy causes and build the human connections that underpin a thriving and inclusive community.

Bank volunteers and their families contributed more than 25,000 hours in service during 2012. We facilitated this giving back to society by organising about 130 volunteer activities, with a particular focus on underprivileged children, elderly people living alone and environmental education.

Youth development

In investing today for a brighter tomorrow, our corporate responsibility activities place a strong emphasis on education and youth development. We reached out to young people through 150 Bank-supported education programmes and workshops in 2012.

Since 1995, we have allocated more than HK$56m to our various scholarship schemes, assisting over 1,700 students from Hong Kong and mainland China. In 2008, we implemented our Community Scholarships programme to reward outstanding undergraduate students in Hong Kong who have contributed to community development with a minimum of 100 hours of volunteer service in the previous 12 months.

We also support community service programmes organised by local universities, including The Chinese University of Hong Kong's CUHK-Hang Seng I•CARE Local Service Project Scheme, which in 2012 brought together about 200 students and over 1,300 underprivileged children in a series of mutually enriching interactions.

Through the Hang Seng Bank – Help the Police Fight Youth Crime Competition, we work with the Hong Kong Police to promote good life values and positive civic action. Over 260,000 young people took part in the 2012 competition – an all-time high for this biennial event that we have sponsored since 1994 – which focused on combatting drug-taking, theft and bullying under the theme of 'Power of Friends'.

The Hang Seng Bank Leaders to Leaders Lecture Series, organised by the Hong Kong Federation of Youth Groups and The University of Hong Kong, gave over 300 secondary school students a valuable opportunity to engage in direct dialogue with prominent community leaders on a broad range of issues related to globalisation.

Our sponsorship of the Ming Pao Student Reporter Programme – which includes a series of media workshops, newsroom visits and reporting activities – has helped almost 7,000 students in the past 16 years learn more about the work of the media while honing their critical analysis and writing skills.

The Tung Wah – Hang Seng Code Kidz Programme Supports Children with Specific Learning Disabilities (SLDs) promoted greater public awareness of the issues for families dealing with the challenges of SLDs, while giving about 600 youngsters the opportunity to explore their potential through alternative ways of learning.

Arts and culture for all

We believe in broadening young people's exposure to the arts, which play an important role in encouraging creativity, communicating positive life values and stimulating discussion of social issues.

For young people facing special challenges, building greater confidence is an important step in unleashing their talents and abilities.

In partnership with the Jockey Club Creative Arts Centre, we organised over 50 Hang Seng Arts Empowerment Workshops throughout the year, providing 500 underprivileged and disabled children with the chance to express their emotions and develop a stronger sense of self-belief through a range of artistic activities.

Through the Field of Dreams – Hang Seng Bank Student Matinees, organised by The Hong Kong Repertory Theatre, nearly 4,000 students from low-income families learned about the inspiring story of eight amateur Hong Kong footballers who joined with players from the Mainland to enter the 1936 Berlin Olympics. Facilitated by post-performance talks and supporting materials, the theatrical production emphasised the importance of courage and determination in striving for one's dreams.

We also continue to facilitate greater access to the arts through our sponsorship of the Hong Kong Arts Festival Student Ticket Scheme.

Sporting inspiration

Participation in sports helps promote community health and provides valuable lessons about the importance of teamwork, dedication and fair play.

Since 1991, we have allocated more than HK$31m to promote table tennis in Hong Kong. Our establishment of the Hang Seng Table Tennis Academy in partnership with the Hong Kong Table Tennis Association in 2001 has since given over 215,000 participants the opportunity to have fun while improving their sporting skills through about 4,000 activities, including training courses, open assessment tests and competitions. We will provide HK$7.5m in sponsorship to continue our support for the Academy between 2013 and 2015.

Hong Kong's top athletes contribute to community pride and are inspiring role models for our young sporting stars of tomorrow.

MAJOR EVENTS

Recognising local sporting excellence

Since 1996, we have partnered with the Hong Kong Sports Institute to recognise the hard work and determination of local athletes through the Hang Seng Athlete Incentive Awards Scheme – giving out over HK$30m for sporting excellence at major national and international games. With outstanding performances by Hong Kong athletes at the London Olympic and Paralympic Games, incentives awarded in 2012 reached a record HK$3.86m.

MILESTONES

Leading the way in sustainability reporting

We continue to take steps to attain international standards in our role as a good corporate citizen. The Global Reporting Initiative (GRI) Sustainability Reporting Guidelines are a globally recognised set of benchmarks for reporting on sustainability performance. In 2012, we became the first local bank in Hong Kong to attain an A+ rating – the highest GRI accreditation available – for our 2011 corporate responsibility report. We are also the only company in Hong Kong included among the 2012 'Global 100 Most Sustainable Corporations in the World' compiled by Corporate Knights.

Under the Hang Seng Athlete Incentive Awards Scheme, organised in partnership with the Hong Kong Sports Institute, we gave HK$3.86m in financial rewards to Hong Kong athletes for their outstanding performances at the 2012 London Olympic and Paralympic Games – the highest amount ever awarded to Hong Kong Olympians and Paralympians. Since 1996, the Scheme has given out over HK$30m to recognise and reward athletic achievement and encourage sporting excellence by Hong Kong athletes at major national and international games.

Broad Environmental Vision

As a leading corporate citizen in Hong Kong, we are proud to be a local pioneer in promoting greater environmental responsibility. Beginning with our headquarters building in 2005, we have led the way in gaining ISO 14001 certification among local banks in Hong Kong. In 2011, we became the first local bank to achieve this internationally recognised environmental accreditation for all Hong Kong offices and branches.

Since 2007, we have worked with The Conservancy Association through the Hang Seng Yunnan Biogas Project to bring a free and stable energy supply to people living in rural areas in Yunnan province on the Mainland. To date, we have helped establish 2,200 biogas facilities that are improving life for 9,000 villagers while saving 15,000 acres of forest every year (equivalent to an area about 95 times the size of Hong Kong's Victoria Park) and reducing annual carbon dioxide emissions by 25,500 tonnes. In November, a team of Bank volunteers visited Yunnan to inspect the 550 facilities constructed in 2012. We have committed to build a further 800 facilities in 2013, benefiting about 3,000 people.

Our involvement with this renewable energy project led to a Gold Award for community relations at the 10th China Golden Awards for Excellence in Public Relations organised by the China International Public Relations Association.

Launched jointly with the Federation of Hong Kong Industries in 2007, the Hang Seng Pearl River Delta Environmental Awards (Awards) are part of our commitment to working with the southern China business community on environmental issues. By recognising the green initiatives of participants, the Awards are helping to accelerate the pace of positive environmental change among manufacturing companies in the Pearl River Delta region.

A record 188 participants submitted 672 projects in 2011/12, with collective achievements including cutting electricity consumption by over 91 million kWh –

equivalent to the electricity used annually by 14,000 average four-member households – and reducing waste by more than 650,000 tonnes.

In light of the Awards' success and to encourage more companies to improve their environmental performance, the 2012/13 Awards will expand to cover the pan Pearl River Delta region.

Other initiatives to promote the reduced consumption of natural resources include our e-Statement and e-InvestAdvice services, through which e-Banking clients can choose to receive account statements and other notices in electronic rather than paper format. By the end of 2012, the number of e-Statement and e-InvestAdvice subscribers had reached over 646,000 and more than 62,000 respectively – collectively saving over 31 million sheets of paper a year.

We also reach out to the wider community in partnership with green groups through our support for events such as Friends of the Earth (HK)'s 'Power Smart' Energy Saving Contest and the Hang Seng Green Carnival co-organised with The Conservancy Association.

We continue to take steps to support the conservation of biodiversity – both through our financing policies and within our own operations. We stopped serving shark's fin at Bank functions in 2003 and have since removed endangered reef fish from our menus. We comply with WWF Hong Kong's *Seafood Guide* and, in 2011, implemented a sustainable seafood menu endorsed by the same organisation at our banquet hall.

Environmental Performance

	2012#	2011*	2012 vs 2011 (%)
Greenhouse gas emissions (kilotonnes CO_2)	**24.34**	23.48	3.69%
Electricity consumption (GWh)	**36.61**	36.22	1.07%
Gas consumption (GWh)	**0.33**	0.40	-18.67%
Water consumption (000 m^3)	**65.90**	68.22	-3.39%
IT/electrical waste recycled (tonnes)	**54.94**	70.52	-22.08%

Data coverage: Hang Seng Bank's Hong Kong operations

KEY: **m^3** Cubic metres | **CO_2** Carbon dioxide | **GWh** Gigawatt hours

* From 1 Oct 2010 - 30 Sep 2011
\# From 1 Oct 2011 - 30 Sep 2012

Corporate Governance and Other Information

Corporate Governance Principles and Practices

Hang Seng Bank Limited (the "Bank") is committed to high standards of corporate governance with a view to safeguarding the interests of shareholders, customers, staff and other stakeholders. The Bank has followed the module on "Corporate Governance of Locally Incorporated Authorised Institutions" under the Supervisory Policy Manual 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 Corporate Governance Code contained in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") throughout the year. The Bank also constantly reviews and enhances its corporate governance framework to ensure that it is in line with international and local best practices.

Board of Directors

The Board has collective responsibilities for promoting the long-term sustainability and success of the Bank by providing entrepreneurial leadership within a framework of prudent and effective controls. In doing so, the Board commits to high standards of integrity and ethics.

According to the Board's terms of reference, specific matters reserved for the Board's consideration and decision include :

– strategic plan and objectives;

– annual operating plans and performance targets;

– annual and interim results;

– capital plans and management;

– risk appetite statement and profile;

– internal control and risk management governance (including the risk management framework);

– significant policies such as large credit exposure policy, liquidity management policy, remuneration policy and policy on board-level conflicts of interest;

– policies, practices and disclosure on corporate governance;

– policies and practices on compliance with legal and regulatory requirements;

– appointments and oversight of senior management;

– corporate values and standards;

– corporate structure;

– effective audit functions;

– transparency in respect of the structure, operation and risk management;

– acquisitions and disposals above predetermined thresholds; and

– significant changes to balance sheet management policies.

Chairman and Chief Executive

The roles of the Chairman and Chief Executive of the Bank are separate, with a clear division of responsibilities as set out in the Board's terms of reference. The Chairman of the Board is an Independent Non-executive Director who is responsible for the leadership and effective running of the Board. The Chairman possesses the requisite experience, competencies and personal qualities to fulfill these responsibilities.

The Chief Executive is an Executive Director who ensures implementation of the strategy and policy as established by the Board. The Chief Executive is responsible for the management and day-to-day running of the Bank's business and operations, and leads and chairs the Executive Committee, Risk Management Committee and Asset and Liability Management Committee.

Board Composition

As at the date of this Annual Report, the Board comprises 16 Directors, of whom two are Executive Directors and 14 are Non-executive Directors ("NEDs"). Of the 14 NEDs, nine are Independent Non-executive Directors ("INEDs"). 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.

The Board possesses, both as individual Directors and collectively, appropriate experience, competencies and personal qualities, including professionalism and integrity, to discharge its responsibilities adequately and effectively. In addition, the Board collectively has adequate knowledge and expertise relevant to each of the material business activities that the Bank pursues and the associated risks in order to ensure effective governance and oversight.

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 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.

The Bank has maintained on its website and on the website of Hong Kong Exchanges and Clearing Limited an updated list of its Directors identifying their roles and functions and whether they are INEDs. INEDs are also identified as such in all corporate communications that disclose the names of the Bank's Directors.

The independence of the INEDs has been assessed in accordance with the guidelines set out in Rule 3.13 of the Listing Rules. Following such assessment, the Board considers all the INEDs to be independent. Further, the Bank has also received from each of the INEDs an annual confirmation of his/her independence.

The Bank issues appointment letters to each of the NEDs, setting out the terms and conditions of their appointment, including the time commitment expected of them.

Board Process

Board meetings shall be held at least once every quarter. Additional Board meetings, or meetings of a board committee established by the Board to consider specific matters, can be convened, when necessary.

Schedule for the regular Board/Board Committee meetings in 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 regular Board meeting.

Other than regular Board meetings, the Chairman also meets with NEDs, including INEDs, without the presence of the Executive Directors, to facilitate an open and frank discussion among the NEDs 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 statement and profile, review of internal control and risk management framework, results of stress testings, as well as reports on large credit exposures and connected lendings.

Directors make their best efforts to contribute to the formulation of strategy, policies and decision-making by attending the Board meetings in person or via telephone or video conference facilities.

Minutes of Board/board committee meetings with details of the matters discussed by the Board/board committees 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 2012, the important matters discussed at Board meetings included :

- financial and business performance;
- strategic plan 2012 - 2014 with update for 2013 - 2015;
- risk appetite statement and profile;
- 2012 annual operating plan and capital plan;
- capital management and internal capital adequacy assessment process;
- results of enterprise stress testing analysis on the Bank's operating plan;
- significant policies such as large credit exposure policy, liquidity management policy, strategic risk management policy and reputational risk management policy;
- liquidity contingency plan;
- appointments of Directors and senior executives;
- pay review for 2012 and variable pay for 2011;
- review of the fees payable to Directors and Board Committee Chairmen/members of the Bank and its subsidiaries (the "Group")

– risk management framework and internal control framework;

– strategies for general insurance manufacturing business;

– change in accounting treatment for the Bank's investment in Industrial Bank;

– shareholders' communication policy;

– terms of appointment of NEDs;

– establishment of Nomination Committee and Risk Committee;

– terms of reference of the Board and Board Committees; and

– major regulatory changes affecting the Bank.

At the Board meeting held in January 2013, the Board also reviewed the Corporate Governance Framework of the Bank which sets out the governance practices and procedures of the Board and Board Committees.

In addition to the regular financial performance reports submitted to the Board at its regular meetings, the Board also receives financial update with information on the Bank's latest financial performance and material variance from the Bank's annual operating plan during those months where no Board meetings will be held. Directors can therefore have a balanced and understandable assessment of the Bank's performance, position and prospects throughout the year.

The Board reviews and evaluates its work process and effectiveness annually, with a view to identifying areas for improvement and further enhancement. The Board also regularly reviews the time commitment required from NEDs.

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 and Re-election of Directors

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 INEDs) will be solicited. The proposed appointments will be considered and if thought fit, approved by the Board after due deliberation and upon recommendation of the Nomination Committee. 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 ("AGM") after their appointments have become effective.

According to the policy on term of appointment of Directors adopted by the Board, term of appointment of each NED is three years except that where an NED has served on the Board for more than nine years, then his/her term of appointment is one year. In renewing the term of appointment of each NED, the Board reviews whether such NED remains qualified for his/her position.

The Bank's Articles of Association provide that one-third (or the number nearest to but not exceeding one-third) of the Directors shall retire from office every year at the Bank's AGM. Retiring Directors are eligible for re-election at AGMs of the Bank.

Responsibilities of Directors

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. In particular, through regular Board meetings and receipt of financial updates, all Directors are kept abreast of the conduct, business activities and development, as well as regulatory updates applicable to the Bank.

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 Management.

The Bank has adopted a Code for Securities Transactions by Directors on terms no less exacting than the required standards as set out in the Model Code for Securities

Transactions by Directors of Listed Issuers (as set out in Appendix 10 to the Listing Rules). Specific enquiries have been made with all Directors who have confirmed that they have complied with the Bank's Code for Securities Transactions by Directors throughout the year of 2012.

Directors' interests in securities of the Bank and HSBC Holdings plc as at 31 December 2012 are disclosed in the Report of the Directors as set out in this Annual Report.

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.

Induction and Training for Directors

Induction programmes on the following key areas are arranged for newly appointed Directors so that they can discharge their responsibilities to the Bank properly and effectively :

- the Bank's business operations in Hong Kong;
- the Bank's business operations and investments on the Mainland; and
- the Bank's controls and support functions.

Further, all Directors are provided with briefings and trainings necessary to ensure that they have a proper understanding of the Bank's operations and business and are fully aware of their responsibilities under the applicable laws, rules and regulations. Such briefings and trainings are provided at the Bank's expenses. The Bank also maintains proper records of the trainings provided to and received by its Directors.

During the year, all Directors received briefings or trainings in relation to the following topics :

- Basel III update;
- business strategy of the Bank's retail banking and wealth management;
- Competition Ordinance in Hong Kong;
- new and revised supervisory policy manuals issued by HKMA including the revised supervisory policy manual on corporate governance of authorised institutions, together with the Bank's compliance status;
- latest changes to the Listing Rules including the Corporate Governance Code, as well as the Bank's compliance status; and
- statutory disclosure obligation under the Securities and Futures Ordinance and the mechanism adopted by the Bank to ensure compliance.

In addition, members of the Audit Committee, namely, Dr Eric Li, Mr Richard Tang and Dr Marvin Cheung, also attended an intensive session on the mechanism relating to the determination of the Bank's Core Risk Appetite Measures. This provided them with more in-depth background knowledge when reviewing the Bank's risk appetite profile on a quarterly basis.

To summarise, the Directors received trainings on the following areas to update and develop their skills and knowledge during the year :

	Training areas		
Directors	**Corporate Governance**	**Regulatory**	**Business/ Management**
Executive Directors			
Ms Rose W M Lee	√	√	√
Mr Andrew H C Fung	√	√	√
NEDs			
Ms Anita Y M Fung	√	√	√
Ms Sarah C Legg	√	√	√
Dr Vincent H S Lo	√	√	√
Mrs Dorothy K Y P Sit	√	√	√
Mr Peter T S Wong	√	√	√
INEDs			
Dr Raymond K F Ch'ien	√	√	√
Dr John C C Chan	√	√	√
Dr Marvin K T Cheung	√	√	√
Ms L Y Chiang	√	√	√
Dr Fred Zuliu Hu	√	√	√
Mr Jenkin Hui	√	√	√
Dr Eric K C Li	√	√	√
Mr Richard Y S Tang	√	√	√
Mr Michael W K Wu	√	√	√

Delegation by the Board

Board Committees

The Board has set up five Committees, namely, the Executive Committee, Audit Committee, Risk Committee, Remuneration Committee and Nomination 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 and Nomination Committee, comprise solely of INEDs. All Committees report back to the Board on their decisions or recommendations on a regular basis.

Board	
Executive Committee	
Members:	Ms Rose W M Lee (Chairman)
	Mr Andrew H C Fung
	Mr Nixon L S Chan
	Mr Andrew W L Leung
	Mr Christopher H N Ho
	Mr Donald Y S Lam
	Mr Nai Pan Tang
Audit Committee	
Members:	Dr Eric K C Li* (Chairman)
	Mr Richard Y S Tang*
	Dr Marvin K T Cheung*
Remuneration Committee	
Members:	Dr John C C Chan* (Chairman)
	Mr Jenkin Hui*
	Dr Raymond K F Ch'ien*
Risk Committee	
Members:	Dr Marvin K T Cheung* (Chairman)
	Dr Eric K C Li*
	Dr Fred Zuliu Hu*
Nomination Committee	
Members:	Dr Raymond K F Ch'ien* (Chairman)
	Ms Rose W M Lee
	Dr John C C Chan*
	Mr Jenkin Hui*
	Mr Peter T S Wong#

* INEDs
\# NED

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 Group. 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 Manuals 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 business (including insurance) risk, pension risk, security and fraud risk, and sustainability risk, and is responsible for approval of all risk management related policies. Risk Management Committee meetings are held monthly. Minutes of the meetings of Risk Management Committee, which have been endorsed by the Chairman of the Risk Management Committee (i.e. the Chief Executive), are provided to the Executive Committee and the Risk Committee for review.

Audit Committee

The Audit Committee meets at least four times a year, with the Bank's executives including, but not limited to, the Chief Executive, Chief Financial Officer, Chief Risk Officer and Head of Audit, and representatives of Bank's external auditor. The Committee reviews, 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 relating to financial reporting. The Audit Committee is also responsible for making recommendations to the Board on the appointment, re-appointment, removal and remuneration of the Bank's external auditor. In addition, the Audit Committee has established a "Policy for the Reporting of Improprieties" to provide a secured and confidential channel through which all staff members may report incidents of improprieties in a secured and confidential manner so that the same will be timely and thoroughly investigated and appropriate actions can be taken promptly.

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

During the year, the Audit Committee held five regular meetings and one informal meeting. The major work performed by the Committee during 2012 included:

– reviewing the Bank's financial statements for the year ended 31 December 2011 and the related documents, and the management letters and audit issues noted by the Bank's external auditor;

– reviewing the Bank's interim financial statements for the six months ended 30 June 2012 and the related documents, and the issues noted by the Bank's external auditor;

– reviewing essential matters or reports relating to financial control, internal audit, compliance and internal control, and discussing the same with the Management;

– reviewing risk-related matters including, but not limited to, the Bank's risk management framework, risk appetite statement and profile, enterprise stress testing analysis, risk dashboards, risk maps, top and emerging risks, and balance sheet management position;

– reviewing the Bank's 2012 annual operating plan and capital plan;

– reviewing the Bank's capital management and internal capital adequacy assessment process;

– reviewing the Bank's progress in implementing Basel III;

– 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 2013;

– reviewing the remuneration and engagement letters of the Bank's external auditor, and its independence and objectivity, and the effectiveness of the audit process;

– reviewing the adequacies of resources, qualifications and experience of staff of the Bank's Accounting and Financial Reporting function, Internal Audit function and Risk Management function, and their training programmes and budgets;

– reviewing the effectiveness of the Policy for the Reporting of Improprieties and the incidents reported through such channel; and

– exercising oversight over the audit and risk committees (as appropriate) of the Bank's principal subsidiaries.

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

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

Risk Committee

The Risk Committee was set up in December 2012. It meets at least four times a year, with the Bank's executives including, but not limited to, the Chief Financial Officer, the Chief Risk Officer, the Chief Compliance Officer and the Head of Audit, and representatives of the Bank's external auditor. The Committee is responsible for, among other things, the Bank's high level risk related matters, risk appetite and tolerance, risks associated with proposed strategic acquisitions or disposals, risk management reports from the Management, the effectiveness of the Bank's risk management framework and the systems of internal control and compliance (other than internal financial control systems), and the appointment and removal of the Bank's Chief Risk Officer.

The Risk Committee reports to the Board following each Risk 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 Risk Committee meets with the Bank's Head of Audit without the presence of the Management at least once a year.

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

Remuneration Committee

The Remuneration Committee meets at least twice a year to consider and make recommendations to the Board on the policy and structure for all remuneration and fees of Directors, senior management and key personnel in order to attract, motivate and retain quality personnel. The Committee also determines the remuneration policy, and the specific remuneration packages of all Executive Directors, senior management and key personnel. In addition, it also reviews at least 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 relevant regulatory requirements and promotes effective risk management.

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

The Remuneration Committee held two meetings in 2012. The major work performed by the Committee during the year included:

– reviewing the outcome of the review of the Bank' s remuneration policy and remuneration system, and the adequacy and effectiveness of its implementation;

– reviewing the fees payable to the Chairman/Directors and Board Committee Chairmen/members of the Group and recommending the same to the Board for approval;

– determining the remuneration packages of the Executive Directors, senior management and key personnel of the Bank; and the Vice-Chairman and Chief Executive of Hang Seng Bank (China) Limited;

– reviewing the proposed variable pay for 2011 and recommending the same to the Board for approval; and

– reviewing the pay review proposal for 2012 and recommending the same to the Board for approval.

At the Remuneration Committee meeting held in February 2013, the Remuneration Committee also reviewed the report on the alignment of risk and remuneration as contained in the Bank's remuneration policy.

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

Nomination Committee

The Nomination Committee was set up in March 2012 with primary objective to lead the process for Board appointments and to identify and nominate for the approval of the Board, candidates for appointment to the Board. It meets at least twice a year.

The Nomination Committee also considers, among other things, the structure, size and composition of the Board, the balance of skills, knowledge and experience on the Board leadership needs of the Bank, both executive and non-executive, the independence of INEDs, the term of appointment of NEDs, membership of Board Committees, and the time required from NEDs.

The Nomination Committee had one meeting in 2012 following its establishment in March 2012. The major work performed by the Committee during the year included:

– reviewing the Nomination Committee's terms of reference;

– reviewing the policy relating to term of appointment of NEDs;

– recommending to the Board for approval of the composition of the Bank's Risk Committee; and

– recommending to the Board for approval of the continuation of NEDs' term of appointment.

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

Attendance Records

The attendance records of Board and Board Committee meetings held in 2012 are set out in the following table:

	Meetings held in 2012					
	2012 AGM	Board	Executive Committee	Audit Committee	Remuneration Committee	Nomination Committee
Number of Meetings	1	9 Note 1	13 Note 2	5	2	1
Directors						
Dr Raymond K F Ch'ien* *(Chairman)*	1/1	9/9	–	–	2/2	1/1
Mrs Margaret Leung Note 3	1/1	5/5	5/5	–	–	–
Ms Rose W M Lee Note 4 *(Vice-Chairman and Chief Executive)*	1/1	6/6	8/8	–	–	1/1
Dr John C C Chan*	1/1	9/9	–	–	2/2	1/1
Dr Marvin K T Cheung*	1/1	8/9	–	5/5	–	–
Ms L Y Chiang*	1/1	7/9	–	–	–	–
Mr Andrew H C Fung	1/1	9/9	12/13	–	–	–
Ms Anita Y M Fung#	1/1	5/9	–	–	–	–
Dr Fred Zuliu Hu*	1/1	7/9	–	–	–	–
Mr Jenkin Hui*	1/1	7/9	–	–	2/2	0/1
Ms Sarah C Legg#	1/1	7/9	–	–	–	–
Dr Eric K C Li*	1/1	7/9	–	5/5	–	–
Dr Vincent H S Lo#	1/1	8/9	–	–	–	–
Mrs Dorothy K Y P Sit#	1/1	9/9	–	–	–	–
Mr Richard Y S Tang*	1/1	9/9	–	5/5	–	–
Mr Peter T S Wong#	1/1	9/9	–	–	–	1/1
Mr Michael W K Wu*	1/1	8/9	–	–	–	–
Senior Executives						
Mr Nixon L S Chan	–	–	11/13	–	–	–
Mr Christopher H N Ho	–	–	13/13	–	–	–
Mr Donald Y S Lam	–	–	13/13	–	–	–
Mr Andrew W L Leung	–	–	12/13	–	–	–
Mr David W H Tam Note 5	–	–	1/1	–	–	–
Mr Nai Pan Tang Note 6	–	–	10/12	–	–	–
Average Attendance Rate	100%	88.9%	94.7%	100%	100%	80%

* INEDs
\# NEDs

Note 1 The Board held eight regular meetings and one strategic session in year 2012.

Note 2 The Executive Committee held 12 regular meetings and one ad hoc meeting in year 2012.

Note 3 Mrs Margaret Leung retired as Vice-Chairman and Chief Executive of the Bank with effect from 11 May 2012.

Note 4 Ms Rose Lee was appointed as NED of the Bank with effect from 22 March 2012 and re-designated as Vice-Chairman and Chief Executive of the Bank with effect from 11 May 2012.

Note 5 Mr David W H Tam retired and ceased to be a member of the Executive Committee with effect from 28 January 2012.

Note 6 Mr Nai Pan Tang was appointed as a member of the Executive Committee with effect from 28 January 2012.

Note 7 The Risk Committee was established on 12 December 2012 and did not hold any meeting during the year.

Remuneration of Directors, Senior Management and Key Personnel

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

Remuneration of Directors

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

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

– business needs;

– general economic situation;

– changes in appropriate markets such as supply/demand fluctuations and changes in competitive conditions;

– individual contributions to results as confirmed in the performance appraisal process; and

– retention consideration and individual potential.

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

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

	Fees for 2012 (HK$ '000)	Fees/Proposed fees for 2013 (HK$ '000)
Board of Directors		
Chairman	440	590 Note 9
Vice-Chairman	Nil Note 8	NIL Note 8
Other Directors	340 Note 8	450 Notes 8 and 9
Audit Committee		
Chairman	260	260 Note 10
Members	160	160 Note 10
Risk Committee		
Chairman	N/A	260 Note 10
Members	N/A	160 Note 10
Members of both Audit Committee and Risk Committee	N/A	280 Note 10
Remuneration Committee/Nomination Committee		
Chairman	90	90
Members	60	60

Note 8 In line with the remuneration policy of HSBC Group, no Directors' fees are paid to those Directors who are full time employees of the Group.

Note 9 Having regard to the recent 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 NEDs, a resolution will be proposed for approval by the Bank's shareholders at the 2013 AGM to increase the fees payable by the Bank to the Chairman and the NEDs to HK$590,000 per annum and HK$450,000 per annum respectively. If approved by the shareholders, the proposed increase in the fees payable to the Chairman and the NEDs will become effective retrospectively as from 1 January 2013. More information on the proposed fees to the Chairman and the NEDs is set out in the Circular in relation to the 2013 AGM to be issued in March 2013.

Note 10 Having regard to the latest market trend, and the workload and commitments required, the Board has approved the fees payable to the Chairman and Members of Risk Committee, and INEDs who will be members of both Audit Committee and Risk Committee, which became effective as from 1 January 2013. Further, the Board has approved to maintain the fees payable to the Chairman and Members of Audit Committee after the establishment of Risk Committee.

Information relating to the remuneration of each Director for the year ended 31 December 2012 is set out in Note 19 to the Bank's 2012 Financial Statements.

Remuneration of Senior Management and Key Personnel

There were 10 employees and three employees being classified as Senior Management [Note 11] and Key Personnel [Note 12] respectively during the year.

Aggregate amount of remuneration [Note 13] of the Senior Management and Key Personnel during the year, split into fixed and variable remuneration, is set out below:

	2012 (13 employees)	
Amount (HK$ '000)	**Non-deferred**	**Deferred**
Fixed remuneration		
Cash	34,326	–
Variable remuneration		
Cash	20,211	2,165
Shares	1,443	9,166

Note 11 Senior Management refers to those executives who are either:
(a) members of the Executive Committee of the Bank, namely, (i) Executive Directors; (ii) senior executives of the Bank at the rank of Band 1; and if not already covered by the aforesaid, (iii) Heads of the Bank's major business lines, namely, Global Banking and Markets, Retail Banking and Wealth Management, and Corporate and Commercial Banking; (iv) Chief Risk Officer; (v) Chief Financial Officer; and (vi) Chief Operating Officer; or
(b) Head(s) of the Bank's principal subsidiary/subsidiaries with offshore operations and with total assets representing more than 5% of the Bank's total assets.

Note 12 Key Personnel refers to those executives other than Senior Management at the rank of Band 3 or above who are engaged in trading and dealing activities which involve the assumption of material risk or the taking on of material exposures on behalf of the Group.

Note 13 Remuneration refers to all remuneration payments payable to employees during the year with reference to their tenure as Senior Management and Key Personnel.

Aggregate amount of deferred variable remuneration, split into (a) vested and paid during the year and (b) outstanding and unvested as at 31 December 2012, is set out below:

Amount (HK$ '000)	Awarded for Performance Year 2012	Awarded for Prior Performance Years
Vested and paid out during 2012		
Cash	–	1,723
Shares	–	27,105
Outstanding and unvested as at 31 December 2012		
Cash	2,165	7,783
Shares	9,166	23,199

There was no deferred variable remuneration being reduced through performance adjustments in 2012.

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

	Amount (HK$ '000)
Total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit/implicit adjustments	42,313
Total amount of reductions during the year due to:	
– Ex post explicit adjustments	–
– Ex post implicit adjustments	+9,501

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

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 an annual basis. Reports on financial results, business performance and variances against the approved annual operating plan are submitted to the Board for regular review and monitoring at Board meetings.

Strategic planning cycles are generally from three to five years. The Bank's strategic plan 2013-2015 was reviewed and approved by the Board in January 2013. Progress on the implementation of the key initiatives in the strategic plan is 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 2012, 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 2012 Financial Statements.

Internal Controls

System and Procedures

The Board is responsible for internal control at the Group 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 encounters. 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 the reporting on risk management. The Bank maintains an effective risk management framework through the setting up of specialised management committees for the oversight and monitoring of major risk areas and the establishment of risk management departments for relevant functions of the Bank. Relevant risk management reports are submitted to Asset and Liability Management Committee, Risk Management Committee, Executive Committee and Risk 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 policies and procedures.

More detailed discussion on the policies and procedures for management of each of the major types of risk the Bank encounters are set out in the risk management section of the "Financial Review" in this Annual Report, and in Note 62 to the Bank's 2012 Financial Statements.

Annual Assessment

A review of the effectiveness of the Bank's internal control system covering all material controls, including financial, operational, compliance, and risk management controls, is conducted annually. The review at the end of 2012 was conducted with reference to the COSO (The Committee of Sponsoring Organisations of the Treadway Commission) internal control framework, which assesses the Bank's internal control system against the five elements of control environment, risk assessment, control activities, information and communication, and monitoring. The Bank has also conducted an annual review to assess the adequacy of resources, qualifications and experience of staff of the Bank's accounting and financial reporting function, and their training programmes and budget. The approach, findings, analysis and results of these annual reviews have been reported to the Audit Committee and the Board.

Framework for Disclosure of Inside Information

The Bank has put in place a robust framework for the disclosure of inside information in compliance with the Securities and Futures Ordinance. The framework sets out the procedures and internal controls for the handling and dissemination of inside information in a timely manner so as to allow the shareholders, customers, staff and other stakeholders to apprehend the latest position of the Group. The framework and its effectiveness are subject to review on a regular basis according to established procedures.

Internal Audit

The internal audit function provides independent, objective assurance to the Management and the Audit Committee over the risk management, governance and controls framework, including financial controls, to add value and to improve operations through process and control enhancement recommendations. It accomplishes its objectives by bringing a systematic, disciplined approach to the evaluation and improvement of the effectiveness of risk management, control, and governance processes and thereby helps the Management to achieve its own objectives within its stated risk appetite and in accordance with the Bank's ethics, values and standards. The scope of work of the internal audit function is to provide assurance as to whether the framework of risk management, control, and governance processes, as designed and represented by the Management, is adequate and functioning. Opportunities for improving management and financial control, profitability, best practice and the Bank's corporate image may be identified during audits and will be communicated to the appropriate level of the Management. The Bank's Head of Audit reports to the Chairman and the Audit Committee.

External Auditor

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

During 2012, fees paid to the Bank's external auditor for audit services amounted to HK$12.7m, compared with HK$13.3m in 2011. For non-audit services, the fees paid to the Bank's external auditor amounted to HK$7.6m, compared with HK$6.7m in 2011. In 2012, the significant non-audit service assignments covered by these fees include the following:

Nature of service	Fees paid (HK$m)
Other assurance services	7.1
Tax services	0.5
	7.6

Audit Committee

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

Risk Committee

The Risk Committee assists the Board in meeting its responsibilities for ensuring effective systems of risk management, internal control and compliance (other than that relating to financial reporting), and in meeting its risk governance obligations.

Communication with Shareholders

Effective Communication

The Bank attaches great importance to communication with shareholders. To this end, a number of means are used to promote greater understanding and dialogue with the investment community. The Bank holds group meetings with analysts in connection with the Bank's annual and interim results. The results announcements are also broadcast live via webcast. Apart from the above, designated senior executives maintain regular dialogue with institutional investors and analysts to keep them abreast of the Bank's development, subject to compliance with the applicable laws and regulations. Including the two results announcements, over a hundred meetings with analysts and fund managers were held in 2012. 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.

Further, the Bank's website (www.hangseng.com) offers timely access to the Bank's financial information, announcements/circulars to shareholders and information on the Bank's corporate governance structure and practices. For efficient communication with shareholders and in the interest of environmental preservation, shareholders are encouraged to browse the Bank's corporate communications on the Bank's website, in the place of receiving printed copies of the same.

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

The Bank's last AGM was held on Friday, 11 May 2012 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 AGM will be held on Thursday, 16 May 2013, 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 2013.

Calling an Extraordinary General Meeting

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

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

The requisition must also (a) state the name(s) of the requisitionist(s), (b) the contact details of the requisitionist(s) and (c) the number of ordinary shares of the Bank held by the requisitionist(s).

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

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

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

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

Putting Forward Proposals at General Meetings

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

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

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

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

Putting Enquiries to the Board

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

Shareholders Communication Policy

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

Material Related Party Transactions and Connected Transactions

Material Related Party Transactions and Contracts of Significance

The Bank's material related party transactions are set out in Note 61 to the 2012 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 2012, the Bank's share of the costs included HK$121m for system development, HK$225m for data processing, and HK$240m 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$202m and HK$63m respectively in 2012. 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 2012 amounted to HK$75m.

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 2012: HK$479m) as contracts of significance for 2012.

Continuing Connected Transactions

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

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

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

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

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

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

The Directors believed that the Management Services Agreement would enable HSIC to run at a reasonably low cost structure by leveraging 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 Investment Management Agreement was based on the commercial terms set out in the previous investment management agreement which expired on 21 June 2010 and the Directors (including the INEDs) believed that these terms should remain in place.

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

For the year ended 31 December 2012, the aggregate amount paid under the Management Services Agreement was HK$84m, whereas the aggregate amount paid under the Investment Management Agreement was HK$67m.

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

(a) in the ordinary and usual course of business of the Group;

(b) on normal commercial terms; and

(c) in accordance with the relevant agreements governing the same on terms that are fair and reasonable and in the interests of the Bank and its shareholders as a whole.

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

Human Resources

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

Employee Statistics

As at 31 December 2012, the Bank's total headcount was 9,680, representing a decrease of 154, or 1.6%, compared with a year earlier. The total headcount comprised 1,493 executives, 4,153 officers and 4,034 clerical and non-clerical staff. The reduction in headcount was mainly caused by enhancement in operational efficiency and a longer lead time in recruiting new hires due to difficulties in identifying suitable candidates in the market.

Employee Remuneration

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

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

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

Bank-wide variable pay budgets are formulated in consideration of the Bank's business performance, people strategy and the risk appetite parameters, including operational risk, credit risk, funding / liquidity risk, risk adjusted return and capital strength. This helps to ensure that the variable pay pool is shaped by risk considerations and the Bank's performance is sustainable in the long-term. The ex ante risk adjustment of remuneration within the Bank is achieved in the way that the Risk Committee of the Bank will advise the Board and/or the Remuneration Committee, as appropriate, on the alignment of risk appetite with performance objectives set in the context of variable incentive and on whether any adjustments for risk need to be applied when considering performance objectives and actual performance. In addition, the overall variable pay funding proposal is refined with reference to the advice of Chief Risk Officer and Chief Financial Officer in respect of the Bank's financial position and performance against its Risk Appetite profile.

Variable pay is determined with respect to individual's performance against respective financial and non-financial goals and measures including sales quality, customer satisfaction, values and behaviours, adherence to risk and compliance and the relevant governance criteria. Under such arrangement, the performance and remuneration of control function staff is assessed according to a performance scorecard specific to the functional role they undertake which is independent of the businesses they oversee.

Variable pay consists of deferred and non-deferred components in the forms of cash and share award. The Bank adopts a progressive deferral mechanism with higher deferral rates and different forms of deferral by reference to (a) the employee's seniority, role, responsibilities and the potential risks that their activities may create for the Bank; and (b) their total amount of variable remuneration exceeding the prescribed thresholds. The deferred award has a vesting period of three to five years and is subject to clawback under certain specific circumstances with respect to the awardee's conduct or the Bank's performance.

The principles of the remuneration policy are applicable to the Group, subject to the local legislative requirements and market practices and are proportionate to the scope and complexity of the local business.

Employee Engagement

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

The Pulse Survey was conducted quarterly in 2012 and follow up actions were taken as a continuous effort to drive business performance and a value-based culture across the Bank. The results showed that the Bank's strategies are well communicated and implemented by leaders and staff, and that our culture is moving towards one driven by the Bank's corporate values. The Bank also puts a continuous focus on improving business performance through enhancing connectivity between the businesses and engagement of the employees.

Growth and Development

The Bank is committed to ensure the competence and ethical behaviour of staff members with due regard to the principles set out in HKMA's Supervisory Policy Manual CG-6 on "Competence and Ethical Behaviour". The Bank has established policies and procedures for monitoring, developing and maintaining the competence levels and ethical behaviour of staff members. These include clear guidance as set out in various policy manuals, robust performance management system and training and development solutions provided on regular and need basis.

In order to fully develop staff competence and potential, the Bank has a comprehensive induction programme that provides new staff with an understanding of the Bank's history, culture, values and corporate governance. To equip staff members to meet future challenges and professional requirements, especially those who are involved in regulated businesses and activities, the Bank offers a wide range of training and development programmes in the areas of sales and relationship management, products, operations, compliance, credit and risk. The Bank also offers Professional Qualifications and Education Award Scheme to support staff members to pursue professional or academic qualifications. On average, our staff members received six days of training in 2012.

The Bank aims to strengthen the leadership pipeline and support the personal growth of staff by providing a broad range of leadership and management development solutions. To ensure sustainability, the Bank has strategy, measures and metrics to plan and manage succession to critical roles, and to facilitate talent feed to the succession pipeline. Line businesses and the Human Resources function are connected to accelerate the development of talents and high potential staff through a mix of on-the-job training, coaching and learning interventions.

With a strategic focus to further strengthen the leading service brand of the Bank, a series of training and on-the-job development solutions were launched in 2012 for managerial staff and front line staff of the Bank's branch network. Through these, branch network staff are reinforced with the mindset and skills to effectively lead, drive and deliver service excellence to the Bank's customers.

Recruitment and Retention

Following the uncertain economic outlook in year 2011, headcount has been closely monitored in the first half of 2012 and external recruitment was focused on front line sales and critical specialist positions justified by business needs. Active recruitment activities gradually resumed in the second half of 2012, especially for front line sales positions, experienced professionals and specialists to meet business needs and for replacement of staff turnover.

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

Other Information

Organisational Structure

Under the Bank's current organisational structure, the Bank's businesses and functions are set out as follows:

Businesses

Retail Banking and Wealth Management
Corporate and Commercial Banking
Global Banking and Markets

Functions

Audit
Communications
Company Secretarial Services
Corporate Sustainability
Financial Control
Human Resources
Legal
Marketing
Risk and Compliance
Strategic Planning and Corporate Development
Technology and Services

Business Principles and Values

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

Code of Conduct

To ensure the Bank operates according to the highest standards of ethical conduct and professional competence, all staff are required to strictly follow the Code of Conduct contained in the Bank's Staff Handbook. With reference to the applicable regulatory guidelines and other industry best practices, the Code sets out ethical standards and values to which all the Bank's staff are required to adhere and covers various legal, regulatory and ethical issues. Topics including but not limited to the prevention of bribery, use of information, insider dealing and personal investment dealing, personal benefits, outside directorships/employment and equal opportunities policy are covered in the Code.

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.

Avoidance of Conflicts of Interest

The Bank has set standards and established policies and procedures to manage actual or potential conflicts of interest. Stringent internal structures have been designed to ensure adequate segregation of duties and avoid conflicts of interest. Staff working in sensitive or high-risk areas are required to adhere to job-specific rules and undergo training regarding avoidance of conflicts of interest in carrying out their duties.

Health and Safety

The Bank has a demonstrated commitment to occupational health and safety ("OH&S") in the workplace with employee engagement through committees, forums and working groups in the development of an OH&S Policy and Management System. By successfully implementing the certified BS OHSAS 18001:2007-compliant Safety Management System, the Bank marks its achievement to be the first bank world-wide to conform to this internationally acclaimed best practice aiming at reducing the exposure of the Bank's staff, contractors and customers to OH&S risks associated with its business activities at premises over which it has control.

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

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

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

Biographical Details of Directors

* Dr Raymond CH'IEN Kuo Fung GBS, CBE, JP CHAIRMAN AGED 61

Joined the Board since August 2007

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited
– Chairman of Nomination Committee;
Member of Remuneration Committee

Other major appointments

Justice of the Peace
^ China.com Inc – Chairman
^ China Resources Power Holdings Company Limited
– Independent Non-executive Director
^ Convenience Retail Asia Limited
– Independent Non-executive Director
Economic Development Commission of HKSAR Government
– Non-official Member *(Note 1)*
Federation of Hong Kong Industries – Honorary President
Hong Kong Mercantile Exchange Limited
– Independent Non-executive Director
^ MTR Corporation Limited – Non-executive Chairman
^ Swiss Re Limited – Independent Non-executive Director
The Hongkong and Shanghai Banking Corporation Limited
– Independent Non-executive Director
The Tianjin Municipal Committee of the Chinese People's Political Consultative Conference
– Member of Standing Committee
^ The Wharf (Holdings) Limited
– Independent Non-executive Director
^ UGL Limited – Non-executive Director *(Note 1)*
University of Pennsylvania, USA – Trustee

Past major appointments

Ascendas China Commercial Fund Management Limited
– Chairman (2011-2012) *(Note 1)*
^ CDC Corporation – Chairman (1999-2011)
^ CDC Software Corporation – Director (2009-2012)
Executive Council of HKSAR Government
– Member (1997-2002)
Executive Council of Hong Kong, then under British Administration – Member (1992-1997)
^ HSBC Holdings plc
– Independent Non-executive Director (1998-2007)
HSBC Private Equity (Asia) Limited – Chairman (1997-2010)
^ Inchcape plc
– Independent Non-executive Director (1997-2009)
Independent Commission Against Corruption
– Chairman of Advisory Committee on Corruption (1998-2006)
The APEC Business Advisory Council
– Hong Kong Member (2004-2009)
The Hong Kong/European Union Business Cooperation Committee – Chairman (2005-2012)

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)

Ms Rose LEE Wai Mun VICE-CHAIRMAN AND CHIEF EXECUTIVE AGED 60

Joined the Board since March 2012

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited
– Chairman of Executive Committee;
Member of Nomination 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

City University of Hong Kong
– Member of the Advisory Committee of the Centre for Transportation, Trade and Financial Studies
Hang Seng Management College
– Chairman of the Board of Governors *(Note 1)*
Hang Seng School of Commerce
– Chairman of the Board of Directors *(Note 1)*
Ho Leung Ho Lee Foundation – Member of Board of Trustees
Hong Kong General Chamber of Commerce
– Vice Chairman of the China Committee
Hong Kong Shipowners' Association
– Honorary Treasurer; Member of the Executive Committee
^ HSBC Holdings plc – Group General Manager *(Note 1)*
^ Hutchison Whampoa Limited
– Independent Non-executive Director *(Note 1)*
^ Swire Pacific Limited – Independent Non-executive Director
The Hongkong and Shanghai Banking Corporation Limited
– Director
The Hong Kong Institute of Bankers – Vice President *(Note 1)*
The Hong Kong University of Science and Technology
– Member of the Court *(Note 1)*

Past major appointments

Bank of Shanghai – Director (2006-2012)
HKSAR Government Education and Manpower Bureau
– Member of the Continuing Education Fund China Business Focus Group (2002-2009)
Hong Kong Monetary Authority
– Member of the PRC Offshore Financing Consultative Committee (1998-2000)
Hong Kong Trade Development Council
– Member of the China Trade Advisory Committee (2007-2011)
The Hong Kong Institute of Bankers
– Member of the China Development Committee (2005-2007)
The Hongkong and Shanghai Banking Corporation Limited
– joined Corporate Finance Department of Wardley Limited in 1977, seconded to Area Office China, HSBC in 1979; appointed Deputy Chief Executive, China Business (1994-2002), Managing Director of Hongkong Bank China Services Limited (1985-2004), Head of Corporate Banking, Hong Kong (2002-2004), Head of Corporate and Institutional Banking, Hong Kong (2004-2007), Head of Corporate Banking, Hong Kong and China (2007-2008), Head of Global Banking, China and Hong Kong (2008-2009) and Advisor, China and Hong Kong (2009-2012)

Qualification

Bachelor's Degree in Business Administration
– The University of Hawaii

* Dr John CHAN Cho Chak GBS, JP DIRECTOR AGED 69

Joined the Board since August 1995

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited
  – Chairman of Remuneration Committee;
    Member of Nomination Committee

Other major appointments

Justice of the Peace
^ Guangdong Investment Limited
  – Independent Non-executive Director
Hong Kong Monetary Authority
  – Member of The Exchange Fund Advisory Committee
Long Win Bus Company Limited
  – Non-executive Director
^ RoadShow Holdings Limited
  – Chairman and Non-executive Director
^ Swire Properties Limited
  – Independent Non-executive Director
Sir Edward Youde Memorial Fund – Chairman of the Council
The Community Chest of Hong Kong – Board Member
The Hong Kong University of Science and Technology
  – Chairman of the Court
The Kowloon Motor Bus Company (1933) Limited
  – Non-executive Director
^ Transport International Holdings Limited
  – Deputy Chairman and Independent
    Non-executive Director

Past major appointments

HKSAR Commission on Strategic Development
  – Non-Official Member (2005-2009)
^ Hong Kong Exchanges and Clearing Limited
  – Independent Non-executive Director (2000-2003)
Hong Kong Civil Service
  – Private Secretary to the Governor;
    Deputy Secretary (General Duties);
    Director of Information Services; Deputy Chief Secretary;
    Secretary for Trade and Industry; Secretary for Education
    and Manpower (1964-1978; 1980-1993)
The Community Chest of Hong Kong
  – Vice Patron (2004-2011)
The Hong Kong Jockey Club – Chairman (2006-2010)

Qualifications

Degree of Doctor of Social Sciences (honoris causa)
  – Lingnan University, The University of Hong Kong and
    The Hong Kong University of Science and Technology
Degree of Doctor of Business Administration (honoris causa)
  – International Management Centres
Diploma in Management Studies – The University of Hong Kong
Honours Degree in English Literature
  – The University of Hong Kong

Major award

Gold Bauhinia Star (1999)

* Dr Marvin CHEUNG Kin Tung GBS, OBE, JP DIRECTOR AGED 65

Joined the Board since May 2004

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited
  – Chairman of Risk Committee *(Note 1)*;
    Member of Audit Committee

Other major appointments

Justice of the Peace
Airport Authority Hong Kong – Chairman
Economic Development Commission of HKSAR Government
  – Non-official Member of the Working Group
    on Transportation *(Note 1)*
^ HKR International Limited
  – Independent Non-executive Director
Hong Kong University of Science and Technology
  – Chairman of the Council
^ HSBC Holdings plc
  – Independent Non-executive Director;
    Audit Committee member
The Tracker Fund of Hong Kong
  – Chairman of the Supervisory Committee

Past major appointments

Barristers Disciplinary Tribunal – Member (1998-2012)
Executive Council of HKSAR Government
  – Non-official Member (2005-2012)
^ Hong Kong Exchanges and Clearing Limited
  – Independent Non-executive Director (2005-2011)
^ Sun Hung Kai Properties Limited
  – Independent Non-executive Director (2007-2009)
Independent Commission Against Corruption
  – Member of Operations Review Committee (2004-2009)
KPMG Hong Kong
  – Chairman and Chief Executive Officer (1996-2003)

Qualifications

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

Major awards

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

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

Biographical Details of Directors

* Ms CHIANG Lai Yuen JP DIRECTOR AGED 47

Joined the Board since September 2010

Other major appointments

Justice of the Peace
^ 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
Federation of Shenzhen Industries – Vice-Chairman
The Hong Kong University of Science and Technology
– Member of the Court *(Note 1)*
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 appointments

Disciplined Services Salaries and Conditions of Service of HKSAR Government
– Member of Standing Committee (retired in December 2010)
The Hong Kong University of Science and Technology
– Member of the Council (2006-2012) *(Note 1)*
The Open University of Hong Kong
– Member of the Council (2006-2012)

Qualification

Bachelor Degree of Arts – Wellesley College, USA

Major award

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

Mr Andrew FUNG Hau Chung JP EXECUTIVE DIRECTOR AND HEAD OF GLOBAL BANKING AND MARKETS AGED 55

Joined the Board since October 2011

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited – Member of Executive Committee
Hang Seng Asset Management Pte Ltd – Director
Hang Seng Bullion Company Limited – Director
Hang Seng Insurance Company Limited – Director
Hang Seng Investment Management Limited
– Director and General Manager
Hang Seng Investment Services Limited – Director
Hang Seng Life Limited – Director
Hang Seng Securities Limited – Executive Director

Other major appointments

Justice of the Peace
Business Facilitation Advisory Committee
– Non-official member
Central Policy Unit of HKSAR Government
– Associate Member *(Note 1)*
Hong Kong Institute of Certified Public Accountants
– Lay Member of the Council
^ Industrial Bank Co., Ltd.
– Director; Member of Executive Committee; Member of Remuneration and Examination Committee
Labour Department
– Member of the Protection of Wages on Insolvency Fund Board
Securities and Futures Commission
– Member of Products Advisory Committee
The Community Chest of Hong Kong – Board member
The Federation of Hong Kong Industries
– Member of General Committee
The Hong Kong Mortgage Corporation Limited – Director
The Liaoning Shenyang Committee of the Chinese People's Political Consultative Conference – Member *(Note 1)*
Treasury Markets Association
– Member of the Executive Board

Past major appointments

Central Policy Unit of HKSAR Government – Pan-Pearl River Delta Panel
– Member (2011-2012) *(Note 1)*
^ Hang Seng Bank Limited
– Executive Director and Head of Treasury and Investment (2011-2012);
General Manager and Head of Treasury and Investment (2009-2011);
General Manager and Head of Investment and Insurance (2008-2009);
Deputy General Manager and Head of Investment and Insurance (2006-2008)
DBS Bank (Hong Kong) Limited
– Managing Director, Advisory Sales, Greater China, Wholesale Banking – Global Financial Markets (2002-2006)
^ Commonwealth Bank of Australia, Hong Kong Branch
– Treasurer and Head of Capital Markets, Asia (1996-2002)
Hong Kong Trade Development Council
– Member of the Financial Services Advisory Committee (2008-2012) *(Note 1)*
The Hongkong and Shanghai Banking Corporation Limited
– Head of Hong Kong Dollar Markets (1991-1996)
Securities and Futures Commission
– Member of Process Review Panel (2006-2012) *(Note 1)*

Qualifications

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

Ms Anita FUNG Yuen Mei DIRECTOR AGED 52

Joined the Board since November 2011

Other major appointments

Airport Authority Hong Kong – Board Member
Aviation Security Company Limited – Board Member
^ Bank of Communications Co., Ltd. – Non-executive Director
Hong Kong Housing Authority – Non-official Member *(Note 1)*
Hong Kong Monetary Authority
– Member of Banking Advisory Committee; Member of the Financial Infrastructure Sub-committee of the Exchange Fund Advisory Committee
HSBC Global Asset Management (Hong Kong) Limited
– Chairman and Director
^ HSBC Holdings plc – Group General Manager
The Community Chest of Hong Kong – Board Member
The Hongkong and Shanghai Banking Corporation Limited
– Chief Executive Officer, Hong Kong
The Hong Kong Trade Development Council
– Member of the Financial Services Advisory Committee
The Hong Kong University of Science and Technology
– Member of the Council
Treasury Markets Association – Member of the Council

Past major appointments

Hong Kong Monetary Authority
– Member of the Currency Board Sub-committee of the Exchange Fund Advisory Committee (2012) *(Note 1)*
HSBC Bank (China) Company Limited
– Deputy Chairman (2011-2012) *(Note 1)*
The Financial Services and the Treasury Bureau
– Non-official member of the Advisory Committee on Bond Market Development (2010-2012) *(Note 1)*
The Hongkong and Shanghai Banking Corporation Limited
– joined as Head of HKD Bond Markets (1996-1998), and was appointed Head of Asian Fixed Income Trading (1998-2001), Head of Trading, Asia-Pacific (2001-2003), Treasurer and Co-Head of Global Markets, Asia-Pacific (2003-2004), Treasurer and Head of Global Markets, Asia-Pacific (2005-2010) and Head of Global Banking and Markets, Asia-Pacific (2010-2011)
The Hong Kong Association of Banks
– Chairman (2012) *(Note 1)*
The Hong Kong Trade Development Council
– Ex-officio Member (2012) *(Note 1)*
Treasury Markets Association
– Member of the Executive Board, and the Chairman of the Market Development Committee (2005-2012) *(Note 1)*

Qualifications

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

* Dr HU Zuliu, Fred DIRECTOR AGED 49

Joined the Board since May 2011

Other position held within Hang Seng Group

^ Hang Seng Bank Limited
– Member of Risk Committee *(Note 1)*

Other major appointments

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

Past major appointments

Goldman Sachs Group Inc.
– Managing Director (2000-March 2010); Chairman of Greater China (2008-March 2010)
HKSAR Commission on Strategic Development
– Member (2007-2009)
Securities and Futures Commission
– Member of Advisory Committee (2009-2011)
^ Shanghai Pudong Development Bank Co., Ltd.
– Independent Director (2002-2008)

Qualifications

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

* Mr Jenkin HUI DIRECTOR AGED 69

Joined the Board since August 1994

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited
– Member of Nomination Committee; 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

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

Biographical Details of Directors

Ms Sarah Catherine LEGG DIRECTOR AGED 45

Joined the Board since February 2011

Other major appointments

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

Past major appointments

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

Qualifications

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

* Dr Eric LI Ka Cheung GBS, OBE, JP DIRECTOR AGED 59

Joined the Board since February 2000

Other positions held within Hang Seng Group

^ Hang Seng Bank Limited
– Chairman of Audit Committee;
Member of Risk Committee *(Note 1)*

Other major appointments

Justice of the Peace
^ Bank of Communications Co., Ltd.
– Independent Non-executive Director;
Chairman of Audit Committee
^ China Resources Enterprise, Limited
– Independent Non-executive Director;
Chairman of Audit Committee
HKSAR Commission on Strategic Development – Member
Li, Tang, Chen & Co, Certified Public Accountants
– Senior Partner
Long Win Bus Company Limited
– Independent Non-executive Director
^ RoadShow Holdings Limited
– Independent Non-executive Director;
Chairman of Audit Committee
^ SmarTone Telecommunications Holdings Limited
– Independent Non-executive Director;
Chairman of Audit Committee
^ Sun Hung Kai Properties Limited
– Independent Non-executive Director;
Chairman of Audit Committee
The Financial Reporting Council
– Convenor of Financial Reporting Review Committee
The Hong Kong Jockey Club – Steward
The Hong Kong Institute of Education
– Treasurer of the Council
The Kowloon Motor Bus Company (1933) Limited
– Independent Non-executive Director;
Chairman of Audit Committee
The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member *(Note 1)*
^ Transport International Holdings Limited
– Independent Non-executive Director;
Chairman of Audit Committee
^ Wong's International (Holdings) Limited
– Independent Non-executive Director;
Chairman of Audit Committee

Past major appointments

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

Qualifications

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

Major awards

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

Dr Vincent LO Hong Sui GBS, JP DIRECTOR AGED 64

Joined the Board since February 1999

Other major appointments

Justice of the Peace
Airport Authority Hong Kong – Board Member *(Note 1)*
APEC Business Advisory Council
– Hong Kong's Representative
Business and Professionals Federation of Hong Kong
– Honorary Life President
Chongqing Municipal Government – Economic Adviser
Council for the Promotion and Development of Yangtze
– President
^ Great Eagle Holdings Limited – Non-executive Director
Shanghai Tongji University; Shanghai University
– Advisory Professorship
Shui On Group – Chairman
^ Shui On Land Limited – Chairman
^ SOCAM Development Limited – Chairman
The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member *(Note 1)*
The Hong Kong University of Science and Technology
– Honorary Court Chairman

Past major appointments

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

Qualification

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

Major awards

"Ernst & Young Entrepreneur Of The Year 2009" in the China Real Estate Sector (2009)
Ernst & Young China Entrepreneur Of The Year 2009 (2009)
Chevalier des Arts et des Lettres by the French Government (2005)
Director of the Year in the category of Listed Company Executive Directors by The Hong Kong Institute of Directors in 2002 (2002)
Businessman of the Year award in the Hong Kong Business Awards 2001 (2001)
Gold Bauhinia Star (1998)
Lifetime Achievement Award for Leadership in Property Sector by the 4th World Chinese Economic Forum (2012)

Mrs Dorothy SIT KWAN Yin Ping

DIRECTOR VICE-CHAIRMAN AND CHIEF EXECUTIVE OF HANG SENG BANK (CHINA) LIMITED AGED 61

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

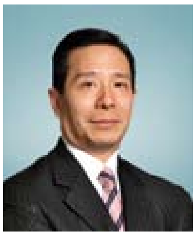
The Banking Industry Training Advisory Committee
– Member (2006-2009); Ex-officio Member of its Sub-committee on Specification of Competency Standards Development (2007-2009)
^ Hang Seng Bank Limited
– General Manager (2005-2009); Chief Operating Officer (2006-2009)
The Hongkong and Shanghai Banking 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

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

Biographical Details of Directors



* Mr Richard TANG Yat Sun BBS, JP DIRECTOR AGED 60

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

Justice of the Peace
China Overseas Friendship Association
– Executive Director-General
Customs and Excise Service Children's Education Trust Fund Committee – Chairman
Fight Crime Committee – Member
Hong Kong Commercial Broadcasting Company Limited
– Director
Hong Kong Institute of Certified Public Accountants
– Member of Investigation Panel A
^ King Fook Holdings Limited – Vice Chairman
^ Miramar Hotel & Investment Company, Limited – Director
Richcom Company Limited
– Chairman and Managing Director
Steering Committee of the HKSAR Government Scholarship Fund – Member
Tang Shiu Kin and Ho Tim Charitable Fund – Advisor
The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member *(Note 1)*
^ Wheelock and Company Limited
– Independent Non-executive Director *(Note 1)*

Past major appointments

Correctional Services Children's Education Trust
– Chairman of the Investment Advisory Board (2006-2011)
Hong Kong Institute of Certified Public Accountants
– Member of Disciplinary Panel A (2006-2012)

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 award

Bronze Bauhinia Star (2000)

Mr Peter WONG Tung Shun JP DIRECTOR AGED 61

Joined the Board since May 2005

Other position held within Hang Seng Group

^ Hang Seng Bank Limited
– Member of Nomination Committee

Other major appointments

Justice of the Peace
^ Bank of Communications Co., Ltd. – Non-executive Director
^ Cathay Pacific Airways Limited
– Independent Non-executive Director
Chongqing Mayor's International Economic Advisory Council
– Member
Economic Development Commission of HKSAR Government
– Non-official Member *(Note 1)*
Greater Pearl River Delta Business Council – Member
Hong Kong General Chamber of Commerce
– Member of General Committee
Hong Kong Monetary Authority
– Member of Exchange Fund Advisory Committee
HSBC Bank (China) Company Limited
– Chairman and Non-executive Director;
Chairman of Nomination Committee *(Note 1)*;
Member of Remuneration Committee
HSBC Bank Malaysia Berhad
– Chairman and Non-executive Director
^ HSBC Holdings plc
– Group Managing Director;
Member of Group Management Board
International Advisor to the Mayor of Tianjin
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
The Twelfth National Committee of the Chinese People's Political Consultative Conference – Member *(Note 1)*

Past major appointments

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

Qualifications

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

* Mr Michael WU Wei Kuo DIRECTOR AGED 42

Joined the Board since September 2010

Other major appointments

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

Past major appointment

Hong Kong Retail Management Association
– Executive Committee Member (2002-2012)

Qualification

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

Major awards

"Ernst & Young Entrepreneur of The Year 2012 China"
– Category Winner (Services) and Country Winner (Hong Kong/Macau Regions) (2012)
"Executive Award" of the DHL/SCMP Hong Kong Business Awards (2008)

Notes:

1 New appointments, re-designation or cessation of appointments since the date of the Bank's 2012 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 2012 are disclosed in the section "Directors' and Alternate Chief Executives' Interests" of the Report of the Directors attached to the Bank's 2012 Annual Report.

3 Some Directors (as disclosed in the section "Biographical Details of Directors" of the Bank's 2012 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 2012 Annual Report.

4 Save as disclosed in the section "Biographical Details of Directors" of the Bank's 2012 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 2012 Annual Report.

8 None of the Directors, except Ms Rose W M Lee, Mrs Dorothy K Y P Sit and Mr Andrew H C Fung, has signed service contracts with the Bank. The term of appointment of Non-executive Directors (including Independent Non-executive Directors) is three years except that where a Non-executive Director (or an Independent Non-executive Director) has served on the Board for more than nine years, then his/her term of appointment is one year.

9 Biographical details of Directors of the Bank are also available on the website of the Bank (www.hangseng.com).

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

Biographical Details of Senior Management

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),
Ms Rose W M Lee,
Mr Andrew H C Fung,
Mr Donald Y S Lam

Ms Rose LEE Wai Mun VICE-CHAIRMAN AND CHIEF EXECUTIVE
(Biographical details are set out on page 60)

Mrs Dorothy SIT KWAN Yin Ping
NON-EXECUTIVE DIRECTOR, VICE-CHAIRMAN AND CHIEF EXECUTIVE OF HANG SENG BANK (CHINA) LIMITED
(Biographical details are set out on page 65)

Mr Andrew FUNG Hau Chung JP EXECUTIVE DIRECTOR AND HEAD OF GLOBAL BANKING AND MARKETS
(Biographical details are set out on page 62)

Mr Nixon CHAN Lik Sang HEAD OF RETAIL BANKING AND WEALTH MANAGEMENT AGED 60

Joined the Bank since October 2009

Major positions held within Hang Seng Group

Hang Seng Bank Limited
– Head of Retail Banking and Wealth Management; Member of Executive Committee
Hang Seng Indexes Company Limited
– Member of Hang Seng Index Advisory Committee
Hang Seng Insurance Company Limited – Director

Other major appointments

Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Review Tribunal – Member
Employers' Federation of Hong Kong
– Elected Member of General Committee
Hang Seng Management College – Governor
Hang Seng School of Commerce – Director
Small and Medium Enterprises Committee – Member

Past major positions

The Hongkong and Shanghai Banking Corporation Limited
– Senior Executive, Commercial Banking (2005-2009); Held various senior positions in commercial banking and personal financial services (1993-2005)

Qualification

Bachelor Degree in Business Administration
– University of Hawaii, USA

Mr Christopher HO Hing Nin CHIEF OPERATING OFFICER AGED 60

Joined the Bank since July 2009

Major positions held within Hang Seng Group

Hang Seng Bank Limited
– Chief Operating Officer; Member of Executive Committee
Hang Seng Real Estate Management Limited – Director
Hang Seng Security Management Limited – Director

Other major appointment

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)
Urban Renewal Authority
– Member of Central Oasis Community Advisory Committee (2009-2012)

Qualification

MSc in Management Information Systems
– Sheffield Hallam University, UK

Mr Donald LAM Yin Shing HEAD OF CORPORATE AND COMMERCIAL BANKING AGED 49

Joined the Bank since March 2003

Major positions held within Hang Seng Group

Hang Seng Bank Limited
– Head of Corporate and Commercial Banking; Member of Executive Committee
Hang Seng Insurance Company Limited – Director

Past major positions

Hang Seng Bank Limited
– Head of Commercial Banking (2007-2011); Head of Commercial Banking Relationship Management (2005-2006); Deputy Head of Commercial Banking Relationship Management (2004-2005); Senior Relationship Manager of Commercial Banking Relationship Management Department A (2003-2004)
Hang Seng General Insurance (Hong Kong) Company Limited
– Director (2008-2012)
Playmates Holdings Limited
– Executive Director and Chief Financial Officer (2001-2003)
The Hongkong and Shanghai Banking Corporation Limited
– Senior Marketing and Planning Manager (1999-2001); Senior Corporate Relationship Manager, Commercial Banking (1997-1999); Held various senior positions in Corporate and Commercial Banking (1987-1997)

Qualifications

Associate – The Hong Kong Institute of Bankers
Bachelor of Social Science (1st Class Honor)
– The University of Hong Kong
Master of Business Administration
– The Chinese University of Hong Kong
Master of Science in e-Commerce
– The Chinese University of Hong Kong

Mr Andrew LEUNG Wing Lok CHIEF FINANCIAL OFFICER AGED 50

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

Major positions held within Hang Seng Group

Hang Seng Bank Limited
– Chief Financial Officer; Member of Executive Committee
Hang Seng Bank (China) Limited – Director
Hang Seng Insurance Company Limited – Director

Other major appointment

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

Past major positions

Hang Seng Bank Limited
– Senior Manager and Deputy Head of China Business (2005-2006); Senior Manager and Deputy Head of Greater China Business (2003-2005); Senior Manager of Corporate Banking (2001-2003); Senior Manager and Deputy Head of Financial Control (1997-2001)

Qualifications

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

Mr TANG Nai Pan CHIEF RISK OFFICER AGED 51

Joined the Bank since August 2011

Major positions held within Hang Seng Group

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

Other major appointment

Yantai Bank Co., Ltd. – Director

Past major positions

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

Qualifications

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

Note:
Definition of senior management is set out in the "Corporate Governance and Other Information" section in this Annual Report.

Report of the Directors

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2012.

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 78 and 112 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 2012 are set out in note 38 to the financial statements for the year ended 31 December 2012.

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$10m. 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$19,426m (2011 restated: HK$16,885m) have been transferred to reserves. Distributable reserve of the Bank as at 31 December 2012 amounted to HK$24,773m (2011 restated: HK$20,630m). 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, Ms Rose W M Lee, Dr John C C Chan, Dr Marvin K T Cheung, Ms L Y Chiang, Mr Andrew H C Fung, Ms Anita Y M Fung, Dr Fred Zuliu Hu, Mr Jenkin Hui, Ms Sarah C Legg, Dr Eric K C Li, Dr Vincent H S Lo, Mrs Dorothy K Y P Sit, Mr Richard Y S Tang, Mr Peter T S Wong and Mr Michael W K Wu.

Mrs Margaret Leung retired from the Board with effect from the conclusion of the Bank's 2012 Annual General Meeting ("AGM") held on 11 May 2012.

Ms Rose W M Lee was appointed a Non-executive Director and Chief Executive Designate of the Bank with effect from 22 March 2012. After the election of Ms Lee as a Director of the Bank by shareholders at the Bank's 2012 AGM, she was re-designated Vice-Chairman and Chief Executive of the Bank with effect from the conclusion of the 2012 AGM.

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Dr John C C Chan, Dr Marvin K T Cheung, Mr Jenkin Hui, Dr Eric K C Li and Dr Vincent H S Lo. Mr Jenkin Hui has informed the Board of his intention of not seeking re-election at the 2013 AGM to be held on 16 May 2013. All the other above-mentioned Directors will offer themselves for re-election at the 2013 AGM.

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

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

Status Of Independent Non-executive Directors

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

Directors' And Alternate Chief Executives' Interests

As at 31 December 2012, 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.

Interests in shares

	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						
Director:						
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	57,814	–	–	–	57,814	0.00
Ms Rose W M Lee	146,940	1,397	–	7,988[5]	156,325	0.00
Dr John C C Chan	24,605[1]	–	–	–	24,605	0.00
Mr Andrew H C Fung	41,943	–	–	38,531[5]	80,474	0.00
Ms Anita Y M Fung	101,313	–	–	459,381[5]	560,694	0.00
Mr Jenkin Hui	18,685	–	2,070,581[2]	–	2,089,266	0.01
Ms Sarah C Legg	60,845	2,008	–	68,001[5]	130,854	0.00
Dr Eric K C Li	–	43,463	–	–	43,463	0.00
Mrs Dorothy K Y P Sit	80,853[3]	1,031	–	32,568[5]	114,452	0.00
Mr Peter T S Wong	712,463	18,413	–	547,165[5]	1,278,041	0.00
Alternate Chief Executives:						
Mr Nixon L S Chan	32,712	–	–	21,839[5]	54,551	0.00
Mr Christopher H N Ho	93,856	46,938	–	8,070[5]	148,864	0.00
Mr Donald Y S Lam	30,504	–	–	18,110[5]	48,614	0.00
Mr Andrew W L Leung	5,369	–	–	2,993[5]	8,362	0.00
Number of perpetual non-cumulative preference shares of US$0.01 each in HSBC Holdings plc						
Director:						
Ms Rose W M Lee	–	–	–	306,075[4]	306,075	0.20

Interests in debentures of associated corporations of the Bank

Name of debenture	Name of Director	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
8.00% perpetual subordinated capital securities, series 2 issued by HSBC Holdings plc	Ms Rose W M Lee	–	–	–	US$7,651,875[(4)]	US$7,651,875
4.75% senior notes, due on 15 July 2013 and issued by HSBC Finance Corporation	Ms Anita Y M Fung	US$1 million	–	–	–	US$1 million
5% senior notes, due on 30 June 2015 and issued by HSBC Finance Corporation	Ms Anita Y M Fung	US$3 million	–	–	–	US$3 million

Notes:

(1) 1,000 shares in the Bank and 4,371 shares in HSBC Holdings plc were jointly held by Dr John C C Chan and his wife.

(2) 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.

(3) 8,046 shares were jointly held by Mrs Dorothy K Y P Sit and her husband.

(4) Ms Rose W M Lee was a beneficiary of a trust, which had interests in the total principal amount of US$7,651,875 of the 8.00% perpetual subordinated capital securities, series 2. These perpetual subordinated capital securities were exchangeable at the option of HSBC Holdings plc into 306,075 perpetual non-cumulative preference shares of US$0.01 each in HSBC Holdings plc. Ms Lee's interests set out in the table under "Interests in shares" and the table under "Interests in debentures of associated corporations of the Bank" represented the same interests.

(5) These represented interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans to acquire ordinary shares of US$0.50 each in HSBC Holdings plc and (ii) conditional awards of ordinary shares of US$0.50 each in HSBC Holdings plc under the HSBC Share Plans made in favour of Directors and Alternate Chief Executives, as set against their respective names below:

	Options (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:			
Ms Rose W M Lee	–	7,988	7,988
Mr Andrew H C Fung	4,197	34,334	38,531
Ms Anita Y M Fung	4,197	455,184	459,381
Ms Sarah C Legg	12,562	55,439	68,001
Mrs Dorothy K Y P Sit	–	32,568	32,568
Mr Peter T S Wong	–	547,165	547,165
Alternate Chief Executives:			
Mr Nixon L S Chan	8,148	13,691	21,839
Mr Christopher H N Ho	3,443	4,627	8,070
Mr Donald Y S Lam	11,082	7,028	18,110
Mr Andrew W L Leung	–	2,993	2,993

Options

As at 31 December 2012, 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 2012	Options exercised/ cancelled during the Director's/ Alternate Chief Executive's term of office in 2012	Exercise price per share	Date granted	Exercisable from	Exercisable until
Directors:						
Mr Andrew H C Fung	4,197	–	HK$37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015
Ms Anita Y M Fung	4,197	–	HK$37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015
Ms Sarah C Legg	–	3,656	£7.3244	7 May 2002	7 May 2005	7 May 2012
	–	3,803	£7.3244	7 May 2002	7 May 2005	7 May 2012
	2,295	–	£6.0216	2 May 2003	2 May 2006	2 May 2013
	5,738	–	£7.2181	30 Apr 2004	30 Apr 2009	30 Apr 2014
	4,529	–	£3.3116	29 Apr 2009	1 Aug 2014	31 Jan 2015
	12,562					
Mrs Dorothy K Y P Sit	–	2,375[(1)]	HK$37.8797	29 Apr 2009	1 Aug 2012	31 Jan 2013
Alternate Chief Executives:						
Mr Nixon L S Chan	–	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
	–	590[(2)]	HK$63.9864	20 Apr 2011	1 Aug 2012	31 Oct 2012
	8,148					
Mr Christopher H N Ho	3,443	–	£7.2181	30 Apr 2004	30 Apr 2009	29 Apr 2014
	–	2,518[(3)]	HK$37.8797	29 Apr 2009	1 Aug 2012	31 Jan 2013
	3,443					
Mr Donald Y S Lam	6,885	–	£7.2181	30 Apr 2004	30 Apr 2009	30 Apr 2014
	4,197	–	HK$37.8797	29 Apr 2009	1 Aug 2014	31 Jan 2015
	11,082					

Notes:

(1) As at the date of exercise, 12 September 2012, the market value per share was £5.6910.

(2) As at the date of exercise, 11 October 2012, the market value per share was £5.9720.

(3) As at the date of exercise, 16 October 2012, the market value per share was £6.1100.

Conditional Awards of Shares

As at 31 December 2012, 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 2012	Awards made during the Director's/ Alternate Chief Executive's term of office in 2012	Awards released/ lapsed during the Director's/Alternate Chief Executive's term of office in 2012	Awards held as at 31 December 2012
Directors:				
Ms Rose W M Lee	7,752(1)	–	–	7,988(2)
Mr Andrew H C Fung	37,471	16,247	21,358	34,334(2)
Ms Anita Y M Fung	1,295,532	215,147	1,097,491	455,184(2)
Ms Sarah C Legg	37,338	38,770	23,575	55,439(2)
Mrs Dorothy K Y P Sit	34,768	17,069	21,135	32,568(2)
Mr Peter T S Wong	406,683	398,753	287,444	547,165(2)
Alternate Chief Executives:				
Mr Nixon L S Chan	20,531	7,611	15,306	13,691(2)
Mr Christopher H N Ho	9,114	2,049	6,852	4,627(2)
Mr Donald Y S Lam	9,722	4,683	7,805	7,028(2)
Mr Andrew W L Leung	1,668	1,829	659	2,993(2)

Notes:

(1) This represented the awards held by Ms Rose W M Lee on 22 March 2012 when she was appointed a Director of the Bank.

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

All the interests stated above represent long positions. As at 31 December 2012, 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 2012.

Directors' Interests In Contracts

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

Directors' Interests In Competing Businesses

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

Mr Andrew H C Fung is a Director, a member of Executive Committee and a member of Remuneration and Examination Committee of Industrial Bank Co., Ltd. ("Industrial Bank"), in which the Bank holds a 10.9% stake after its completion of a private placement of additional share capital to a number of third parties in January 2013. Industrial Bank conducts general banking business in mainland China.

Ms Anita Y M Fung is a Group General Manager of HSBC Holdings plc and the Chief Executive Officer, Hong Kong of The Hongkong and Shanghai Banking Corporation Limited. She is also the Chairman and Director of HSBC Global Asset Management (Hong Kong) Limited, subsidiary of The Hongkong and Shanghai Banking Corporation Limited, and a Director of various HSBC Group subsidiaries. She is also a Non-executive Director of Bank of Communications Co., Ltd. and a member of its Personnel and Compensation Committee. Bank of Communications Co., Ltd. conducts general banking business.

Ms Rose W M Lee is a Group General Manager of HSBC Holdings plc and a Director of The Hongkong and Shanghai Banking Corporation Limited.

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.

Mr Peter T S Wong is a Group Managing Director and a member of Group Management Board of HSBC Holdings plc. He is also the Chief Executive and Executive Director of The Hongkong and Shanghai Banking Corporation Limited; and Chairman and Non-executive Director of HSBC Bank Malaysia Berhad and HSBC Bank (China) Company Limited which are the wholly-owned subsidiaries of The Hongkong and Shanghai Banking Corporation Limited. He is a Non-executive Director of Bank of Communications Co., Ltd.

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

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

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

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

Directors' Emoluments

The emoluments of the Directors of the Bank (including Executive Directors and Independent Non-executive Directors) on a named basis are set out in note 19 to the financial statements for the year ended 31 December 2012.

Substantial Interests In Share Capital

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2012, the following corporations had interests or short positions in the shares or underlying shares (as defined in the SFO) in the Bank set opposite their respective names:

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

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

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

All the interests stated above represent long positions. As at 31 December 2012, no short positions were recorded in the Register of Interests in Shares and Short Positions required to be kept under section 336 of the SFO.

Purchase, Sale Or Redemption Of The Bank's Listed Securities

Save for the redemption of all the US$300,000,000 floating rate subordinated notes due 2017 at par on 6 July 2012, 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, 4 March 2013

2012 Financial Statements

Consolidated Income Statement

for the year ended 31 December 2012
(Expressed in millions of Hong Kong dollars)

	note	2012	2011 (restated)
Interest income	8	**21,861**	19,845
Interest expense	8	**(4,915)**	(4,109)
Net interest income		**16,946**	15,736
Fee income		**6,298**	5,923
Fee expense		**(1,212)**	(1,087)
Net fee income	9	**5,086**	4,836
Trading income	10	**2,063**	1,796
Net income/(loss) from financial instruments designated at fair value	11	**376**	(160)
Dividend income	12	**17**	17
Net earned insurance premiums	13	**10,947**	11,061
Other operating income	14	**1,181**	921
Total operating income		**36,616**	34,207
Net insurance claims incurred and movement in policyholders' liabilities	15	**(12,235)**	(11,610)
Net operating income before loan impairment charges		**24,381**	22,597
Loan impairment charges	16	**(386)**	(440)
Net operating income		**23,995**	22,157
Employee compensation and benefits		**(4,137)**	(3,888)
General and administrative expenses		**(3,375)**	(3,191)
Depreciation of premises, plant and equipment		**(762)**	(700)
Amortisation of intangible assets		**(115)**	(119)
Operating expenses	17	**(8,389)**	(7,898)
Impairment loss on intangible assets		**–**	(78)
Operating profit		**15,606**	14,181
Gains less losses from financial investments and fixed assets	21	**(5)**	50
Gain on disposal of a subsidiary		**355**	–
Net surplus on property revaluation	22	**776**	992
Share of profits from associates		**5,381**	4,032
Profit before tax		**22,113**	19,255
Tax expense	23	**(2,687)**	(2,370)
Profit for the year		**19,426**	16,885
Profit attributable to shareholders		**19,426**	16,885
(Figures in HK$) Earnings per share	25	**10.16**	8.83

The notes on pages 84 to 236 form part of these financial statements.

Consolidated Statement of Comprehensive Income

for the year ended 31 December 2012
(Expressed in millions of Hong Kong dollars)

	2012	2011 (restated)
Profit for the year	**19,426**	16,885
Other comprehensive income		
Premises:		
– unrealised surplus on revaluation of premises	**2,222**	3,729
– deferred taxes	**(358)**	(610)
– exchange difference	**–**	3
Available-for-sale investment reserve:		
– fair value changes taken to equity:		
– on debt securities	**380**	255
– on equity shares	**90**	8
– fair value changes transferred to the income statement:		
– on hedged items	**22**	(538)
– on disposal	**(1)**	(53)
– share of changes in equity of associates:		
– fair value changes	**459**	(646)
– deferred taxes	**(157)**	221
– exchange difference	**(1)**	(5)
Cash flow hedging reserve:		
– fair value changes taken to equity	**341**	119
– fair value changes transferred to the income statement	**(328)**	(197)
– deferred taxes	**(2)**	13
– exchange difference	**–**	(1)
Defined benefit plans:		
– actuarial gains/(losses) on defined benefit plans	**605**	(1,600)
– deferred taxes	**(100)**	264
Share-based payments	**(7)**	9
Exchange differences on translation of:		
– financial statements of overseas branches, subsidiaries and associates	**28**	974
– retained profits	**–**	(1)
Others	**(35)**	–
Other comprehensive income for the year, net of tax	**3,158**	1,944
Total comprehensive income for the year	**22,584**	18,829
Total comprehensive income for the year attributable to shareholders	**22,584**	18,829

Consolidated Balance Sheet

at 31 December 2012
(Expressed in millions of Hong Kong dollars)

	note	2012	2011 (restated)
ASSETS			
Cash and balances with banks	30	**27,082**	39,533
Placings with and advances to banks	31	**140,382**	107,742
Trading assets	32	**34,399**	64,171
Financial assets designated at fair value	33	**8,343**	8,096
Derivative financial instruments	34	**5,179**	4,710
Loans and advances to customers	35	**536,162**	480,574
Financial investments	36	**253,408**	209,190
Interest in associates	39	**24,655**	19,627
Investment properties	40	**4,860**	4,314
Premises, plant and equipment	41	**19,262**	17,983
Intangible assets	42	**6,783**	5,962
Other assets	43	**16,581**	13,763
Total assets		**1,077,096**	975,665
LIABILITIES AND EQUITY			
Liabilities			
Current, savings and other deposit accounts	44	**769,147**	699,857
Deposits from banks		**19,845**	14,004
Trading liabilities	45	**59,853**	59,712
Financial liabilities designated at fair value	46	**464**	434
Derivative financial instruments	34	**4,118**	4,848
Certificates of deposit and other debt securities in issue	47	**11,291**	9,284
Other liabilities	48	**21,653**	20,138
Liabilities to customers under insurance contracts	49	**81,670**	72,225
Current tax liabilities	50	**588**	305
Deferred tax liabilities	50	**4,323**	3,378
Subordinated liabilities	51	**11,821**	11,846
Total liabilities		**984,773**	896,031
Equity			
Share capital	52	**9,559**	9,559
Retained profits		**59,683**	49,519
Other reserves		**19,257**	16,923
Proposed dividends	26	**3,824**	3,633
Shareholders' funds		**92,323**	79,634
Total equity and liabilities		**1,077,096**	975,665

Raymond K F Ch'ien *Chairman*

Rose Lee *Vice-Chairman and Chief Executive*

Eric K C Li *Director*

Andrew W L Leung *Chief Financial Officer*

The notes on pages 84 to 236 form part of these financial statements.

Balance Sheet

at 31 December 2012
(Expressed in millions of Hong Kong dollars)

	note	2012	2011 (restated)
ASSETS			
Cash and balances with banks	30	**24,797**	36,475
Placings with and advances to banks	31	**74,846**	47,724
Trading assets	32	**31,635**	60,526
Financial assets designated at fair value	33	**–**	140
Derivative financial instruments	34	**4,634**	4,436
Loans and advances to customers	35	**476,734**	425,629
Amounts due from subsidiaries		**81,143**	85,222
Financial investments	36	**145,414**	105,142
Investments in subsidiaries	38	**14,778**	14,434
Interest in associates	39	**5,172**	5,172
Investment properties	40	**2,988**	2,806
Premises, plant and equipment	41	**14,135**	13,249
Intangible assets	42	**406**	408
Other assets	43	**10,266**	9,182
Total assets		**886,948**	810,545
LIABILITIES AND EQUITY			
Liabilities			
Current, savings and other deposit accounts	44	**730,533**	661,012
Deposits from banks		**13,952**	11,989
Trading liabilities	45	**27,776**	36,077
Financial liabilities designated at fair value	46	**–**	–
Derivative financial instruments	34	**3,517**	4,102
Certificates of deposit and other debt securities in issue	47	**11,291**	9,284
Amounts due to subsidiaries		**15,282**	10,797
Other liabilities	48	**17,489**	16,960
Current tax liabilities	50	**509**	270
Deferred tax liabilities	50	**1,687**	1,342
Subordinated liabilities	51	**11,821**	11,846
Total liabilities		**833,857**	763,679
Equity			
Share capital	52	**9,559**	9,559
Retained profits	53	**28,064**	23,277
Other reserves	53	**11,644**	10,397
Proposed dividends	26	**3,824**	3,633
Shareholders' funds		**53,091**	46,866
Total equity and liabilities		**886,948**	810,545

Raymond K F Ch'ien *Chairman*

Rose Lee *Vice-Chairman and Chief Executive*

Eric K C Li *Director*

Andrew W L Leung *Chief Financial Officer*

The notes on pages 84 to 236 form part of these financial statements.

Consolidated Statement of Changes in Equity

for the year ended 31 December 2012
(Expressed in millions of Hong Kong dollars)

	2012	2011
Share capital		
At beginning and end of the year	**9,559**	9,559
Retained profits (including proposed dividends)		
At beginning of the year	**52,273**	46,599
Opening adjustment for the adoption of the amendments to HKAS 12	**879**	674
As restated	**53,152**	47,273
Dividends to shareholders		
– dividends approved in respect of the previous year	**(3,633)**	(3,633)
– dividends declared in respect of the current year	**(6,309)**	(6,309)
Transfer	**373**	264
Total comprehensive income for the year	**19,924**	15,557
	63,507	53,152
Other reserves		
Premises revaluation reserve		
At beginning of the year	**12,280**	9,426
Transfer	**(354)**	(268)
Total comprehensive income for the year	**1,864**	3,122
	13,790	12,280
Available-for-sale investment reserve		
At beginning of the year	**(561)**	202
Transfer	**(4)**	(5)
Total comprehensive income for the year	**792**	(758)
	227	(561)
Cash flow hedging reserve		
At beginning of the year	**6**	72
Total comprehensive income for the year	**11**	(66)
	17	6
Foreign exchange reserve		
At beginning of the year	**3,043**	2,069
Total comprehensive income for the year	**28**	974
	3,071	3,043
Other reserves		
At beginning of the year	**2,155**	2,085
Cost of share-based payment arrangements	**47**	61
Transfer	**(15)**	9
Total comprehensive income for the year	**(35)**	–
	2,152	2,155
Total equity		
At beginning of the year	**78,755**	70,012
Opening adjustment for the adoption of the amendments to HKAS 12	**879**	674
As restated	**79,634**	70,686
Dividends to shareholders	**(9,942)**	(9,942)
Cost of share-based payment arrangements	**47**	61
Total comprehensive income for the year	**22,584**	18,829
	92,323	79,634

Consolidated Cash Flow Statement

for the year ended 31 December 2012
(Expressed in millions of Hong Kong dollars)

	note	2012	2011
Net cash outflow from operating activities	54(a)	**(5,709)**	(19,577)
Cash flows from investing activities			
Dividends received from associates		**717**	488
Purchase of an interest in an associate		**(32)**	–
Purchase of available-for-sale investments		**(36,218)**	(44,199)
Purchase of held-to-maturity debt securities		**(747)**	(1,009)
Proceeds from sale or redemption of available-for-sale investments		**54,839**	66,367
Proceeds from redemption of held-to-maturity debt securities		**573**	530
Net cash inflow from sales of loan portfolio		**48**	5,643
Net cash inflow from the sale of a subsidiary		**1,382**	–
Purchase of fixed assets and intangible assets		**(359)**	(422)
Proceeds from sale of fixed assets and assets held for sale		**87**	–
Interest received from available-for-sale investments		**1,873**	2,038
Dividends received from available-for-sale investments		**16**	14
Net cash inflow from investing activities		**22,179**	29,450
Cash flows from financing activities			
Dividends paid		**(9,942)**	(9,942)
Interest paid for subordinated liabilities		**(289)**	(197)
Issue of subordinated liabilities		**2,326**	3,496
Repayment of subordinated liabilities		**(2,326)**	(3,502)
Net cash outflow from financing activities		**(10,231)**	(10,145)
Increase/(decrease) in cash and cash equivalents		**6,239**	(272)
Cash and cash equivalents at 1 January		**120,469**	118,560
Effect of foreign exchange rate changes		**(1,674)**	2,181
Cash and cash equivalents at 31 December	54(b)	**125,034**	120,469

The notes on pages 84 to 236 form part of these financial statements.

1. Basis of preparation

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

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

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

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

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

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

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

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and major sources of estimation uncertainty are discussed in note 6. Disclosures under HKFRS 4 "Insurance Contract" and HKFRS 7 "Financial Instrument: Disclosure" relating to the nature and extent of risks have been included in note 62 "Financial risk management".

2. Nature of business

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

3. Basis of consolidation

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

4. Principal accounting policies

(a) Interest income and expense

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

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

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

(b) Non-interest income

(i) Fee income

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

– income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);

– income earned from the provision of services is recognised as revenue when the services are provided (for example, asset management, portfolio and other management advisory and service fees); and

– income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and reported in "Interest income" (see note 4(a)).

(ii) Rental income from operating lease

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

(iii) Dividend income

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

(iv) Trading income

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

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

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

(c) Segment reporting

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

4. Principal accounting policies continued

(d) Cash and cash equivalents

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

(e) Loans and advances to banks and customers

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

(f) Loan impairment

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

(i) Individually assessed loans

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

– known cash flow difficulties experienced by the borrower;

– past due contractual payments of either principal or interest;

– breach of loan covenants or conditions;

– the probability that the borrower will enter bankruptcy or other financial restructuring; and

– a significant downgrading in credit rating by an external rating agency.

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

– the Group's aggregate exposure to the borrower;

– the viability of the borrower's business model and capability to trade successfully out of financial difficulties and generate cash flow to service their debt obligations;

– the amount and timing of expected receipts and recoveries;

– the likely dividend available on liquidation or bankruptcy;

– the extent of other creditors' commitments ranking ahead of, or pari passu with, the Group and the likelihood of other creditors continuing to support the borrower;

– the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;

– the realisable value of collateral (or other credit mitigants) and likelihood of successful repossession;

– the likely deduction of any costs involved in recovery of amounts outstanding;

– the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and

– where available, the secondary market price for the debt.

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

4. Principal accounting policies continued

(f) Loan impairment continued

(ii) Collectively assessed loans

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

– to cover losses which have been incurred but have not yet been identified as loans subject to individual assessment; and

– for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

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

– historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);

– the estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan; and

– management's judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

Homogeneous groups of loans

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

(iii) Loan write-offs

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

(iv) Reversals of impairment

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

(v) Repossessed assets

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

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

(vi) Renegotiated loans

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

4. Principal accounting policies continued

(g) Financial instruments

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

(i) Trading assets and trading liabilities

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

(ii) Financial instruments designated at fair value

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

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

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

(iii) Available-for-sale financial assets

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

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

(iv) Held-to-maturity investments

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

4. Principal accounting policies continued

(h) Derivative financial instruments

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

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

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

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

(i) Hedge accounting

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

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

(i) Fair value hedge

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

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

(ii) Cash flow hedge

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

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

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

(iii) Hedge effectiveness testing

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

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

4. Principal accounting policies continued

(i) Hedge accounting continued

(iii) Hedge effectiveness testing continued

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

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

(iv) Derivatives that do not qualify for hedge accounting

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

(j) Sale and repurchase agreements

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

(k) Offsetting financial instruments

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

(l) Application of trade date accounting

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

(m) Derecognition of financial assets and liabilities

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

(n) Valuation of financial instruments

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the Group recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the Group enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the Group's valuation methodologies, which are described in note 63.

4. Principal accounting policies continued

(o) Subsidiaries

A subsidiary is a corporate entity in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half of the voting power or controls the composition of the board of directors, or a non-corporate entity the Group otherwise controls, directly or indirectly, by way of having the power to govern its financial and operating policies so that the Group obtains benefits from these activities. A subsidiary is fully consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. In the Bank's balance sheet, an investment in subsidiary is stated at cost less impairment allowances.

(p) Associates

An associate is an entity over which the Group or the Bank has the ability to significantly influence, but not control over its management, including participation in the financial and operating policy decision. An interest in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition, post tax results of the associate and any impairment losses for the year, whereas the Group's share of the post-acquisition post-tax items of the associate's other comprehensive income is recognised in the consolidated statement of comprehensive income.

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

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

(q) Goodwill and intangible assets

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

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

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

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

(r) Investment properties

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

4. Principal accounting policies continued

(s) Premises, plant and equipment

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

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

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

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

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

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

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

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

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

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

The Government of Hong Kong owns all the land in Hong Kong and permits its use under leasehold arrangements. Similar arrangements exist in mainland China. At inception of the lease, where the cost of land is known or can be reliably determined and the term of the lease is less than 50 years, the Group records its interest in leasehold land and land use rights separately as operating leases.

Where the cost of land is known or can be reliably determined and the term of the lease is not less than 50 years, the Group records its interest in leasehold land and land use rights as land and buildings held for own use.

Where the cost of the land is unknown or cannot be reliably determined, and the leasehold land and land use rights are not clearly held under an operating lease, they are accounted for as land and buildings held for own use.

4. Principal accounting policies continued

(u) Finance and operating leases

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

(i) Finance leases

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

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

(ii) Operating leases

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

(v) Impairment of assets

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

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

(i) Held-to-maturity investments

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

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

(ii) Available-for-sale financial assets

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

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

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

4. Principal accounting policies continued

(v) Impairment of assets continued

(ii) Available-for-sale financial assets continued

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

– for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if there is objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income and accumulated separately in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value; and

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

(iii) Other assets

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

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

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

– investments in subsidiaries and associates; and

– intangible assets.

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

Calculation of recoverable amount

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

Recognition of impairment losses

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

Reversals of impairment losses

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

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

4. Principal accounting policies continued

(w) Income tax

Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised in other comprehensive income or directly in equity, in which case the relevant amounts of tax are recognised in other comprehensive income or directly in equity, respectively. Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset.

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

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

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

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

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

(x) Employee benefits

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

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

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

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

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

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

4. Principal accounting policies continued

(y) Share-based payments

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

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

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

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

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

(z) Translation of foreign currencies

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

Exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of separate subsidiary financial statements. In the consolidated financial statements, these exchange differences are recognised in other comprehensive income and accumulated separately in equity in the foreign exchange reserve.

(aa) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a present legal or constructive obligation as a result of past events and a reliable estimate can be made as to the amount of the obligation.

(ab) Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of the loans or debt instruments.

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

4. Principal accounting policies continued

(ac) Insurance contracts

Through its insurance subsidiaries, the Group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the Group accepts significant insurance risk from another party, by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

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

Insurance contracts are accounted for as follows:

Net earned insurance premiums

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

Gross insurance premiums for general insurance business are accounted for in the period in which the amount is determined, which is generally the period in which the risk commences. The proportion of premiums written in the accounting year relating to the period of risk after the balance sheet date is carried forward as a provision for unearned premium and is calculated on a daily pro rata basis.

Reinsurance premiums, netted by the reinsurers' share of provision for unearned premiums, are accounted for in the same accounting year as the premiums for the direct insurance to which they relate.

Claims and reinsurance recoveries

Gross insurance claims for life insurance reflect the total cost of claims arising during the year, including policyholder cash dividend payment upon policy anniversary and payments of maturities, surrenders and death claims. The technical reserves for non-linked liabilities (long-term business provision) are calculated based on actuarial principles. The technical reserves for linked liabilities are at least the element of any surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices. Reinsurance recoveries are accounted for in the same period as the related claims.

Gross insurance claims for general insurance business include paid claims and movements in outstanding claims reserves. Full provision for outstanding claims is made for the estimated cost of all claims notified but not settled at the balance sheet date, and claims incurred but not reported by that date. Provision is also made for the estimated cost of servicing claims notified but not settled at the balance sheet date, reduced by estimates of salvage and subrogation recoveries, and to meet expenses on claims incurred but not reported. Reinsurance recoveries are assessed in a manner similar to the assessment of provision for outstanding claims.

Deferred acquisition costs

The deferred acquisition costs related to insurance contract, such as initial commission, are amortised over the period in which the related revenues are earned.

Present value of in-force long-term insurance business

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

The value of the in-force long-term insurance business, referred to as PVIF, is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as future mortality, lapse rates, levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. The calculation of the PVIF asset was refined during the year by incorporating the explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the discount rate. The valuation has also included explicit risk margins for non-economic risks in the projection assumptions, and explicit allowances for financial options and guarantees using stochastic methods. Risk discount rates are set on an active basis with reference to market risk free yields. Movements in the value of in-force long-term insurance business are included in other operating income on a pre-tax basis. The value of in-force long-term insurance business is reported under "Intangible assets" in the balance sheet.

4. Principal accounting policies continued

(ac) Insurance contracts continued

Liabilities under insurance contracts

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

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

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

(ad) Investment contracts

Customer liabilities under linked investment contracts are measured at fair value and reported under "Financial liabilities designated at fair value". The linked financial assets are measured at fair value and the movements in fair value are recognised in the income statement in "Net income from financial instruments designated at fair value". Deposits receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Investment management fee receivables are recognised in the income statement over the period of the provision of the investment management services.

(ae) Debt securities in issue and subordinated liabilities

Debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest rate method, and are reported under "Debt securities in issue" or "Subordinated liabilities", except for those issued for trading or designated at fair value, which are carried at fair value and reported under the "Trading liabilities" and "Financial liabilities designated at fair value" in the balance sheet.

(af) Assets held for sale

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

(ag) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are members of the same group. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or other entities which are under the significant influence of related parties of the Group and post employment benefit scheme. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and its holding companies, directly or indirectly, including any directors (whether executive or otherwise) and Executive Committee members of the Bank and its holding companies.

(ah) Dividends

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

5. Changes in accounting policies

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

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

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

- to understand the relationship between transferred financial assets that are not derecognised in their entirety and associated liabilities; and
- to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

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

Amendments to HKAS 12 "Income Taxes"

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

(i) For the Group

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

(ii) For the Bank

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

6. Critical accounting estimates and judgements in applying accounting policies

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

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

(i) Impairment allowances on loans and advances

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

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

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

(ii) Valuation of financial instruments

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

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

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

– an appropriate discount rate for the instrument. Management uses all relevant market information in determining the appropriate spread over the risk-free/benchmark rate used by market participants for the particular instrument; and

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

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

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

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

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

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

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

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

(iv) Held-to-maturity investments

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

(v) Insurance contracts

Classification

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

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

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

Insurance liabilities

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

(vi) Income taxes

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

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

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

- Amendment to HKAS 1 "Presentation of financial statements" issued in July 2011 which requires grouping of items presented in other comprehensive income on the basis of whether they are potentially reclassifiable to profit or loss subsequently, will be effective for annual periods beginning on or after 1 July 2012, with early adoption permitted.

- HKAS 28 (2011) "Investments in associates and joint ventures", HKFRS 10 "Consolidated Financial Statements" ("HKFRS 10"), HKFRS 11 "Joint Arrangements" ("HKFRS 11") and HKFRS 12 "Disclosure of Interests in Other Entities" ("HKFRS 12") will be effective for annual periods beginning on or after 1 January 2013, with early adoption permitted.

Under HKFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal control or exposure to risks and rewards, depending on the nature of the entity. HKFRS 11 places more focus on rights and obligations than on legal form, and introduces the concept of a joint operation. It requires a joint venturer to recognise an investment and to account for that investment using the equity method in accordance with HKAS 28, unless the entity is exempted from applying the equity method as specified in that standard. HKFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities.

The Group is currently assessing the impact of these new HKFRSs but it is expected that the overall impact of HKFRS 10 and HKFRS 11 on the consolidated financial statements is immaterial.

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

– HKFRS 13 "Fair Value Measurement" ("HKFRS 13") will be effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of HKFRS 13 do not require comparative information to be provided for periods prior to initial application.

HKFRS 13 establishes a single source of guidance for all fair value measurements required or permitted by HKFRSs. The standard clarifies the definition of fair value as an exit price, which is defined as a price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions, and enhances disclosures about fair value measurement.

The Group is currently assessing the impact of this new HKFRS but it is impracticable to quantify its effect as at the date of publication of these consolidated financial statements.

– Amendments to HKAS 19 "Employee Benefits" ("HKAS 19 revised") issued in July 2011 will be effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKAS 19 revised is required to be applied retrospectively.

The most significant amendment to HKAS 19 for the Group is the replacement of interest cost and expected return on plan assets by a finance cost component comprising the net interest on the net defined benefit liability or asset. This finance cost component is determined by applying the same discount rate used to measure the defined benefit obligation to the net defined benefit liability or asset. The difference between the actual return on plan assets and the return included in the finance cost component in the income statement will be presented in other comprehensive income. The effect of this change is to increase the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

Based on an initial estimate of the impact of this particular amendment on the 2012 consolidated financial statements, the change would decrease total operating expenses and pre-tax profit, with no effect on the pension liability.

– Amendments to HKFRS 7 "Disclosures – Offsetting Financial Assets and Financial Liabilities" issued in December 2011 requires disclosures about the effect or potential effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. The amendments are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendments are required to be applied retrospectively.

– Amendments to HKAS 32 "Offsetting Financial Assets and Financial Liabilities" issued in December 2011 clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32 "Financial Instruments: Presentation". The amendments are effective for annual periods beginning on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively. The Group is currently assessing the impact of these clarifications but it is impracticable to quantify its effect as at the date of publication of these consolidated financial statements.

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

– HKFRS 9 "Financial Instruments" ("HKFRS 9") was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. In December 2010, the HKICPA issued additions to HKFRS 9 dealing with financial liabilities. The main changes to the requirements of HKAS 39 are summarised below.

All financial assets are classified into two measurement categories: amortised cost or fair value on the basis of both an entity's business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets. These two categories replace the four categories under the current HKAS 39 "Financial Instruments: Recognition and Measurement".

Financial assets are measured at fair value through profit or loss, if they do not meet the criteria specified for measurement at amortised cost or if doing so significantly reduces or eliminates an accounting mismatch. An entity has the option to designate all subsequent changes in fair value of an equity instrument not held for trading at fair value through other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.

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

Financial assets which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under HKFRS 9.

HKFRS 9 retains all the existing requirements for derecognition of financial instruments and most of the requirements for financial liabilities, except that for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts, fair value changes attributable to changes in own credit risk are to be presented in the statement of other comprehensive income, and are not subsequently reclassified to income statement but may be transferred within equity.

HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2015 with earlier application permitted. In December 2011, the amendment to HKFRS 9 and HKFRS 7 issued by HKICPA provided relief from the requirement to restate prior period comparative information and required additional disclosures on transition from HKAS 39 to HKFRS 9. The Group is presently studying the implications of applying HKFRS 9 but it is impracticable to quantify its effect as at the date of publication of these consolidated financial statements.

8. Interest income/interest expense

(a) Interest income

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

(b) Interest expense

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

9. Net fee income

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

10. Trading income

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

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

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

12. Dividend income

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

13. Net earned insurance premiums

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2012				
Gross written premiums	**221**	**11,219**	**8**	**11,448**
Movement in unearned premiums	**7**	**–**	**–**	**7**
Gross earned premiums	**228**	**11,219**	**8**	**11,455**
Gross written premiums ceded to reinsurers	**(46)**	**(453)**	**–**	**(499)**
Reinsurers' share of movement in unearned premiums	**(9)**	**–**	**–**	**(9)**
Reinsurers' share of gross earned premiums	**(55)**	**(453)**	**–**	**(508)**
Net earned insurance premiums	**173**	**10,766**	**8**	**10,947**
2011				
Gross written premiums	456	10,802	9	11,267
Movement in unearned premiums	(12)	–	–	(12)
Gross earned premiums	444	10,802	9	11,255
Gross written premiums ceded to reinsurers	(107)	(88)	–	(195)
Reinsurers' share of movement in unearned premiums	1	–	–	1
Reinsurers' share of gross earned premiums	(106)	(88)	–	(194)
Net earned insurance premiums	338	10,714	9	11,061

14. Other operating income

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

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

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2012				
Claims, benefits and surrenders paid	**61**	**2,465**	**108**	**2,634**
Movement in provisions	**11**	**10,111**	**(91)**	**10,031**
Gross claims incurred and movement in policyholders' liabilities	**72**	**12,576**	**17**	**12,665**
Reinsurers' share of claims, benefits and surrenders paid	**(15)**	**(36)**	**–**	**(51)**
Reinsurers' share of movement in provisions	**(1)**	**(378)**	**–**	**(379)**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(16)**	**(414)**	**–**	**(430)**
Net insurance claims incurred and movement in policyholders' liabilities	**56**	**12,162**	**17**	**12,235**
2011				
Claims, benefits and surrenders paid	109	3,533	30	3,672
Movement in provisions	23	8,040	(41)	8,022
Gross claims incurred and movement in policyholders' liabilities	132	11,573	(11)	11,694
Reinsurers' share of claims, benefits and surrenders paid	(28)	(29)	–	(57)
Reinsurers' share of movement in provisions	(9)	(18)	–	(27)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(37)	(47)	–	(84)
Net insurance claims incurred and movement in policyholders' liabilities	95	11,526	(11)	11,610

16. Loan impairment charges

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

There was no impairment charge (2011: Nil) provided for available-for-sale debt securities by the Group and the Bank. There was also no impairment loss made in relation to held-to-maturity debt securities in 2012 (2011: Nil).

17. Operating expenses

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

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

18. The emoluments of the five highest paid individuals

(a) The aggregate emoluments

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

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

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

The emoluments of the five highest paid individuals set out above include the emoluments of three (2011: two) Executive Directors and one Non-executive Director (2011: one). Their respective directors' emoluments are included in note 19.

19. Directors' emoluments

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

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

Notes:

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

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

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

(4) Independent Non-Executive Director.

(5) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.3million in 2012. The Bank made contributions during 2012 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.

(6) The amount of bonus comprises the cash and the estimated purchase cost of the award of HSBC Holdings Restricted Share and Performance Share which is measured according to the Group's accounting policies for share-based payment as set out in note 4(y). The bonus comprises the deferred and non-deferred bonus, details of which are also set out in the section of "Remuneration of senior management and key personnel" under "Corporate Governance and Other Information". The details are also set out in note 61.

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

20. Auditors' remuneration

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

21. Gains less losses from financial investments and fixed assets

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

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

22. Net surplus on property revaluation

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

23. Tax expense

(a) Taxation in the consolidated income statement represents:

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

The current tax provision is based on the estimated assessable profit for 2012, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2011: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

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

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

24. Profit attributable to shareholders

Of the profit attributable to shareholders, HK$13,044 million (2011: HK$14,247 million) has been dealt with in the financial statements of the Bank.

Reconciliation of the above amount to the Bank's profit for the year:

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

25. Earnings per share

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

26. Dividends per share

(a) Dividends attributable to the year:

	2012		2011	
	per share HK$	**HK$ million**	per share HK$	HK$ million
First interim	**1.10**	**2,103**	1.10	2,103
Second interim	**1.10**	**2,103**	1.10	2,103
Third interim	**1.10**	**2,103**	1.10	2,103
Fourth interim	**2.00**	**3,824**	1.90	3,633
	5.30	**10,133**	5.20	9,942

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

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

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

27. Segmental analysis

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

Hong Kong and other business segment

Retail Banking and Wealth Management activities offer a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance and wealth management. **Corporate and Commercial Banking** activities include the provision of financial services, payments and cash management, international trade finance, insurance, wealth management and tailored financial solutions to corporate and commercial customers. **Treasury** activities are mainly the provision of treasury operation services in credit, interest rates, foreign exchange, money markets and securities services. Treasury also manages the funding and liquidity positions of the Group and other market risk positions arising from banking activities. "**Other**" mainly represents management of shareholders' funds and investments in premises, investment properties, equity shares and subordinated debt funding.

Mainland China business segment

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

27. Segmental analysis continued

(a) Segment result

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

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

27. Segmental analysis continued

(a) Segment result continued

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

27. Segmental analysis continued

(b) Geographic Information

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

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

* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

28. Analysis of assets and liabilities by remaining maturity

The maturity analysis is based on the remaining contractual maturity at the balance sheet date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

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

28. Analysis of assets and liabilities by remaining maturity continued

	Group								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2011 (restated)									
Assets									
Cash and balances with banks	39,533	–	–	–	–	–	–	–	39,533
Placings with and advances to banks	9,089	47,698	43,687	5,639	–	1,629	–	–	107,742
Trading assets	–	–	–	–	–	–	64,171	–	64,171
Financial assets designated at fair value	–	140	82	116	3,615	49	–	4,094	8,096
Derivative financial instruments	–	7	13	72	87	–	4,531	–	4,710
Loans and advances to customers	11,131	39,239	43,024	89,609	164,318	133,253	–	–	480,574
Financial investments:									
– available-for-sale investments	–	10,940	19,648	68,426	47,510	1,621	–	1,134	149,279
– held-to-maturity debt securities	–	668	1,083	2,529	21,736	33,895	–	–	59,911
Interest in associates	–	–	–	–	–	–	–	19,627	19,627
Investment properties	–	–	–	–	–	–	–	4,314	4,314
Premises, plant and equipment	–	–	–	–	–	–	–	17,983	17,983
Intangible assets	–	–	–	–	–	–	–	5,962	5,962
Other assets	5,185	3,231	3,234	1,616	124	19	–	354	13,763
	64,938	101,923	110,771	168,007	237,390	170,466	68,702	53,468	975,665
Liabilities									
Current, savings and other deposit accounts	503,537	93,809	69,086	32,401	1,024	–	–	–	699,857
Deposits from banks	2,072	8,941	2,374	617	–	–	–	–	14,004
Trading liabilities	–	–	–	–	–	–	59,712	–	59,712
Financial liabilities designated at fair value	1	–	–	–	–	433	–	–	434
Derivative financial instruments	–	22	4	65	1,046	203	3,508	–	4,848
Certificates of deposit and other debt securities in issue:									
– certificates of deposit in issue	–	1,596	–	1,475	6,213	–	–	–	9,284
Other liabilities	6,629	4,205	3,343	1,817	64	19	–	4,061	20,138
Liabilities to customers under insurance contracts	–	–	–	–	–	–	–	72,225	72,225
Current tax liabilities	–	–	–	305	–	–	–	–	305
Deferred tax liabilities	–	–	–	–	–	–	–	3,378	3,378
Subordinated liabilities	–	–	–	2,328	–	9,518	–	–	11,846
	512,239	108,573	74,807	39,008	8,347	10,173	63,220	79,664	896,031
of which:									
Certificates of deposit included in:									
– trading assets	–	–	–	–	–	–	432	–	432
– financial assets designated at fair value	–	–	–	–	1	–	–	–	1
– available-for-sale investments	–	2,650	1,538	926	853	–	–	39	6,006
– held-to-maturity debt securities	–	–	6	429	673	2,272	–	–	3,380
	–	2,650	1,544	1,355	1,527	2,272	432	39	9,819
Debt securities included in:									
– trading assets	–	–	–	–	–	–	63,226	–	63,226
– financial assets designated at fair value	–	140	82	116	3,613	49	–	(2)	3,998
– available-for-sale investments	–	8,290	18,110	67,500	46,657	1,621	–	836	143,014
– held-to-maturity debt securities	–	668	1,077	2,100	21,063	31,623	–	–	56,531
	–	9,098	19,269	69,716	71,333	33,293	63,226	834	266,769
Certificates of deposit in issue included in:									
– trading liabilities	–	–	–	–	–	–	2,641	–	2,641
– financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– issue at amortised cost	–	1,596	–	1,475	6,213	–	–	–	9,284
	–	1,596	–	1,475	6,213	–	2,641	–	11,925

28. Analysis of assets and liabilities by remaining maturity continued

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

28. Analysis of assets and liabilities by remaining maturity continued

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2011 (restated)									
Assets									
Cash and balances with banks	36,475	–	–	–	–	–	–	–	36,475
Placings with and advances to banks	5,429	19,521	20,877	1,897	–	–	–	–	47,724
Trading assets	–	–	–	–	–	–	60,526	–	60,526
Financial assets designated at fair value	–	140	–	–	–	–	–	–	140
Derivative financial instruments	–	7	13	28	20	–	4,368	–	4,436
Loans and advances to customers	11,156	33,675	33,991	78,447	144,295	124,065	–	–	425,629
Amounts due from subsidiaries	57,743	2,469	10,655	8,133	6,222	–	–	–	85,222
Financial investments:									
– available-for-sale investments	–	9,307	14,809	55,856	23,108	1,621	–	441	105,142
Investments in subsidiaries	–	–	–	–	–	–	–	14,434	14,434
Interest in associates	–	–	–	–	–	–	–	5,172	5,172
Investment properties	–	–	–	–	–	–	–	2,806	2,806
Premises, plant and equipment	–	–	–	–	–	–	–	13,249	13,249
Intangible assets	–	–	–	–	–	–	–	408	408
Other assets	4,433	2,820	1,470	365	50	–	–	44	9,182
	115,236	67,939	81,815	144,726	173,695	125,686	64,894	36,554	810,545
Liabilities									
Current, savings and other deposit accounts	489,880	90,583	60,669	19,425	455	–	–	–	661,012
Deposits from banks	2,065	7,007	2,300	617	–	–	–	–	11,989
Trading liabilities	–	–	–	–	–	–	36,077	–	36,077
Derivative financial instruments	–	22	–	27	530	203	3,320	–	4,102
Certificates of deposit and other debt securities in issue:									
– certificates of deposit in issue	–	1,596	–	1,475	6,213	–	–	–	9,284
Amounts due to subsidiaries	6,143	4,629	22	3	–	–	–	–	10,797
Other liabilities	6,019	4,214	1,936	847	8	19	–	3,917	16,960
Current tax liabilities	–	–	–	270	–	–	–	–	270
Deferred tax liabilities	–	–	–	–	–	–	–	1,342	1,342
Subordinated liabilities	–	–	–	2,328	–	9,518	–	–	11,846
	504,107	108,051	64,927	24,992	7,206	9,740	39,397	5,259	763,679
of which:									
Certificates of deposit included in:									
– trading assets	–	–	–	–	–	–	432	–	432
– financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– available-for-sale investments	–	2,650	1,538	926	853	–	–	39	6,006
– held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	2,650	1,538	926	853	–	432	39	6,438
Debt securities included in:									
– trading assets	–	–	–	–	–	–	59,581	–	59,581
– financial assets designated at fair value	–	140	–	–	–	–	–	–	140
– available-for-sale investments	–	6,657	13,271	54,930	22,255	1,621	–	340	99,074
– held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	6,797	13,271	54,930	22,255	1,621	59,581	340	158,795
Certificates of deposit in issue included in:									
– trading liabilities	–	–	–	–	–	–	2,641	–	2,641
– financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– issue at amortised cost	–	1,596	–	1,475	6,213	–	–	–	9,284
	–	1,596	–	1,475	6,213	–	2,641	–	11,925

29. Accounting classifications

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

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

29. Accounting classifications continued

	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total (restated)
	Group						
2011							
Cash and balances with banks	–	–	–	–	–	39,533	39,533
Placings with and advances to banks	–	–	–	–	107,742	–	107,742
Derivative financial instruments	4,531	–	179	–	–	–	4,710
Loans and advances to customers	–	–	–	–	480,574	–	480,574
Investment securities	63,665	8,096	149,279	59,911	–	–	280,951
Acceptances and endorsements	–	–	–	–	–	4,697	4,697
Other financial assets	506	–	–	–	–	8,638	9,144
Total financial assets	68,702	8,096	149,458	59,911	588,316	52,868	927,351
Non-financial assets							48,314
Total assets							975,665
Current, savings and other deposit accounts	30,923	–	–	–	–	699,857	730,780
Deposits from banks	–	–	–	–	–	14,004	14,004
Derivative financial instruments	3,505	3	1,340	–	–	–	4,848
Certificates of deposit and other debt securities in issue	3,183	–	–	–	–	9,284	12,467
Other financial liabilities	25,606	–	–	–	–	11,290	36,896
Subordinated liabilities	–	–	–	–	–	11,846	11,846
Liabilities to customers under investment contracts	–	434	–	–	–	–	434
Acceptances and endorsements	–	–	–	–	–	4,697	4,697
Total financial liabilities	63,217	437	1,340	–	–	750,978	815,972
Non-financial liabilities							80,059
Total liabilities							896,031

29. Accounting classifications continued

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

29. Accounting classifications continued

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total (restated)
2011							
Cash and balances with banks	–	–	–	–	–	36,475	36,475
Placings with and advances to banks	–	–	–	–	47,724	–	47,724
Derivative financial instruments	4,368	–	68	–	–	–	4,436
Loans and advances to customers	–	–	–	–	425,629	–	425,629
Investment securities	60,020	140	105,142	–	–	–	165,302
Amounts due from subsidiaries	–	–	–	–	–	85,222	85,222
Acceptances and endorsements	–	–	–	–	–	3,052	3,052
Other financial assets	506	–	–	–	–	5,971	6,477
Total financial assets	64,894	140	105,210	–	473,353	130,720	774,317
Non-financial assets							36,228
Total assets							810,545
Current, savings and other deposit accounts	7,288	–	–	–	–	661,012	668,300
Deposits from banks	–	–	–	–	–	11,989	11,989
Derivative financial instruments	3,317	3	782	–	–	–	4,102
Certificates of deposit and other debt securities in issue	3,183	–	–	–	–	9,284	12,467
Amounts due to subsidiaries	–	–	–	–	–	10,797	10,797
Other financial liabilities	25,606	–	–	–	–	10,845	36,451
Subordinated liabilities	–	–	–	–	–	11,846	11,846
Acceptances and endorsements	–	–	–	–	–	3,052	3,052
Total financial liabilities	39,394	3	782	–	–	718,825	759,004
Non-financial liabilities							4,675
Total liabilities							763,679

30. Cash and balances with banks

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

31. Placings with and advances to banks

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

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

32. Trading assets

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

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

33. Financial assets designated at fair value

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

34. Derivative financial instruments

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

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading, or financial instruments designated at fair value, or designated as either fair value hedge or cash flow hedge. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives.

Trading derivatives

Most of the Group's trading derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters.

Derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

Hedging instruments

The Group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the Group to optimise the cost of managing the balance sheet, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

(a) Fair value hedge

The Group's fair value hedge principally consists of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates.

34. Derivative financial instruments continued

(b) Cash flow hedge

The Group is exposed to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio for financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedge of forecast transactions.

Gains and losses are initially recognised in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2012, the amount of cash flow hedging reserve transferred to the income statement comprised HK$68 million (2011: HK$197 million) included in net interest income and HK$260 million (2011: Nil) included in net trading income.

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2012 and 2011. During the years of 2012 and 2011, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur. In 2012, there was no gain recognised due to termination of such forecast transactions (2011: Nil).

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

	Group		
	Three months or less	Over three months but within one year	Over one year but within five years
At 31 December 2012			
Cash inflows from assets	**10,994**	**10,567**	**2,734**
Cash outflows from liabilities	**–**	**–**	**–**
Net cash inflows	**10,994**	**10,567**	**2,734**
At 31 December 2011			
Cash inflows from assets	48,385	34,920	9,681
Cash outflows from liabilities	–	–	–
Net cash inflows	48,385	34,920	9,681

34. Derivative financial instruments continued

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

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

34. Derivative financial instruments continued

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

The above derivative assets and liabilities, being the positive or negative marked-to-market value of the respective derivative contracts, represent gross replacement costs.

34. Derivative financial instruments continued

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

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

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

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

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

The Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2012 and 2011 were calculated based on the advanced internal ratings-based approach.

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

The total fair value of the derivatives at 31 December 2012 was HK$2,965 million (31 December 2011: HK$2,411 million) after taking into account the effect of valid bilateral netting agreement amounting to HK$1,641 million (31 December 2011: HK$1,664 million).

34. Derivative financial instruments continued

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

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2011						
Exchange rate contracts:						
– spot and forward foreign exchange	493,588	2,441	1,169	480,558	2,198	1,056
– currency swaps	4,827	155	17	4,827	155	16
– currency options purchased	87,005	2,316	1,749	87,083	2,317	1,749
– other exchange rate contracts	131	4	–	131	4	–
	585,551	4,916	2,935	572,599	4,674	2,821
Interest rate contracts:						
– interest rate swaps	342,801	2,624	950	276,398	2,099	757
– interest rate options purchased	–	–	–	–	–	–
	342,801	2,624	950	276,398	2,099	757
Equity and other contracts:						
– equity swaps	4,386	276	39	8,274	798	70
– equity options purchased	1,087	95	75	1,087	95	75
– others	–	–	–	–	–	–
	5,473	371	114	9,361	893	145

35. Loans and advances to customers

(a) Loans and advances to customers

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

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

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

35. Loans and advances to customers continued

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

	Group		
	Individually assessed	Collectively assessed	Total
2012			
At 1 January	**896**	**771**	**1,667**
Amounts written off	**(277)**	**(416)**	**(693)**
Recoveries of advances written off in previous years	**13**	**47**	**60**
New impairment allowances charged to income statement (note 16)	**294**	**376**	**670**
Impairment allowances released to income statement (note 16)	**(237)**	**(47)**	**(284)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(7)**	**(3)**	**(10)**
Exchange	**(1)**	**–**	**(1)**
At 31 December	**681**	**728**	**1,409**
2011			
At 1 January	1,118	718	1,836
Amounts written off	(355)	(330)	(685)
Recoveries of advances written off in previous years	35	43	78
New impairment allowances charged to income statement (note 16)	359	381	740
Impairment allowances released to income statement (note 16)	(256)	(44)	(300)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(10)	(3)	(13)
Exchange	5	6	11
At 31 December	896	771	1,667

	Bank		
	Individually assessed	Collectively assessed	Total
2012			
At 1 January	**789**	**620**	**1,409**
Amounts written off	**(276)**	**(416)**	**(692)**
Recoveries of advances written off in previous years	**4**	**47**	**51**
New impairment allowances charged to income statement (note 16)	**131**	**379**	**510**
Impairment allowances released to income statement (note 16)	**(139)**	**(47)**	**(186)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(6)**	**(3)**	**(9)**
At 31 December	**503**	**580**	**1,083**
2011			
At 1 January	844	588	1,432
Amounts written off	(235)	(330)	(565)
Recoveries of advances written off in previous years	22	43	65
New impairment allowances charged to income statement (note 16)	297	365	662
Impairment allowances released to income statement (note 16)	(134)	(43)	(177)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(5)	(3)	(8)
At 31 December	789	620	1,409

35. Loans and advances to customers continued

(c) Impaired loans and advances to customers and allowances

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

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

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

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

35. Loans and advances to customers continued

(d) Overdue loans and advances to customers

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

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

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

35. Loans and advances to customers continued

(e) Rescheduled loans and advances to customers

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

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

Rescheduled loans and advances to customers are those loans and advances that have been rescheduled or renegotiated for reasons related to the borrower's financial difficulties. This will normally involve the granting of concessionary terms and resetting the overdue account to non-overdue status.

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

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

Loans and advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when a loan is guaranteed by a party located in an area that is different from that of the counterparty.

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

	Bank				
	Gross loans and advances	Individually impaired loans and advances	Overdue loans and advances	Individually assessed allowances	Collectively assessed allowances
At 31 December 2012					
Hong Kong	**431,548**	**925**	**715**	**502**	**539**
Rest of Asia-Pacific	**43,490**	**21**	**22**	**–**	**38**
Others	**2,779**	**24**	**–**	**1**	**3**
	477,817	**970**	**737**	**503**	**580**
At 31 December 2011					
Hong Kong	385,958	1,261	920	778	573
Rest of Asia-Pacific	38,089	32	32	9	43
Others	2,991	20	–	2	4
	427,038	1,313	952	789	620

35. Loans and advances to customers continued

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

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

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

35. Loans and advances to customers continued

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

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

35. Loans and advances to customers continued

(h) Net investments in finance leases

Loans and advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring by the lessee the leased asset at nominal value at the end of the lease period. The total minimum lease payments receivable and their present value at the year-end are as follows:

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

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

35. Loans and advances to customers continued

(h) Net investments in finance leases continued

	Bank		
	Present value of minimum lease payments receivable	**Interest income relating to future periods**	**Total minimum lease payments receivable**
2012			
Amounts receivable:			
– within one year	**329**	**53**	**382**
– after one year but within five years	**806**	**170**	**976**
– after five years	**2,313**	**286**	**2,599**
	3,448	**509**	**3,957**
Loans impairment allowances	**(1)**		
Net investments in finance leases and hire purchase contracts	**3,447**		
2011			
Amounts receivable:			
– within one year	417	56	473
– after one year but within five years	893	171	1,064
– after five years	2,395	292	2,687
	3,705	519	4,224
Loans impairment allowances	(25)		
Net investments in finance leases and hire purchase contracts	3,680		

36. Financial investments

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

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

(a) Held-to-maturity debt securities

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

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

36. Financial investments continued

(b) Available-for-sale debt securities

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

At 31 December 2012 and 2011, there were no available-for-sale debt securities individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities for the Group and the Bank.

(c) Available-for-sale equity shares

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

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

36. Financial investments continued

(d) Available-for-sale investment funds

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

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

37. Transfers of financial assets not qualifying for derecognition

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

- Full derecognition occurs when the Group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, and transfers substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.
- Partial derecognition occurs when the Group sells or otherwise transfers financial assets in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These financial assets are recognised in the balance sheet to the extent of the Group's continuing involvement.

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

Financial assets and associated financial liabilities not qualifying for full derecognition

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

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

38. Investments in subsidiaries

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

The principal subsidiaries of the Bank are:

Name of company	Place of incorporation	Principal activities	Issued equity capital
Hang Seng Bank (China) Limited	People's Republic of China	Banking	RMB4,817,500,000
Hang Seng Finance Limited	Hong Kong SAR	Lending	HK$1,000,000,000
Hang Seng Credit Limited	Hong Kong SAR	Lending	HK$200,000,000
Hang Seng Bank (Bahamas) Limited	Bahamas	Banking	US$1,000,000
Hang Seng Finance (Bahamas) Limited	Bahamas	Finance	US$5,000
Hang Seng Bank (Trustee) Limited	Hong Kong SAR	Trustee service	HK$3,000,000
Hang Seng (Nominee) Limited	Hong Kong SAR	Nominee service	HK$100,000
Hang Seng Life Limited	Hong Kong SAR	Retirement benefits and life assurance	HK$970,000,000
Hang Seng Insurance Company Limited	Hong Kong SAR	Retirement benefits and life assurance	HK$5,826,184,570
Hang Seng Asset Management Pte Ltd	Singapore	Fund management	SG$2,000,000
Hang Seng Investment Management Limited	Hong Kong SAR	Fund management	HK$10,000,000
Haseba Investment Company Limited	Hong Kong SAR	Investment holding	HK$6,000
Hang Seng Securities Limited	Hong Kong SAR	Stockbroking	HK$26,000,000
Yan Nin Development Company Limited	Hong Kong SAR	Investment holding	HK$100,000
Hang Seng Indexes Company Limited	Hong Kong SAR	Compilation and dissemination of the Hang Seng share index	HK$10,000
Hang Seng Real Estate Management Limited	Hong Kong SAR	Property management	HK$10,000
High Time Investments Limited	Hong Kong SAR	Investment holding	HK$2,250,010,000

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

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

39. Interest in associates

	Group		Bank	
	2012	2011 (restated)	**2012**	2011
Unlisted investments, at cost	**–**	–	**912**	912
Listed investments, at cost	**–**	–	**4,260**	4,260
Share of net assets	**24,151**	19,095	**–**	–
Intangible asset	**29**	57	**–**	–
Goodwill	**475**	475	**–**	–
	24,655	19,627	**5,172**	5,172

The associates are:

Name of company	Place of incorporation and operation	Principal activity	Group's interest in equity capital	Issued equity capital
Unlisted				
Barrowgate Limited	Hong Kong SAR	Property investment	24.64%	HK$10,000
Yantai Bank Co., Ltd.	People's Republic of China	Banking	20.00%	RMB2,000,000,000
Guangzhou GuangZheng Hang Seng Securities Investment Advisory Co., Ltd.	People's Republic of China	Conduct market/ securities analysis and publish research reports	33.00%	RMB44,680,000
Listed				
Industrial Bank Co., Ltd.	People's Republic of China	Banking	12.80%	RMB10,786,000,000

Interest in associates included listed investment of HK$22,099 million (2011: HK$17,199 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$28,409 million (2011: HK$21,307 million).

In accordance with Hong Kong Accounting Standard 28 "Investments in Associates", an associate is an entity over which the investor has significant influence, including the power to participate in the financial and operating policy decisions without controlling the management of the investee. Usually a holding of less than 20 per cent is presumed not to have significant influence, unless such influence can be clearly demonstrated. The interests are recognised at cost and dividends accounted for as declared.

The interest in Barrowgate Limited is owned by a subsidiary of the Bank. The interest in Industrial Bank Co., Ltd. ("Industrial Bank") and Yantai Bank Co., Ltd. ("Yantai Bank") are owned directly by the Bank. Our partnership with Guangzhou Securities Company Limited to set up the joint venture securities investment advisory company – Guangzhou GuangZheng Hang Seng Securities Investment Advisory Company Limited ("GuangZheng Securities") was incorporated in May 2012. The Group has a 33% stake in the joint venture.

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

For the year ended 31 December 2012, the financial results of Industrial Bank, Yantai Bank and GuangZheng Securities were included in the financial statements based on financial statements drawn up to 30 September 2012, but taking into account any changes in the subsequent period from 1 October 2012 to 31 December 2012 that would materially affect the results. The Group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 "Investments in Associates" whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

39. Interest in associates continued

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

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

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

40. Investment properties

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2012, and were updated for any material changes in the valuation as at 31 December 2012. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

(a) Movement of investment properties

	Group		Bank	
	2012	2011	**2012**	2011
At 1 January	**4,314**	3,251	**2,806**	2,100
Surplus on revaluation credited to income statement (note 22)	**742**	982	**447**	613
Transfer (to)/from assets held for sale	**(228)**	77	**(228)**	77
Transfer from/(to) premises (note 41(a))	**32**	4	**(37)**	16
At 31 December	**4,860**	4,314	**2,988**	2,806

(b) Terms of lease

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

40. Investment properties continued

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

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

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

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

41. Premises, plant and equipment

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2012, and were updated for any material changes in the valuation as at 31 December 2012. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use.

(a) Movement of premises, plant and equipment

	Group		
	Premises	**Plant and equipment**	**Total**
2012			
Cost or valuation:			
At 1 January	**17,377**	**3,686**	**21,063**
Additions	**–**	**214**	**214**
Disposals	**–**	**(107)**	**(107)**
Elimination of accumulated depreciation on revalued premises	**(497)**	**–**	**(497)**
Surplus on revaluation:			
– credited to premises revaluation reserve	**2,222**	**–**	**2,222**
Transfer to assets held for sale	**(322)**	**–**	**(322)**
Transfer to investment property (note 40(a))	**(32)**	**–**	**(32)**
Other	**–**	**(42)**	**(42)**
At 31 December	**18,748**	**3,751**	**22,499**
Accumulated depreciation:			
At 1 January	**(7)**	**(3,073)**	**(3,080)**
Charge for the year (note 17)	**(492)**	**(270)**	**(762)**
Written off on disposal	**–**	**100**	**100**
Transfer to assets held for sale	**2**	**–**	**2**
Elimination of accumulated depreciation on revalued premises	**497**	**–**	**497**
Other	**–**	**6**	**6**
At 31 December	**–**	**(3,237)**	**(3,237)**
Net book value at 31 December	**18,748**	**514**	**19,262**

41. Premises, plant and equipment continued

(a) Movement of premises, plant and equipment continued

	Group		
	Premises	Plant and equipment	Total
2011			
Cost or valuation:			
At 1 January	13,899	3,502	17,401
Exchange adjustments	31	21	52
Additions	–	254	254
Disposals	–	(77)	(77)
Elimination of accumulated depreciation on revalued premises	(398)	–	(398)
Surplus on revaluation:			
– credited to premises revaluation reserve	3,729	–	3,729
– credited to income statement (note 22)	2	–	2
Transfer from assets held for sale	102	–	102
Transfer to investment property (note 40(a))	(4)	–	(4)
Other	16	(14)	2
At 31 December	17,377	3,686	21,063
Accumulated depreciation:			
At 1 January	(1)	(2,839)	(2,840)
Exchange adjustments	–	(12)	(12)
Charge for the year (note 17)	(404)	(296)	(700)
Written off on disposal	–	74	74
Elimination of accumulated depreciation on revalued premises	398	–	398
At 31 December	(7)	(3,073)	(3,080)
Net book value at 31 December	17,370	613	17,983

41. Premises, plant and equipment continued

(a) Movement of premises, plant and equipment continued

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

41. Premises, plant and equipment continued

(a) Movement of premises, plant and equipment continued

	Bank		
	Premises	Plant and equipment	Total
2011			
Cost or valuation:			
At 1 January	10,107	3,054	13,161
Additions	–	178	178
Disposals	–	(71)	(71)
Elimination of accumulated depreciation on revalued premises	(305)	–	(305)
Surplus on revaluation:			
– credited to premises revaluation reserve	2,923	–	2,923
– credited to income statement	1	–	1
Transfer from assets held for sale	102	–	102
Transfer to investment property (note 40(a))	(16)	–	(16)
At 31 December	12,812	3,161	15,973
Accumulated depreciation:			
At 1 January	–	(2,573)	(2,573)
Charge for the year	(305)	(220)	(525)
Written off on disposal	–	69	69
Elimination of accumulated depreciation on revalued premises	305	–	305
At 31 December	–	(2,724)	(2,724)
Net book value at 31 December	12,812	437	13,249

(b) Terms of lease

The net book value of premises comprises:

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

(c) The carrying amount of all premises which have been stated in the balance sheet would have been as follows had they been stated at cost less accumulated depreciation:

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

42. Intangible assets

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

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

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

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

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

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

(b) Goodwill

	Group		Bank	
	2012	2011	**2012**	2011
At 1 January and at 31 December	**329**	329	**–**	–

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

During 2012, there was no impairment of goodwill (2011: Nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating unit based on appraisal value with the carrying amount of its net assets, including attributable goodwill.

The appraisal value comprises HSIC's net assets (other than value of business acquired and goodwill) as at 31 December 2012, the PVIF and the expected value of future business. The PVIF is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 42(a) and 62(d).

42. Intangible assets continued

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

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

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

43. Other assets

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

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

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

44. Current, savings and other deposit accounts

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

45. Trading liabilities

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

46. Financial liabilities designated at fair value

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

47. Certificates of deposit and other debt securities in issue

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

48. Other liabilities

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

49. Liabilities to customers under insurance contracts

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

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

The movement of liabilities under insurance contracts was as follows:

(a) Non-life insurance

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

49. Liabilities to customers under insurance contracts continued

(a) Non-life insurance continued

	Group		
	Gross	Reinsurance	Net
2011			
Unearned premiums			
At 1 January	227	(75)	152
Gross written premiums	456	(107)	349
Gross earned premiums	(444)	106	(338)
Exchange and other movements	6	(1)	5
At 31 December	245	(77)	168
Notified and incurred but not reported claims			
At 1 January			
– notified claims	160	(18)	142
– claims incurred but not reported	41	(9)	32
	201	(27)	174
Claims paid	(109)	28	(81)
Claims incurred	132	(37)	95
	23	(9)	14
Exchange and other movements	(4)	1	(3)
At 31 December			
– notified claims	183	(27)	156
– claims incurred but not reported	37	(8)	29
	220	(35)	185
Other	54	(1)	53
	519	(113)	406

49. Liabilities to customers under insurance contracts continued

(b) Policyholders' liabilities

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

	Group		
	Gross	Reinsurance	Net
2011			
Life (non-linked)			
At 1 January	63,722	(35)	63,687
Benefits paid	(3,533)	29	(3,504)
Claims incurred and movement in policyholders' liabilities	11,573	(47)	11,526
Exchange and other movements	(239)	11	(228)
At 31 December	71,523	(42)	71,481
Life (linked)			
At 1 January	226	–	226
Benefits paid	(30)	–	(30)
Claims incurred and movement in policyholders' liabilities	(11)	–	(11)
Exchange and other movements	(2)	–	(2)
At 31 December	183	–	183
	71,706	(42)	71,664

50. Current tax and deferred tax

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

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

(b) Deferred tax assets and liabilities recognised

The major components of deferred tax (assets)/liabilities recognised in the balance sheet and the movements during the year are as follows:

	Group						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available-for-sale financial assets	Cash flow hedge	Other	Total
2012							
At 1 January	**93**	**2,410**	**(88)**	**(31)**	**1**	**993**	**3,378**
(Credited)/charged to income statement (note 23(a))	**(14)**	**(66)**	**1**	**–**	**–**	**526**	**447**
Charged to reserves	**–**	**358**	**–**	**41**	**2**	**99**	**500**
Exchange and others	**–**	**–**	**–**	**(1)**	**–**	**(1)**	**(2)**
At 31 December	**79**	**2,702**	**(87)**	**9**	**3**	**1,617**	**4,323**
2011 (restated)							
At 1 January	106	1,852	(85)	28	14	823	2,738
(Credited)/charged to income statement (note 23(a))	(13)	(52)	(3)	–	–	434	366
Charged/(credited) to reserves	–	610	–	(59)	(13)	(264)	274
At 31 December	93	2,410	(88)	(31)	1	993	3,378

50. Current tax and deferred tax continued

(b) Deferred tax assets and liabilities recognised continued

	Bank						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available-for-sale financial assets	Cash flow hedge	Other	Total
2012							
At 1 January	**92**	**1,950**	**(87)**	**(34)**	**1**	**(580)**	**1,342**
(Credited)/charged to income statement	**(18)**	**(58)**	**11**	**–**	**–**	**27**	**(38)**
Charged to reserves	**–**	**243**	**–**	**39**	**2**	**99**	**383**
At 31 December	**74**	**2,135**	**(76)**	**5**	**3**	**(454)**	**1,687**
2011 (restated)							
At 1 January	101	1,511	(84)	25	14	(307)	1,260
Credited to income statement	(9)	(43)	(3)	–	–	(8)	(63)
Charged/(credited) to reserves	–	482	–	(59)	(13)	(265)	145
At 31 December	92	1,950	(87)	(34)	1	(580)	1,342

(c) Deferred tax assets not recognised

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

(d) Deferred tax liabilities not recognised

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

51. Subordinated liabilities

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

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

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

52. Share capital

Authorised:

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

	2012	2011
Issued and fully paid:		
1,911,842,736 shares (2011: 1,911,842,736 shares) of HK$5 each	**9,559**	9,559

During the year, the Bank made no repurchase of its own shares (2011: Nil).

53. Reserves

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity.

The Bank and its banking subsidiaries operate under regulatory jurisdictions which require the maintenance of minimum capital adequacy ratios and which could therefore potentially restrict the amount of realised profits which can be distributed to shareholders.

Regulatory reserve

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2012, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group and the Bank to shareholders by HK$4,866 million (2011: HK$4,226 million) and HK$4,497 million (2011: HK$3,896 million) respectively.

Retained profits

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

Premises revaluation reserve

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

The premises revaluation reserve included HK$216 million in relation to premises classified as assets held for sale, included in "Other assets" in the consolidated balance sheet at 31 December 2012 (31 December 2011: HK$22 million).

Cash flow hedging reserve

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

Available-for-sale investment reserve

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

Capital redemption reserve

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

Other reserves

Other reserves mainly comprise foreign exchange reserve and share-based payment reserve. The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations. The share-based payment reserve is used to record the corresponding amount of share options granted by ultimate holding company to the Group's employees and other cost of share-based payment arrangement. Other reserves also included the gain on dilution of investment in an associate of HK$1,465 million transferred from retained profits.

53. Reserves continued

Details of the changes in the Bank's individual components of equity between the beginning and the end of the year are set out below:

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

53. Reserves continued

At 31 December 2012, the aggregate amount of reserves available for distribution to equity shareholders of the Bank as calculated under the provision of section 79B of the Hong Kong Companies Ordinance amounted to HK$24,773 million (2011 (restated): HK$20,630 million). After considering regulatory capital requirement and business development needs, an amount of HK$3,824 million has been declared as the proposed fourth interim dividends in respect of the financial year ended 31 December 2012 (2011: HK$3,633 million). The difference between the aggregate distributable reserves of HK$24,773 million and the Bank's retained profit of HK$31,888 million as reported above mainly represents the exclusion of unrealised revaluation gain on investment properties and the regulatory reserve of the Bank.

54. Reconciliation of cash flow statement

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

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

54. Reconciliation of cash flow statement continued

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

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

The balances of cash and cash equivalents included cash balances with central banks and financial institutions that are subject to exchange control and regulatory restrictions, amounting to HK$18,881 million at 31 December 2012 (31 December 2011: HK$20,004 million).

55. Contingent liabilities and commitments

(a) Off-balance sheet contingent liabilities and commitments

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

For the purposes of these financial statements, acceptances and endorsements are recognised on the balance sheet in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK$5,264 million (2011: HK$4,697 million) and HK$2,548 million (2011: HK$3,052 million) respectively.

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

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

The risk-weighted assets at balance sheet dates were calculated based on the "Advanced internal ratings-based approach".

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

55. Contingent liabilities and commitments continued

(a) Off-balance sheet contingent liabilities and commitments continued

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2011						
Direct credit substitutes	5,438	5,308	3,426	3,704	3,574	1,692
Transaction-related contingencies	1,220	138	72	1,178	135	72
Trade-related contingencies	9,807	979	532	7,933	791	394
Forward asset purchases	35	35	35	35	35	35
Undrawn formal standby facilities, credit lines and other commitments to lend:						
– not unconditionally cancellable*	31,311	15,081	5,384	31,262	14,243	5,334
– unconditionally cancellable	232,469	76,890	23,420	196,627	70,777	18,524
	280,280	98,431	32,869	240,739	89,555	26,051

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

(b) Contingencies

There is no material litigation expected to result in a significant adverse effect on the financial position of the Group and the Bank, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

56. Assets pledged as security for liabilities

At 31 December 2012, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements for the Group and the Bank amounted to HK$21,006 million (Group and Bank at 31 December 2011: HK$25,569 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK$21,073 million (Group and Bank at 31 December 2011: HK$25,881 million) and mainly comprised items included in "Trading assets" and "Financial investments".

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

57. Capital commitments

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

58. Lease commitments

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

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

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

59. Employee retirement benefits

(a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 40 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The latest annual actuarial valuations at 31 December 2012 were performed by T Ching, fellow of the Society of Actuaries of the United States of America, of HSBC Insurance (Asia) Limited, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the balance sheet at year-end and retirement benefits costs recognised in the income statement for the year in respect of these defined benefit schemes are set out below.

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

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

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

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

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

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

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

(iii) Change in the present value of scheme obligations

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

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

(iv) Change in the fair value of scheme assets

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

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

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

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

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

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

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

The net actuarial gains recognised in the Group's retained profit during 2012 in respect of defined benefit schemes were HK$505 million (net actuarial losses of HK$1,336 million during 2011). The total cumulative amount of actuarial losses recognised in the retained profits was HK$2,733 million (2011: the cumulative amount of actuarial losses was HK$3,238 million). The total effect of the limit on schemes surpluses in 2012 and 2011 in respect of defined benefit schemes was nil.

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

	Group and Bank		
	HSBDBS %	HSBPS %	HSBNTBS %
2012			
Discount rate	**0.6**	**0.6**	**0.6**
Expected rate of return on scheme assets	**5.3**	**5.3**	**1.7**
Expected rate of salary increases	**4.5**	**4.5**	**4.5**
Expected rate of pension increases	**–**	**1.5**	**–**
2011			
Discount rate	1.5	1.5	1.5
Expected rate of return on scheme assets	4.5	4.0	1.8
Expected rate of salary increases	5.0	5.0	5.0
Expected rate of pension increases	–	1.5	–

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

59. Employee retirement benefits continued

(a) Defined benefit schemes continued

(viii) Amounts for the current and previous years

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

(b) Defined contribution schemes

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

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

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

Under the schemes, the Group's contributions are reduced by contributions forfeited by those employees who leave the schemes prior to the contributions vesting fully. There was no forfeited contributions utilised during the year or available at the year-end to reduce future contributions (2011: Nil).

60. Share-based payments

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

Share Awards Plans

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

Share Option Plans

Plans	Policy	Purpose
Savings-Related Share Option Plan	– Exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively – The exercise price is set at a 20% (2011: 20%) discount to the market value immediately preceding the date of invitation	– Eligible employees save up to £250 per month (or its equivalent in Hong Kong dollars), with the option to use the savings to acquire shares
Executive Share Option Scheme ("ESOS") and Group Share Option Plan ("GSOP")	– Vesting of awards based on achievement of certain corporate performance condition targets – Exercisable between third and tenth anniversaries of the date of grant – Plan ceased in 2004	– Long-term incentive plan between 2000 and 2004 during which certain employees were awarded share options

60. Share-based payments continued

(a) Savings-Related Share Option Plan

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

Option scheme with exercise price set in Hong Kong dollars

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

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

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

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

(b) Executive/Group Share Option Plan

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

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

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

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

60. Share-based payments continued

(c) Calculation of fair value

The recognition of compensation cost of share option is based on the fair value of the options on grant date. The calculation of the fair value of HSBC share option is centrally managed by HSBC Holdings plc. Fair values of share options, measured at the date of grant of the options are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. Expected dividends are incorporated into the valuation model for share options and awards where applicable. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

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

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

The risk-free rate was determined from the UK gilts yield curve for Savings-Related Share Option Plan. Expected life is not a single input parameter but a function of various behavioural assumptions. Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options. Expected dividend yield was based on historic levels of dividend growth.

60. Share-based payments continued

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

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

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

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

(e) Income statement charge

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

* This charge, which was computed from the fair values of the share-based payment transaction when contracted, arose under employee share awards made in accordance with the Group's reward structures.

61. Material related-party transactions

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

In 2012, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The Group used the IT service of, and shared an automated teller machine network with, its immediate holding company. The Group also shared certain IT projects with and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. A fellow subsidiary company was appointed as fund manager to manage the Group's investment portfolios. The Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies.

There was an arrangement whereby a fellow subsidiary provided certain management services, being services related to risk management, back office processing and administration, development and pricing of selected products, information technology and business recovery, financial control and actuarial services, to Hang Seng Insurance Company Limited. The fees on these transactions are determined on an arm's length basis.

61. Material related-party transactions continued

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

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

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

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

61. Material related-party transactions continued

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

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

61. Material related-party transactions continued

(b) Key management personnel remuneration

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

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

(c) Material transactions with key management personnel

During the year, the Group provided credit facilities to and accepted deposits from key management personnel of the Bank and its holding companies, their close family members and companies controlled or significantly influenced by them. The credit facilities extended and deposit taken were provided in the ordinary course of business and on substantially the same terms as for comparable transactions with persons of a similar standing or, where applicable, with other employees.

Material transactions conducted with key management personnel of the Bank and its holding companies and parties related to them are as follows:

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

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

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

61. Material related-party transactions continued

(d) Loans to officers

Loans to officers of the Bank disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

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

(e) Associates

Information relating to associates and transactions with associates can be found in notes 39 and 61(a).

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2012 was HK$233 million (2011: HK$233 million).

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

(f) Ultimate holding company

The Group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the Group. As disclosed in note 60, the Group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under "Other reserves". The balance of this reserve as at 31 December 2012 amounted to HK$618 million comprising HK$625 million relating to share option schemes and negative reserve amounted to HK$7 million relating to share award schemes (2011: HK$571 million comprising HK$576 million relating to share option schemes and negative reserve amounted to HK$5 million relating to share award schemes).

(g) Employee retirement benefits

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

62. Financial risk management

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

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

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

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

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

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

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising senior executives from Risk, Legal, Compliance, Finance, and Operations/IT, is responsible for reviewing and approving the launch of such new products and services. Each new service and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new products and services in development prior to implementation.

(a) Credit risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, and treasury businesses. The Group has dedicated standards, policies and procedures in place to control and monitor risk from all such activities.

The Credit Risk Management ("CRM") function headed by the Chief Credit Officer who reported to Chief Risk Officer is mandated to provide centralised management of credit risk through:

- formulating credit policies on approval process, post disbursement monitoring, recovery process and large exposure;
- issuing guidelines on lending to specified market sectors, industries and products; the acceptability of specific classes of collateral or risk mitigations and valuation parameters for collateral;
- undertaking an independent review and objective assessment of credit risk for all commercial non-bank credit facilities in excess of designated amount prior to the facilities being committed to customers;
- controlling exposures to selected industries, counterparties, countries and portfolio types etc by setting limits;
- maintaining and developing credit risk rating/facility grading process to categorise exposures and facilitate focused management;
- reporting to senior executives and various committees on aspects of the Group loan portfolio;
- managing and directing credit-related systems initiatives; and
- providing advice and guidance to business units on various credit-related issues.

62. Financial risk management continued

(a) Credit risk continued

Impaired loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loan impairment allowances are made promptly where necessary and need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

Risk rating framework

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

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

Collateral and other credit enhancements

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

– in the personal sector, charges over the properties, securities, investment funds and deposits;

– in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery; and

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

Repossessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the balance sheet within "Other assets" at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The Group does not generally occupy repossessed properties for its business use.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured.

Settlement risk

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

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

62. Financial risk management continued

(a) Credit risk continued

Concentration of credit risk

Concentration of credit risk exists when changes in geographic, economic or industry factors similarly affect groups of counterparties whose aggregate credit exposure is material in relation to the Group's total exposures. The Group's portfolio of financial instrument is diversified along geographic, industry and product sectors. Analysis of geographical concentration of the Group's assets is disclosed in note 27 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 32, 33, 35 and 36.

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

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

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

(ii) Collateral and other credit enhancements

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the Group's practice to lend on the basis of the customer's ability to meet their obligations out of their cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. However, for certain lending decisions a charge over collateral is usually obtained, and is important for the credit decision and pricing, and it is the Bank's practice to obtain that collateral and sell it in the event of default as a source of repayment. Such collateral has a significant financial effect and the objective of the disclosure below is to quantify these forms. We may manage our risk further by employing other types of collateral and credit risk enhancements but these are harder to evaluate and subject to a greater uncertainty in the event of default, these have been described below.

We have quantified below the value of fixed charges we hold over a specific asset (or assets) of a borrower for which we have a practical ability and history of enforcing in satisfying a debt in the event of a borrower failing to meet their contractual obligations and where the asset is cash or can be realised in the form of cash by sale in an established market.

Personal lending

For personal lending the collateral held has been analysed below separately for residential mortgages and other personal lending due to the different nature of collateral held on the portfolios.

62. Financial risk management continued

(a) Credit risk continued

(ii) Collateral and other credit enhancements continued

Residential mortgages

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

Residential mortgages loans and advances

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

The collateral included in the table above consists of fixed first charges on residential real estate.

The loan-to-value ("LTV") ratio in the table above is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date as a percentage of the current value of collateral. The current value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation excludes any adjustments for obtaining and selling the collateral.

Other personal lending

The remainder of our personal lending consists primarily of motor vehicle finance, credit cards, instalment loan, overdraft or revolving loan. Motor vehicle lending is generally collateralised by the motor vehicle financed. Credit cards are generally unsecured. Instalment loan, overdraft and revolving loan could be partially secured by cash or marketable securities.

Corporate and commercial and financial (non-bank) lending

For corporate and commercial and financial (non-bank) lending, the collateral held has been analysed below separately for commercial real estate and other corporate and commercial and financial (non-bank) lending due to the different nature of collateral held on the portfolios.

62. Financial risk management continued

(a) Credit risk continued

(ii) Collateral and other credit enhancements continued

Commercial real estate

The following table shows commercial real estate lending including off-balance sheet loan commitments by level of collateralisation.

Commercial real estate loans and advances

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

The collateral included in the table above consists of fixed first charges on real estate.

The value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation will exclude any adjustments for obtaining and selling the collateral.

Other corporate and commercial and financial (non-bank) lending

The following table shows corporate, commercial and financial (non-bank) lending including off-balance sheet loan commitments by level of collateralisation.

Corporate, commercial and financial (non-bank) loans and advances

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

The collateral used in the assessment of the above relates primarily to charges held over business assets in the commercial and industrial sector and charges over marketable financial instruments in the financial sector.

The value of collateral is determined through a combination of professional valuations, physical inspections or house price indices. The collateral valuation will exclude any adjustments with respect of obtaining and selling the collateral.

62. Financial risk management continued

(a) Credit risk continued

(ii) Collateral and other credit enhancements continued

Loans and advances to banks

The following table shows loans and advances to banks including off-balance sheet loan commitments by level of collateralisation.

Loans and advances to banks

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

Derivatives

The ISDA Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of OTC products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or another pre-agreed termination event occurs. It is common, and the Group's preferred practice, for the parties to execute a Credit Support Annex ("CSA") in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institutional clients.

Other

The table below describes other types of collateral held, other credit enhancements employed and methods used to mitigate credit risk arising from financial assets presented in the maximum exposure to credit risk table on page 181.

Cash and balances with banks	Generally no collateral or other credit enhancements held.
Items in the course of collection from other banks	Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt of cash, securities or equities. Daily settlement limits are established for counterparties to cover the aggregate of our transactions with each one on any single day. The Group generally mitigates settlement risk on many transactions, particularly those involving securities and equities, by settling through assured payment systems or on a delivery-versus-payment basis.
Trading assets, Financial assets designated at fair value, Financial investments	Debt securities, treasury and other eligible bills consist of government, bank or other financial institution issued securities for which either government guarantees are held or no collateral is held.
Other assets	Generally no collateral or other credit enhancements held.
Loans and advances to customers, Financial guarantees and similar contracts, Loan commitment and other credit related commitments	Depending on the customer's standing and the type of products, facilities may be secured or unsecured. The general types of collaterals and other credit enhancements are highlighted in page 180.

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality

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

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

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

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

Quality classification definitions:

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

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

– Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail accounts show longer delinquency periods of up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate through security realisation or other recovery processes.

– Impaired: Exposures have been assessed, individually or collectively, as impaired. The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ("Expected loss") grade, whereby in the higher quality grades the grading assignment will reflect the offsetting impact by credit risk mitigation in one form or another.

The Group's policy in respect of impairment on loans and advances and debt securities is set out in note 4 on the financial statements. Analysis of impairment allowances as at 31 December 2012 and the movement of such allowances during the year are disclosed in note 35.

Granular risk rating scales:

The CRR ("Customer Risk Rating") 10-grade scale maps to a more granular underlying 23-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

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

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

Distribution of financial instruments by credit quality

	Group						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2012							
Items in the course of collection from other banks	5,418	224	–	–	–	–	5,642
Trading assets:							
– treasury and eligible bills	26,808	–	–	–	–	–	26,808
– debt securities	6,161	345	–	–	–	–	6,506
– loans and advances to banks	1,045	–	–	–	–	–	1,045
– loans and advances to customers	10	–	–	–	–	–	10
	34,024	345	–	–	–	–	34,369
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	3,905	142	–	–	–	–	4,047
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	3,905	142	–	–	–	–	4,047
Derivatives	4,604	539	36	–	–	–	5,179
Loans and advances held at amortised cost:							
– balances/placings with and advances to banks	142,365	14,058	–	–	–	–	156,423
– loans and advances to customers	312,427	218,657	2,031	3,116	1,340	(1,409)	536,162
	454,792	232,715	2,031	3,116	1,340	(1,409)	692,585
Financial investments:							
– treasury and similar bills	98,262	–	–	–	–	–	98,262
– debt securities	146,159	8,653	–	–	–	–	154,812
	244,421	8,653	–	–	–	–	253,074
Other assets:							
– acceptances and endorsements	1,120	4,143	1	–	–	–	5,264
– other	2,187	2,309	4	23	–	–	4,523
	3,307	6,452	5	23	–	–	9,787

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Group						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2011							
Items in the course of collection from other banks	4,319	194	–	–	–	–	4,513
Trading assets:							
– treasury and eligible bills	54,220	–	–	–	–	–	54,220
– debt securities	9,418	20	–	–	–	–	9,438
– loans and advances to banks	–	501	–	–	–	–	501
– loans and advances to customers	5	–	–	–	–	–	5
	63,643	521	–	–	–	–	64,164
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	3,962	37	–	–	–	–	3,999
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	3,962	37	–	–	–	–	3,999
Derivatives	3,094	1,555	61	–	–	–	4,710
Loans and advances held at amortised cost:							
– balances/placings with and advances to banks	124,140	13,644	–	–	–	–	137,784
– loans and advances to customers	280,312	194,278	2,842	3,225	1,584	(1,667)	480,574
	404,452	207,922	2,842	3,225	1,584	(1,667)	618,358
Financial investments:							
– treasury and similar bills	43,296	–	–	–	–	–	43,296
– debt securities	157,242	8,393	–	–	–	–	165,635
	200,538	8,393	–	–	–	–	208,931
Other assets:							
– acceptances and endorsements	1,512	2,988	197	–	–	–	4,697
– other	2,168	2,016	6	42	–	–	4,232
	3,680	5,004	203	42	–	–	8,929

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

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

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2011							
Items in the course of collection from other banks	4,319	194	–	–	–	–	4,513
Trading assets:							
– treasury and eligible bills	54,220	–	–	–	–	–	54,220
– debt securities	5,773	20	–	–	–	–	5,793
– loans and advances to banks	–	501	–	–	–	–	501
– loans and advances to customers	5	–	–	–	–	–	5
	59,998	521	–	–	–	–	60,519
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	140	–	–	–	–	–	140
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	140	–	–	–	–	–	140
Derivatives	2,978	1,420	38	–	–	–	4,436
Loans and advances held at amortised cost:							
– balances/placings with and advances to banks	68,279	6,673	–	–	–	–	74,952
– loans and advances to customers	257,965	163,570	1,577	2,522	1,404	(1,409)	425,629
	326,244	170,243	1,577	2,522	1,404	(1,409)	500,581
Financial investments:							
– treasury and similar bills	43,296	–	–	–	–	–	43,296
– debt securities	59,860	1,924	–	–	–	–	61,784
	103,156	1,924	–	–	–	–	105,080
Other assets:							
– acceptances and endorsements	867	2,157	28	–	–	–	3,052
– other	674	823	2	2	–	–	1,501
	1,541	2,980	30	2	–	–	4,553

* Includes HK$5,233 million (2011: HK$5,198 million) and HK$615 million (2011: HK$780 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2012, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

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

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

	Group					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2012						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,663	353	96	4	–	3,116
	2,663	353	96	4	–	3,116
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	14	4	3	2	–	23
	14	4	3	2	–	23

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Group					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2011						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,768	394	63	–	–	3,225
	2,768	394	63	–	–	3,225
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	27	8	3	2	2	42
	27	8	3	2	2	42

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2012						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,182	248	77	4	–	2,511
	2,182	248	77	4	–	2,511
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	1	–	–	–	–	1
	1	–	–	–	–	1

62. Financial risk management continued

(a) Credit risk continued

(iii) Credit quality continued

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2011						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– balances/placings with and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,219	256	47	–	–	2,522
	2,219	256	47	–	–	2,522
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	1	1	–	–	–	2
	1	1	–	–	–	2

The majority of the loans and advances to customers that are operating within revised terms following restructuring are excluded from this table.

Impaired loans and advances

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

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

Analysis of impairment allowances at 31 December 2012 and the movement of such allowances during the year are disclosed in note 35.

62. Financial risk management continued

(a) Credit risk continued

(iv) Collateral and other credit enhancements obtained

The Group obtained assets by taking possession of collateral held as security, or calling other credit enhancement.

The carrying amount outstanding as at the year end was as follows:

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

(b) Liquidity risk

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

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

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

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

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

62. Financial risk management continued

(b) Liquidity risk continued

Primary sources of funding

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

The management of funding and liquidity risk

Inherent liquidity risk categorisation

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

Core deposits

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

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

– price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;

– size: depositors with total balances above certain monetary thresholds, the excess balances are classified as non-core. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and

– line of business: the element of any deposit remaining after the application of the price and size filter is assessed on the basis of the line of business to which the deposit is associated. The proportion of any customer deposit that can be considered as core under this filter is between 35% and 90%.

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

Advances to core funding ratio

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

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

62. Financial risk management continued

(b) Liquidity risk continued

Stressed coverage ratio

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

The stressed cash inflows include:

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

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

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

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

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

Liquidity behaviouralisation

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

Contingent liquidity risk

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

62. Financial risk management continued

(b) Liquidity risk continued

Contingency funding plan

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

Liquidity ratio under the Hong Kong Banking Ordinance

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

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

Basel III update

The Basel Committee on Banking Supervision has issued the final rules in two documents "A global regulatory framework for more resilient banks and banking systems" and "International framework for liquidity risk measurement, standards and monitoring" in December 2010, widely referred to as Basel III rules, on the areas of capital and liquidity. The Hong Kong Monetary Authority has then issued a consultation paper in January 2012 on the implementation of Basel III Liquidity Standards in Hong Kong. Under the consultation paper, a new minimum standard, the Liquidity Coverage Ratio, will be developed to promote the short-term resilience of banks to potential liquidity disruptions. A Net Stable Funding Ratio will also be introduced to promote the longer term resilience of banks. These will be phased in 2015 and 2018 respectively after the observation periods.

62. Financial risk management continued

(b) Liquidity risk continued

The below tables are an analysis of undiscounted cash flows on the Group's financial liabilities including future interest payments on the basis of their earliest possible contractual maturity.

The balances in the below table will not agree with the balances in the balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and all future coupon payments (except for trading liabilities and trading derivatives). Also, loans commitments are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the "On demand" time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loans commitments expire without being drawn upon. The undiscounted cash flows potentially payable under loan commitments and financial guarantee are classified on the basis of the earliest date they can be called.

	Group					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2012						
Current, savings and other deposit accounts	**567,310**	**168,224**	**34,416**	**937**	**–**	**770,887**
Deposits from banks	**3,369**	**16,501**	**3**	**–**	**–**	**19,873**
Financial liabilities designated at fair value	**1**	**–**	**–**	**–**	**463**	**464**
Trading liabilities	**59,853**	**–**	**–**	**–**	**–**	**59,853**
Derivative financial instruments	**2,763**	**122**	**232**	**965**	**50**	**4,132**
Certificates of deposit and other debt securities in issue	**–**	**34**	**7,404**	**3,952**	**–**	**11,390**
Other financial liabilities	**7,634**	**6,699**	**3,171**	**40**	**18**	**17,562**
Subordinated liabilities	**–**	**128**	**234**	**1,250**	**12,968**	**14,580**
	640,930	**191,708**	**45,460**	**7,144**	**13,499**	**898,741**
Commitments	**263,867**	**35,272**	**143**	**5**	**–**	**299,287**
Financial guarantee contracts	**12,481**	**64**	**–**	**–**	**–**	**12,545**
	276,348	**35,336**	**143**	**5**	**–**	**311,832**
At 31 December 2011						
Current, savings and other deposit accounts	503,663	163,776	33,036	1,119	–	701,594
Deposits from banks	2,072	11,320	618	–	–	14,010
Financial liabilities designated at fair value	1	–	–	–	433	434
Trading liabilities	59,712	–	–	–	–	59,712
Derivative financial instruments	3,508	156	320	904	79	4,967
Certificates of deposit and other debt securities in issue	–	1,633	1,535	6,280	–	9,448
Other financial liabilities	6,319	7,071	1,800	62	19	15,271
Subordinated liabilities	–	94	2,511	939	10,497	14,041
	575,275	184,050	39,820	9,304	11,028	819,477
Commitments	240,159	42,488	1,823	982	–	285,452
Financial guarantee contracts	6,531	51	1	–	–	6,583
	246,690	42,539	1,824	982	–	292,035

62. Financial risk management continued

(b) Liquidity risk continued

	Bank					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2012						
Current, savings and other deposit accounts	**553,445**	**157,362**	**20,079**	**188**	**–**	**731,074**
Deposits from banks	**3,289**	**10,686**	**3**	**–**	**–**	**13,978**
Financial liabilities designated at fair value	**–**	**–**	**–**	**–**	**–**	**–**
Trading liabilities	**27,776**	**–**	**–**	**–**	**–**	**27,776**
Derivative financial instruments	**2,807**	**87**	**149**	**446**	**50**	**3,539**
Certificates of deposit and other debt securities in issue	**–**	**34**	**7,404**	**3,952**	**–**	**11,390**
Amounts due to subsidiaries	**5,441**	**9,840**	**–**	**–**	**–**	**15,281**
Other financial liabilities	**7,327**	**5,461**	**1,289**	**40**	**19**	**14,136**
Subordinated liabilities	**–**	**128**	**234**	**1,250**	**12,968**	**14,580**
	600,085	**183,598**	**29,158**	**5,876**	**13,037**	**831,754**
Commitments	**228,488**	**35,243**	**143**	**5**	**–**	**263,879**
Financial guarantee contracts	**10,415**	**64**	**–**	**–**	**–**	**10,479**
	238,903	**35,307**	**143**	**5**	**–**	**274,358**
At 31 December 2011						
Current, savings and other deposit accounts	489,952	151,649	19,671	500	–	661,772
Deposits from banks	2,065	9,311	618	–	–	11,994
Financial liabilities designated at fair value	–	–	–	–	–	–
Trading liabilities	36,077	–	–	–	–	36,077
Derivative financial instruments	3,319	102	177	488	79	4,165
Certificates of deposit and other debt securities in issue	–	1,633	1,535	6,280	–	9,448
Amounts due to subsidiaries	6,143	4,651	3	–	–	10,797
Other financial liabilities	5,917	5,890	971	8	19	12,805
Subordinated liabilities	–	94	2,511	939	10,497	14,041
	543,473	173,330	25,486	8,215	10,595	761,099
Commitments	216,941	29,772	79	1	–	246,793
Financial guarantee contracts	4,831	51	1	–	–	4,883
	221,772	29,823	80	1	–	251,676

(c) Market risk

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

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

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

62. Financial risk management continued

(c) Market risk continued

Value at risk ("VAR")

One of the principal tools used by the Group to monitor and limit market risk exposure is VAR.

VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence. Historical simulation uses scenarios derived from historical market rates and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The assumed holding period is a 1-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

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

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

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

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

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

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

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

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

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

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

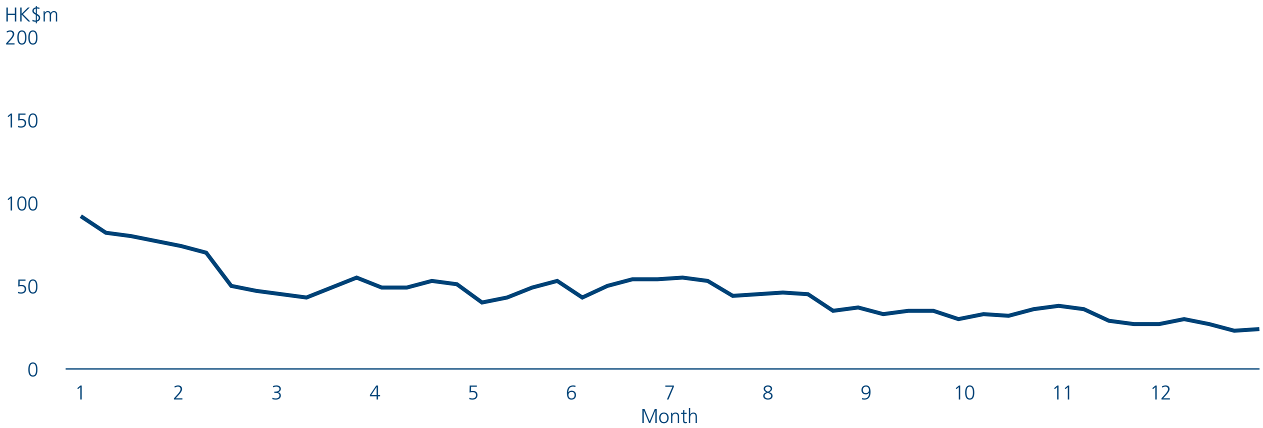
* Stressed VAR reporting is effective since 2012.

62. Financial risk management continued

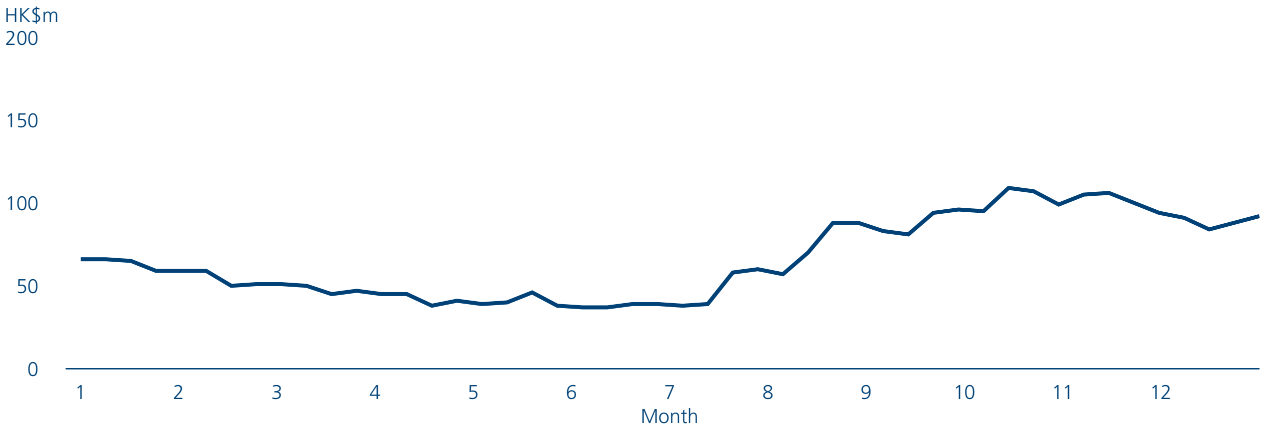
(c) Market risk continued

	At 31 December 2011	Minimum during the year	Maximum during the year	Average for the year
Total VAR	91	37	110	66
Total trading VAR	10	5	18	10
VAR for foreign exchange risk (trading)	5	2	9	6
VAR for interest rate risk:				
– trading	10	3	16	8
– non-trading	27	15	30	21

Total Value at Risk for 2012



Total Value at Risk for 2011



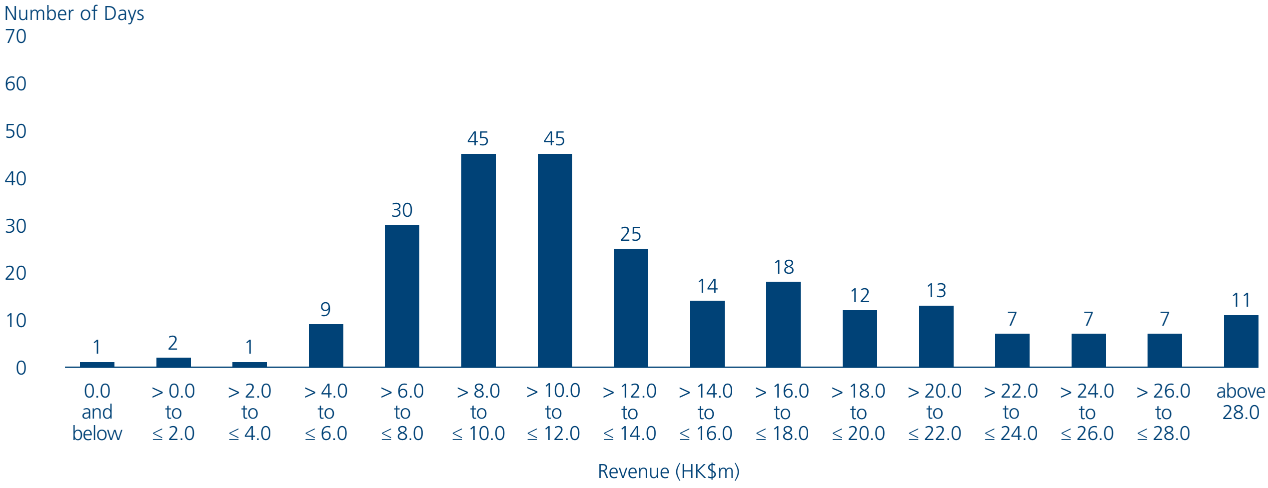
62. Financial risk management continued

(c) Market risk continued

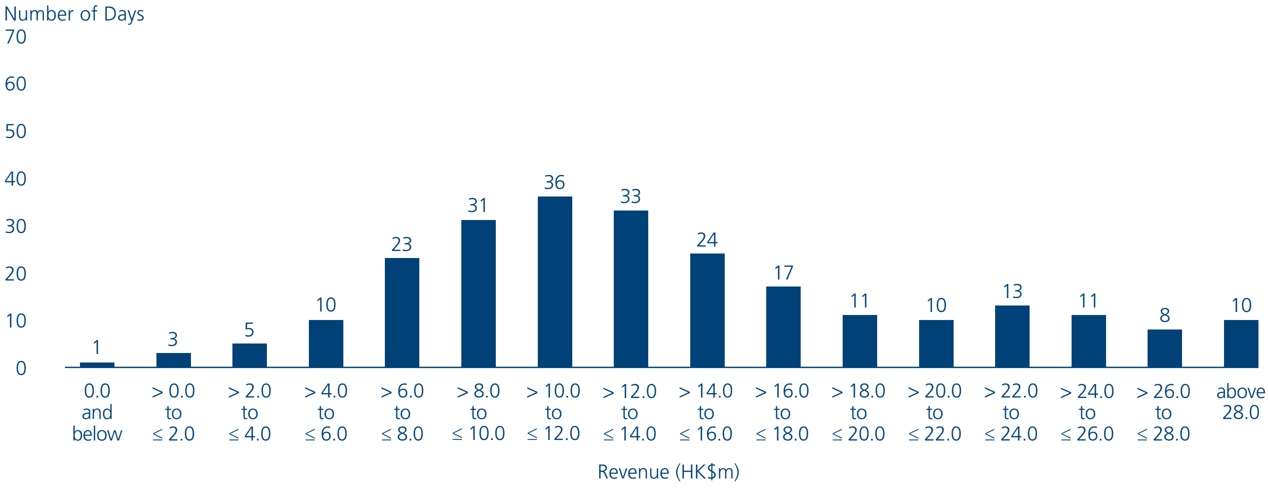
The average daily revenue earned from market risk-related treasury activities in 2012, including non-trading book net interest income and funding related to trading positions, was HK$14 million (2011: HK$14 million). The standard deviation of these daily revenues was HK$8 million, compared with HK$7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

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

Daily Distribution of Market Risk Revenues for 2012



Daily Distribution of Market Risk Revenues for 2011



62. Financial risk management continued

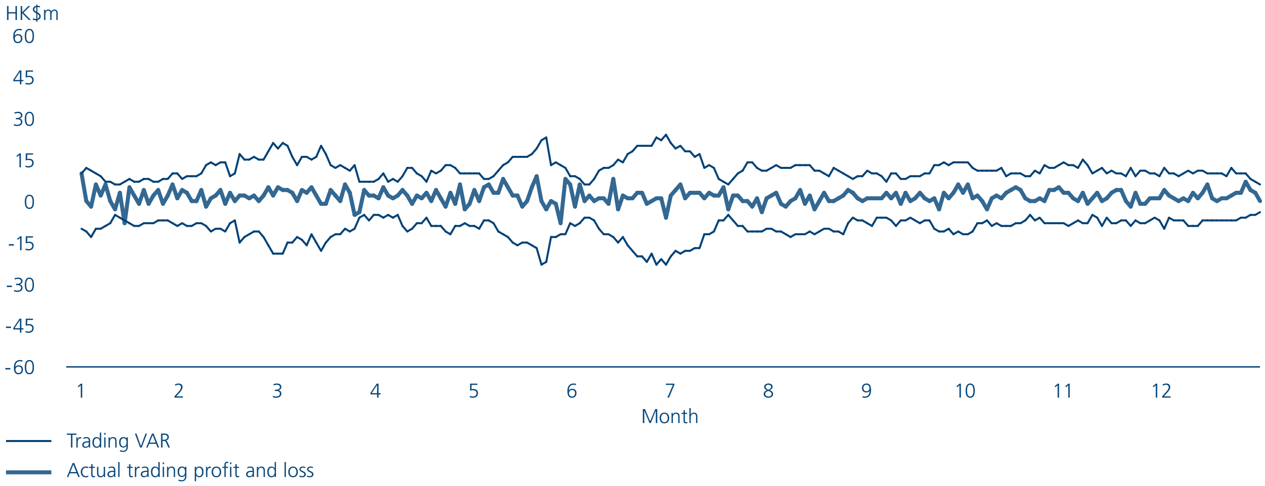
(c) Market risk continued

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

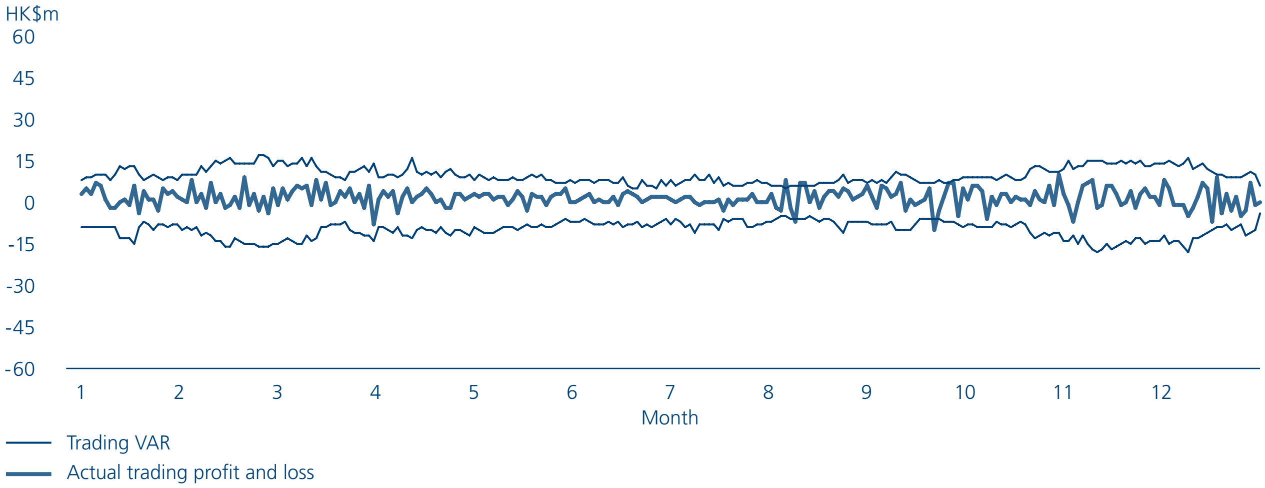
The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

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

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



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



62. Financial risk management continued

(c) Market risk continued

Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios which include structural interest rate exposures. Treasury manages interest rate risks within the limits approved by the Risk Management Committee and under the monitoring of both ALCO and Risk Management Committee.

Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point ("PVBP") limits and option limits, and a list of permissible instruments authorised by the Risk Management Committee, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Structural interest rate risk arises from the different repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts.

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

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

Net interest income

A principal part of the Group's management of interest rate risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

The table below sets out the impact on future net interest income of a 100 basis points parallel fall or rise in all-in yield curves at the beginning of year from 1 January 2013 and 25 basis points parallel fall or rise in all-in yield curves at the beginning of each quarter during the 12 month period from 1 January 2013.

Assuming no management actions, such a series of incremental parallel rises in all-in yield curves would increase planned net interest income for the year ending 31 December 2013 by HK$1,882 million for 100 basis points case and by HK$1,378 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK$1,726 million for 100 basis points case and by HK$1,447 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and take into account the change in pricing of retail products relative to change in market interest rates.

62. Financial risk management continued

(c) Market risk continued

Projected Net Interest Income

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

	100bp parallel increase	100bp parallel decrease	25bp increase at the beginning of each quarter	25bp decrease at the beginning of each quarter
Change in 2013 projected net interest income				
– HKD	**1,491**	**(1,190)**	**1,027**	**(1,050)**
– US$	**274**	**(310)**	**224**	**(252)**
– other	**117**	**(226)**	**127**	**(145)**
Total	**1,882**	**(1,726)**	**1,378**	**(1,447)**
Change in 2012 projected net interest income				
– HKD	867	(1,466)	646	(1,216)
– US$	426	(386)	272	(271)
– other	184	(197)	54	(20)
Total	1,477	(2,049)	972	(1,507)

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. The figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Group's current interest rate risk profile. This effect, however, does not incorporate actions that would be taken by Treasury or in the business units to mitigate the impact of this interest rate risk. In reality, Treasury seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections also make other simplifying assumptions, including that all positions run to maturity.

It can be seen from the above that projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. In a rising rate environment, the most critical exposures are those managed within Treasury.

62. Financial risk management continued

(c) Market risk continued

Sensitivity of reserves

The Group monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all-in yield curves. The table below describes the sensitivity to these movements at the balance sheet dates indicated below and the maximum and minimum month figures during the year then ended:

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

	At 31 December 2011	Maximum impact	Minimum impact
+ 100 basis points parallel move in all-in yield curves	(973)	(1,047)	(827)
As a percentage of shareholders' funds at 31 December 2011 (%)	(1.2)	(1.3)	(1.0)
– 100 basis points parallel move in all-in yield curves	256	292	246
As a percentage of shareholders' funds at 31 December 2011 (%)	0.3	0.4	0.3

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

Foreign exchange exposure

The Group's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the Risk Management Committee. Net option position is calculated on the basis of delta-weighted positions of all foreign exchange options contract. Structural foreign exchange positions arising from capital investments in associate, subsidiaries and branches outside Hong Kong, mainly in US dollar and Chinese renminbi, are managed by ALCO. The details of net structural and non-structural foreign currency positions of the Group are set out in supplementary note 15.

Equities exposure

The Group's equities exposures in 2012 and 2011 are mainly long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

62. Financial risk management continued

(d) Insurance risk

Risk management objectives and policies for management of insurance risk

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

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

The Group manages its insurance risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues, taking into account where appropriate local market conditions and regulatory requirements apply.

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

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

Asset/liability management

The Group actively manages its assets using an approach that considers asset quality, risk profile, diversification, asset/liability matching, liquidity and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Market and Liquidity Risk Committee of the Group's insurance subsidiaries reviews and approves the investment policy including asset allocation, investment guidelines and limits on a periodic basis, while Asset and Liability Management Committee provides oversight of the asset/liability management process.

The Group establishes the investment policy for each major insurance product category according to specific product requirements and local regulatory requirement. The investment policy defines the asset allocations and restrictions with an aim to achieve the target investment return in the long term. The estimates and assumptions used in determining the approximate amounts and timing of payments to or on behalf of policyholders for insurance liabilities are regularly re-evaluated. Many of these estimates and assumptions are inherently subjective and could impact the Group's ability to achieve its asset/liability management goals and objectives.

62. Financial risk management continued

(d) Insurance risk continued

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

Balance sheet of insurance subsidiaries by type of contract

	Life linked contracts[1]	Life non-linked contracts[2]	Non-life insurance[3]	Other assets[4]	Total[5]
2012					
Financial assets:					
– financial assets designated at fair value	**224**	**8,119**	**–**	**–**	**8,343**
– derivatives	**–**	**171**	**–**	**–**	**171**
– financial investments	**–**	**64,297**	**–**	**3,350**	**67,647**
– other financial assets	**11**	**7,878**	**49**	**2,105**	**10,043**
Total financial assets	**235**	**80,465**	**49**	**5,455**	**86,204**
Reinsurance assets	**–**	**414**	**–**	**16**	**430**
Present value of in-force long-term insurance contracts	**–**	**–**	**–**	**6,003**	**6,003**
Other assets	**–**	**889**	**–**	**2,333**	**3,222**
Total assets	**235**	**81,768**	**49**	**13,807**	**95,859**
Liabilities under investment contracts designated at fair value	**141**	**323**	**–**	**–**	**464**
Liabilities under insurance contracts	**91**	**81,579**	**–**	**–**	**81,670**
Deferred tax	**–**	**–**	**–**	**991**	**991**
Other liabilities	**–**	**–**	**–**	**627**	**627**
Total liabilities	**232**	**81,902**	**–**	**1,618**	**83,752**
Shareholders' equity	**–**	**–**	**–**	**12,107**	**12,107**
Total liabilities and shareholders' equity	**232**	**81,902**	**–**	**13,725**	**95,859**
2011					
Financial assets:					
– financial assets designated at fair value	192	7,764	–	–	7,956
– derivatives	–	94	–	–	94
– financial investments	–	56,714	–	3,831	60,545
– other financial assets	114	5,919	459	1,039	7,531
Total financial assets	306	70,491	459	4,870	76,126
Reinsurance assets	–	42	113	14	169
Present value of in-force long-term insurance contracts	–	–	–	5,188	5,188
Other assets	–	783	12	2,104	2,899
Total assets	306	71,316	584	12,176	84,382
Liabilities under investment contracts designated at fair value	120	314	–	–	434
Liabilities under insurance contracts	183	71,523	519	–	72,225
Deferred tax	–	–	–	856	856
Other liabilities	–	–	21	145	166
Total liabilities	303	71,837	540	1,001	73,681
Shareholders' equity	–	–	–	10,701	10,701
Total liabilities and shareholders' equity	303	71,837	540	11,702	84,382

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

62. Financial risk management continued

(d) Insurance risk continued

Underwriting strategy

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

Reinsurance strategy

The Group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. These reinsurance agreements transfer part of the risk and limit the exposure from each life insured. The amount of each risk retained depends on the Group's evaluation of the specific risk, subject in certain circumstances, to maximum limits based on characteristics of coverage. Under the terms of the reinsurance agreements, the reinsurer agrees to reimburse the ceded amount in the event the claim is paid. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum-at-risk so that it falls within specified insurance risk appetite. The Group also utilises reinsurance to manage the risk arising from guaranteeing minimum investment performance under a non-linked traditional non-participating insurance product. In addtion, the Group uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes. However, the Group remains liable to its policyholders with respect to ceded insurance if any reinsurer fails to meet the obligations it assumes.

Nature of risks covered

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

(i) Long-term insurance contracts – non-linked products

The basic feature of long-term non-linked insurance business is to provide guaranteed death benefit determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender and maturity benefit are usually provided. Most of the Group's non-linked products include a discretionary participating feature which allows policyholders to participate in the profits of the life fund. These plans offer a discretionary annual bonus in the form of dividend payable to the policyholders on each policy anniversary date.

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

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

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

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

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

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

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

62. Financial risk management continued

(d) Insurance risk continued

(ii) Long-term insurance contracts – linked products

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

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

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

(iii) Long-term investment contracts – non-linked products

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

(iv) Long-term investment contracts – linked products

The Group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions. The accumulated fund balance will be payable to scheme members upon retirement or termination of employment. Although scheme members bear the market risk on the funds, the Group assumes reputational risk for any undue market risk taken by the scheme members. Consequently, it is in the Group interest to ensure that the scheme members' exposure to market risk is consistent with any market risk information that the Company has communicated to the scheme members.

(v) Non-life insurance contracts

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

Concentration of insurance risks

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

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

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

62. Financial risk management continued

(d) Insurance risk continued

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

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

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

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

Financial risks

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

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

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

62. Financial risk management continued

(d) Insurance risk continued

Financial assets held by insurance operations

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

	Group				
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2011					
Financial assets designated at fair value:					
– debt securities	–	3,859	–	–	3,859
– equity securities	192	3,905	–	–	4,097
	192	7,764	–	–	7,956
Financial investments					
Held-to-maturity:					
– debt securities	–	56,714	–	3,197	59,911
	–	56,714	–	3,197	59,911
Available-for-sale:					
– debt securities	–	–	–	619	619
– equity securities	–	–	–	15	15
	–	–	–	634	634
Derivatives	–	94	–	–	94
Other financial assets	114	5,919	459	1,039	7,531
	306	70,491	459	4,870	76,126

The table demonstrates that for linked contracts, the Group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 0.3% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2012 (2011: 0.4%). The table also shows that approximately 83.1% of financial assets was invested in debt securities at 31 December 2012 (2011: 84.6%) and 5.0% (2011: 5.4%) invested in equity securities.

62. Financial risk management continued

(d) Insurance risk continued

Market risk

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

Interest rate risk

The insurance subsidiaries of the Group's exposure to interest rate risk because there is a chance that the yields earned on its debt securities holding are lower than the investment returns implied by the guarantees payable to policyholders. The held-to-maturity debt securities account for a significant portion of the debt securities holding which is managed to match expected liability payments. The Group monitors this exposure through periodic reviews of its asset and liability positions. Estimates of cash flows, as well as the impact of interest rate fluctuations relating to the investment portfolio and insurance reserves, are modelled and reviewed regularly. The overall objective of these strategies is to limit the net changes in the value of assets and liabilities arising from interest rate movements.

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

An immediate and permanent movement in interest yield curves as at 31 December 2012 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the aggregated profit after taxation for the year and shareholders' equity at that date:

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

The interest rate sensitivities set out above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The effects are calculated taking into account the sharing of investment returns with policyholders through the discretionary participating feature. Other than that, they do not incorporate other actions that could be taken by management to mitigate the effect of the interest rate movements, nor do they take into account any resultant changes in policyholder behaviour.

62. Financial risk management continued

(d) Insurance risk continued

Equity price risk

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

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

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

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The impact is estimated taking into account the sharing of risk through the discretionary participation feature (2011: without sharing of risk).

Foreign currency risk

The assets and liabilities are mainly denominated in United States dollar ("USD") and Hong Kong dollar ("HKD"). The Group adopts a policy of predominately matching the assets with liabilities in the same currency, effectively reducing the foreign currency exchange rate exposure. Limits are set to ensure that the net foreign currency exposure is kept to an acceptable level. The Group uses foreign exchange forward contracts to manage its foreign currency risk. Most of the foreign exchange forward contracts have maturities of less than one year after the balance sheet date.

Credit risk

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

62. Financial risk management continued

(d) Insurance risk continued

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

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

62. Financial risk management continued

(d) Insurance risk continued

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2011							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,822	37	–	–	–	–	3,859
	3,822	37	–	–	–	–	3,859
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	52,082	4,632	–	–	–	–	56,714
	52,082	4,632	–	–	–	–	56,714
Supporting shareholders funds							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–	–
	–	–	–	–	–	–	–
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	3,632	184	–	–	–	–	3,816
	3,632	184	–	–	–	–	3,816
Total							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,822	37	–	–	–	–	3,859
	3,822	37	–	–	–	–	3,859
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	55,714	4,816	–	–	–	–	60,530
	55,714	4,816	–	–	–	–	60,530

62. Financial risk management continued

(d) Insurance risk continued

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

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2012							
Linked insurance contracts	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Non-linked insurance contracts	**414**	**–**	**–**	**–**	**–**	**–**	**414**
Total	**414**	**–**	**–**	**–**	**–**	**–**	**414**
Reinsurance Debtors	**4**	**–**	**–**	**12**	**–**	**–**	**16**
2011							
Linked insurance contracts	–	–	–	–	–	–	–
Non-linked insurance contracts	110	45	–	–	–	–	155
Total	110	45	–	–	–	–	155
Reinsurance Debtors	7	1	–	6	–	–	14

Liquidity risk

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

The following table shows the expected maturity of insurance contract liabilities at balance sheet dates:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year	Over 1 year but within 5 years	Over 5 years but within 15 years	Over 15 years	Total
2012					
Non-life insurance	**–**	**–**	**–**	**–**	**–**
Life insurance (non-linked)	**15,414**	**34,173**	**68,544**	**46,688**	**164,819**
Life insurance (linked)	**12**	**49**	**132**	**853**	**1,046**
	15,426	**34,222**	**68,676**	**47,541**	**165,865**
2011					
Non-life insurance	291	206	43	–	540
Life insurance (non-linked)	3,592	33,943	67,507	42,430	147,472
Life insurance (linked)	112	50	126	833	1,121
	3,995	34,199	67,676	43,263	149,133

62. Financial risk management continued

(d) Insurance risk continued

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			
	Linked investment contracts	Non-linked investment contracts	Investment contracts with DPF	Total
2012				
Remaining contractual maturity:				
– due within 1 year	**1**	**–**	**–**	**1**
– due over 1 year but within 5 years	**–**	**–**	**–**	**–**
– due over 5 years but within 10 years	**–**	**–**	**–**	**–**
– due over 10 years	**–**	**–**	**–**	**–**
– undated	**140**	**323**	**–**	**463**
	141	**323**	**–**	**464**
2011				
Remaining contractual maturity:				
– due within 1 year	1	–	–	1
– due over 1 year but within 5 years	–	–	–	–
– due over 5 years but within 10 years	–	–	–	–
– due over 10 years	–	–	–	–
– undated	119	314	–	433
	120	314	–	434

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

The Group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2012 was HK$6,003 million (31 December 2011: HK$5,188 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at balance sheet dates can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF at balance sheet date of reasonably possible changes in the main economic and business assumptions:

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

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

62. Financial risk management continued

(d) Insurance risk continued

Non-economic assumptions

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

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

Process used to determine assumptions for long-term insurance contracts

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

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

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

62. Financial risk management continued

(d) Insurance risk continued

Assumptions

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

(i) Mortality

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

(ii) Morbidity

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

(iii) Discount rates

Rate of interest

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

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

Sensitivity to changes in variables

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

Impact on reported profit to changes in key variable

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

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

62. Financial risk management continued

(e) Operational risk

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

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

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

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

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

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

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

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

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

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

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

(f) Capital management

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

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

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

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

62. Financial risk management continued

(f) Capital management continued

Externally imposed capital requirements:

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

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

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

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

For credit risk, with the Hong Kong Monetary Authority approval, the Group has adopted the advanced IRB approach for the majority of its non-securitisation business with effect from 1 January 2009, with the remainder on standardised approach.

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

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

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

62. Financial risk management continued

(f) Capital management continued

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

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

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

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

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

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

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

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

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

63 Fair value of financial instruments

(a) Determination of fair value

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

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

Control framework

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

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of valuation models, independent determination or validation of valuation model inputs and any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, there is independent price determination or validation.

Determination of fair value of financial instruments carried at fair value

Fair values are determined according to the following hierarchy:

(i) Level 1: Quoted market price
Financial instruments with quoted prices for identical instruments in active markets.

(ii) Level 2: Valuation technique using observable inputs
Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(iii) Level 3: Valuation technique with significant non-observable inputs
Financial instruments valued using models where one or more significant inputs are not observable.

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

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

In certain circumstances, the Group applies the fair value option to its own debt in issue. Where available, the fair value will be based upon quoted prices in an active market for the specific instrument concerned. Where unavailable, the fair value will either be based upon quoted prices in an inactive market for the specific instrument concerned, or estimated by comparison with quoted prices in an active market for similar instruments. The fair value of these instruments therefore includes the effect of own credit spread.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are marked at fair value. The credit spread applied to these instruments is derived from the spreads at which the Group issues structured notes. Gains and losses arising from changes in the credit spread of liabilities issued by the Group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

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

63. Fair value of financial instruments continued

(a) Determination of fair value continued

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

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

Examples of such adjustments are:

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

– Market data/model uncertainty: an adjustment to reflect uncertainties in fair values based on uncertain market data inputs (e.g. as a result of illiquidity) or in areas where the choice of valuation model is particularly subjective.

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

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

– Debt securities, Treasury and eligible bills, and Equities

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

– Structured notes

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

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

– Derivatives

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

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

63. Fair value of financial instruments continued

(a) Determination of fair value continued

Analysis of fair value determination

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

	Group					
	Valuation techniques					
	quoted market price Level 1	using observable inputs Level 2	with significant non-observable inputs Level 3	Third party total	Amounts with HSBC entities*	Total
2012						
Assets						
Trading assets	**30,930**	**3,469**	**–**	**34,399**	**–**	**34,399**
Financial assets designated at fair value	**2,545**	**1,874**	**478**	**4,897**	**3,446**	**8,343**
Derivative financial instruments	**325**	**4,278**	**161**	**4,764**	**415**	**5,179**
Available-for-sale financial investments	**112,245**	**73,308**	**224**	**185,777**	**–**	**185,777**
Liabilities						
Trading liabilities	**21,492**	**38,226**	**135**	**59,853**	**–**	**59,853**
Financial liabilities designated at fair value	**–**	**464**	**–**	**464**	**–**	**464**
Derivative financial instruments	**63**	**3,398**	**–**	**3,461**	**657**	**4,118**
2011						
Assets						
Trading assets	59,866	4,305	–	64,171	–	64,171
Financial assets designated at fair value	758	3,165	634	4,557	3,539	8,096
Derivative financial instruments	541	3,814	71	4,426	284	4,710
Available-for-sale financial investments	59,411	89,718	150	149,279	–	149,279
Liabilities						
Trading liabilities	25,605	33,584	523	59,712	–	59,712
Financial liabilities designated at fair value	–	434	–	434	–	434
Derivative financial instruments	48	4,153	–	4,201	647	4,848

* Included structured instruments and derivative contracts transacted with HSBC entities which were mainly classified within level 2 of the valuation hierarchy.

There were no material movements between Level 1 and Level 2 during the year.

63. Fair value of financial instruments *continued*

(a) Determination of fair value *continued*

	Bank					
	Valuation techniques					
	quoted market price Level 1	using observable inputs Level 2	with significant non-observable inputs Level 3	Third party total	Amounts with HSBC entities*	Total
2012						
Assets						
Trading assets	**30,930**	**705**	**–**	**31,635**	**–**	**31,635**
Financial assets designated at fair value	**–**	**–**	**–**	**–**	**–**	**–**
Derivative financial instruments	**320**	**3,891**	**–**	**4,211**	**423**	**4,634**
Available-for-sale financial investments	**112,179**	**33,135**	**100**	**145,414**	**–**	**145,414**
Liabilities						
Trading liabilities	**21,492**	**6,167**	**117**	**27,776**	**–**	**27,776**
Financial liabilities designated at fair value	**–**	**–**	**–**	**–**	**–**	**–**
Derivative financial instruments	**57**	**2,745**	**–**	**2,802**	**715**	**3,517**
2011						
Assets						
Trading assets	59,866	660	–	60,526	–	60,526
Financial assets designated at fair value	–	140	–	140	–	140
Derivative financial instruments	539	3,308	–	3,847	589	4,436
Available-for-sale financial investments	59,168	45,930	44	105,142	–	105,142
Liabilities						
Trading liabilities	25,605	10,051	421	36,077	–	36,077
Financial liabilities designated at fair value	–	–	–	–	–	–
Derivative financial instruments	42	3,468	–	3,510	592	4,102

* Included structured instruments and derivative contracts transacted with HSBC entities which were mainly classified within level 2 of the valuation hierarchy.

There were no material movements between Level 1 and Level 2 during the year.

63. Fair value of financial instruments continued

(a) Determination of fair value continued

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

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

63. Fair value of financial instruments continued

(a) Determination of fair value continued

	Group						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2011	283	–	510	106	553	–	–
Total gains or losses recognised in profit and loss	–	–	(1)	(154)	(5)	–	–
Total gains or losses recognised in other comprehensive income	9	–	–	–	–	–	–
Purchases	–	–	355	–	–	–	–
Issues/deposit taking	–	–	–	–	933	–	–
Sales	–	–	(63)	–	–	–	–
Settlements	–	–	(22)	119	(935)	–	–
Transfers out	(142)	–	(150)	–	(160)	–	–
Transfers in	–	–	5	–	122	–	–
Exchange adjustments	–	–	–	–	15	–	–
At 31 December 2011	150	–	634	71	523	–	–
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date	13	–	2	(154)	5	–	–

63. Fair value of financial instruments continued

(a) Determination of fair value continued

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

63. Fair value of financial instruments continued

(a) Determination of fair value continued

	Bank						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2011	36	–	–	–	284	–	–
Total gains or losses recognised in profit and loss	8	–	–	–	–	–	–
Total gains or losses recognised in other comprehensive income	–	–	–	–	–	–	–
Purchases	–	–	–	–	–	–	–
Issues/deposit taking	–	–	–	–	721	–	–
Sales	–	–	–	–	–	–	–
Settlements	–	–	–	–	(584)	–	–
Transfers out	–	–	–	–	–	–	–
Transfers in	–	–	–	–	–	–	–
Exchange adjustments	–	–	–	–	–	–	–
At 31 December 2011	44	–	–	–	421	–	–
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date	6	–	–	–	–	–	–

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

For held-for-trading liabilities, transfers out of Level 3 were primarily due to change in observability of equity correlation during the year.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under "Trading income".

Fair value changes on assets designated at fair value are presented in the income statement under "Net income/(loss) from financial instruments designated at fair value".

Realised gains and losses from available-for-sale securities are presented under "Gains less losses from financial investments and fixed assets" in the income statement while unrealised gains and losses are presented in "Fair value changes taken to/(from) equity" within "Available-for-sale investment reserve" in other comprehensive income.

63. Fair value of financial instruments continued

(a) Determination of fair value continued

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

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

	Group			
	Reflected in income statement		Reflected in other comprehensive income	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
2012				
Derivatives/trading assets/trading liabilities	**3**	**(3)**	**–**	**–**
Financial assets/liabilities designated at fair value	**48**	**(48)**	**–**	**–**
Available-for-sale financial investments	**–**	**–**	**22**	**(22)**
2011				
Derivatives/trading assets/trading liabilities	8	(8)	–	–
Financial assets/liabilities designated at fair value	63	(63)	–	–
Available-for-sale financial investments	–	–	15	(15)

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

63. Fair value of financial instruments continued

(a) Determination of fair value continued

Changes in fair value recorded in the income statement

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

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

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

Fair value of financial instruments not carried at fair value

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

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

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

(i) Loans and advances to customers

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

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

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

63. Fair value of financial instruments continued

(a) Determination of fair value continued

(ii) Financial investments

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

(iii) Deposits and customer accounts

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

(iv) Debt securities in issue and subordinated liabilities

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

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

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

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

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

Assets

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

Liabilities

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

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

63. Fair value of financial instruments continued

(b) Fair value

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

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

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

64. Comparative figures

As a result of the adoption of the amendment to HKAS 12 "Income Taxes", certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2012.

65. Immediate and ultimate holding companies

The immediate and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

66. Events after the balance sheet date

Non-adjusting post balance sheet event

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

Financial implication of change in accounting treatment for Industrial Bank

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

Financial implication

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

Capital Adequacy Impact

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

67. Approval of financial statements

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

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 78 to 236, which comprise the consolidated and the Bank balance sheets as at 31 December 2012, 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 2012 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

4 March 2013

These notes set out on pages 238 to 260 are supplementary to and should be read in conjunction with the consolidated financial statements set out on pages 78 to 236. 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 2012 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 2012 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 2012. In addition, there is no relevant capital shortfall in any of the Group's subsidiaries which are not included in its consolidation group for regulatory purposes.

2. Capital adequacy continued

(a) Capital adequacy ratios continued

The capital base after deductions used in the calculation of capital adequacy ratios as at 31 December and reported to Hong Kong Monetary Authority is analysed as follows:

	2012	2011
Core capital:		
Paid-up ordinary share capital	9,559	9,559
– Reserves per balance sheet	78,940	65,563
– Unconsolidated subsidiaries	(8,872)	(7,234)
– Cash flow hedging reserve	(17)	(6)
– Regulatory reserve	(4,866)	(4,226)
– Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities	(18,936)	(15,860)
Total reserves included in core capital	46,249	38,237
– Goodwill, intangible assets and valuation adjustment	(965)	(977)
– 50% of unconsolidated investments	(13,683)	(11,304)
– 50% of securitisation positions and other deductions	(158)	(158)
Deductions	(14,806)	(12,439)
Total core capital	41,002	35,357
Supplementary capital:		
– Term subordinated debt	11,821	11,846
– Property revaluation reserves [1]	5,894	5,894
– Available-for-sale investments revaluation reserves [2]	183	117
– Regulatory reserve [3]	303	296
– Collective impairment allowances [3]	46	54
– Excess impairment allowances over expected losses [4]	1,727	1,522
Supplementary capital before deductions	19,974	19,729
– 50% of unconsolidated investments	(13,683)	(11,304)
– 50% of securitisation positions and other deductions	(158)	(158)
Deductions	(13,841)	(11,462)
Total supplementary capital	6,133	8,267
Capital base	47,135	43,624
Risk-weighted assets		
– credit risk	295,743	266,567
– market risk	2,447	2,054
– operational risk	37,827	35,649
	336,017	304,270
– Capital adequacy ratio	14.0%	14.3%
– Core capital ratio	12.2%	11.6%
Reserves and deductible items		
Published reserves	39,152	31,640
Profit and loss account	7,097	6,597
Total reserves included in core capital	46,249	38,237
Total of items deductible 50% from core capital and 50% from supplementary capital	27,682	22,924

1 Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with the Capital Rules.

2 Includes adjustments made in accordance with the Capital Rules.

3 Total regulatory reserve and collective impairment allowances are apportioned between the standardised approach and internal ratings-based approach in accordance with the 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.

2. Capital adequacy continued

(a) Capital adequacy ratios continued

The capital ratios at 31 December 2011 have not been restated as a results of the adoption of Hong Kong Accounting Standard 12 "Income Taxes". Accordingly, the amount of "reserves per balance sheet" under the core capital would not correspond with the total reserves in the Group's financial statements.

(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 Insurance Company Limited

Hang Seng Insurance (Bahamas) Limited

Hang Seng Investment Management Limited

Hang Seng Investment Services Limited

Hang Seng Life Limited

Hang Seng (Nominee) Limited

Hang Seng Securities Limited

Imenson Limited

The Group operates subsidiaries in a number of countries and territories where capital will be governed by local rules and there may be restrictions on the transfer of regulatory capital and funds between members of the banking group.

3. Credit risk capital requirements

The table below shows the capital requirements for credit risk for each class and subclass of exposures as specified in the Capital Rules.

	2012	2011
Subject to internal ratings-based approach		
Sovereign exposures	**492**	587
Bank exposures	**2,061**	1,766
Corporate exposures	**16,096**	14,020
Residential mortgages to individuals and property-holding shell companies	**626**	532
Qualifying revolving retail exposures	**1,166**	1,081
Small business retail exposures	**16**	24
Other retail exposures to individuals	**349**	309
Other exposures	**1,418**	1,405
Securitisation exposures	**–**	–
Equity exposures	**–**	–
Total capital requirements for credit risk under internal ratings-based approach	**22,224**	19,724
Subject to standardised (credit risk) approach		
On-balance sheet		
Sovereign exposures	**–**	–
Public sector entity exposures	**110**	194
Multilateral development bank exposures	**–**	–
Bank exposures	**–**	–
Securities firm exposures	**1**	–
Corporate exposures	**345**	372
Collective investment scheme exposures	**3**	3
Cash items	**–**	–
Regulatory retail exposures	**110**	88
Residential mortgage loans	**578**	524
Other exposures which are not past due exposures	**142**	154
Past due exposures	**25**	22
Total capital requirements for on-balance sheet exposures	**1,314**	1,357
Off-balance sheet		
Direct credit substitutes	**17**	172
Transaction-related contingencies	**–**	1
Trade-related contingencies	**3**	–
Forward asset purchases	**4**	3
Partly paid-up shares and securities	**–**	–
Forward forward deposits placed	**–**	–
Unconditionally cancellable commitments	**–**	–
Other commitments	**81**	54
Exchange rate contracts	**5**	6
Interest rate contracts	**1**	2
Equity contracts	**8**	5
OTC derivative transactions and credit derivative contracts subject to valid bilateral netting agreements	**2**	1
Other off-balance exposures which are not elsewhere specified	**–**	–
Total capital requirements for off-balance sheet exposures	**121**	244
Total capital requirements for credit risk under standardised (credit risk) approach	**1,435**	1,601
Total capital requirements for credit risk	**23,659**	21,325

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 central governments, government agencies, central monetary institutions and relevant international organisations.

– Bank exposures include exposures to banks and regulated securities firms.

– Retail exposures include residential mortgages, qualifying revolving retail exposures, small business retail exposures and other retail exposures to individuals.

– Other exposures mainly include notes and coins, premises, plant and equipment and other assets.

(ii) Risk rating systems and control mechanisms

The Group's exposure to credit risk arises from a wide range of customers and product types. To measure and manage the risk in these exposures, both to distinct customer types or product categories, the Group employs diverse risk rating systems and methodologies: judgmental, analytical, and hybrids of the two.

A fundamental principle of the Group's policy and approach is that analytical risk rating systems and scorecards are decision tools facilitating management, serving ultimately judgemental decisions for which individual approvers are accountable. In case of automated decision making process, accountability rests with those responsible for the parameters built into those processes/systems and the controls surrounding their use. For individually assessed customers, the credit process provides for at least annual review of the facility granted. Review may be more frequent, as required by circumstances.

The Group adopts a set of standards that govern the process through which risk rating systems are developed, judged fit for purpose, approved and implemented, the conditions under which analytical risk model outcomes can be overridden by approvers; and the process of model performance monitoring and reporting. The framework emphasises on an effective dialogue between business line and risk management, suitable independence of decision takers and a good understanding and robust challenge of senior management.

Analytical risk rating systems are not static and are subject to review and modification in light of the changing environment and the availability or quality of data. Processes are established to capture the relevant data for continuous model improvement.

4. Credit risk under the internal ratings-based approach continued

(a) The internal rating system continued

(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 sovereign, bank and corporate 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 on economic, political, financial and social conditions. For corporate, bank and sovereign exposures, obligor PD is estimated using a Customer Risk Rating (CRR) of 23 grades, of which 21 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. Credit score generated by a model and/or a scorecard for individual obligor, mapped to the corresponding Customer Risk Rating, is recommended to and reviewed by credit approver taking into account all relevant information (including external rating and market data where available) for risk rating determination. The approved CRR is mapped to a PD value range of which the "mid-point" is used in regulatory capital calculation. PD models are developed where the risk profile of corporate borrower is specific to a country or a region.

LGD and EAD estimation for wholesale business is subject to Group framework of basic principles. EAD is estimated to a 12-month horizon and broadly represents the current exposure plus an estimate for future draw down on undrawn facilities and the crystallization of contingent exposures after default. LGD focuses on the facility and collateral structure which takes into account the priority/seniority of the facility, the type and value of the collateral and past experience on the type of counterparty, which is expressed as a percentage of EAD.

The Group uses supervisory slotting criteria approach in rating its regulatory specialised lending exposure. Under this approach, rating will be assigned based on the borrower and transaction characteristics.

For retail business including residential mortgage exposures, qualifying revolving retail exposures, small business retail exposures and other retail exposures to individuals, a wide range of application and behavioural models used in the management of retail portfolios has been supplemented to develop the credit models for measuring PD, EAD and LGD under the IRB approach. The PD models typically incorporate the characteristics of the products and the borrower's account behaviour.

EAD models are developed for retail revolving exposures to predict additional drawdown at the time of default, plus current outstanding balance. For non-revolving retail exposures such as residential mortgage, EAD is mainly estimated based on current outstanding balance.

LGD models for retail exposures are developed based on the Group's internal loss and default experience including recovery values for different types of collaterals for secured retail exposures such as residential mortgage; for unsecured retail exposures such as qualifying revolving retail exposures, LGD models are developed based on past recovery experiences, account behaviours and repayment ability.

For management information and reporting purposes, retail portfolios are segmented into 10 Expected Loss ("EL") bands facilitating comparability across retail customer segment and product types. EL band is derived through a combination of PD and LGD.

(iv) Model governance

Model governance is under the Credit Risk Analytics Oversight Committee ("CRAOC"), whose responsibilities are to oversee the governance, including development, validation and monitoring of risk rating models. The CRAOC is chaired by the Chief Risk Officer and its memberships include heads of business groups and finance function.

Compliance with the Group standards for development, validation and implementation of credit risk models are subject to review by Independent Model Review Team and Internal Audit. Internal Audit also conducts regular reviews of the risk rating model application by business groups.

4. Credit risk under the internal ratings-based approach continued

(a) The internal rating system continued

(v) Use of internal ratings

While internal estimates derived from applying the IRB approach are employed in the calculation of risk-weighted exposure amounts for the purpose of determining regulatory capital requirements, they are also used in a multitude of contexts within risk management and business processes. Such uses continue to develop and become embedded as experience grows and the repository of quality data improves. They include:

– credit approval: authorities, including those for specific counterparty types and transactions, are delegated to officers and executives in the Group's credit risk function and business division involving lending activities using a risk-based approach, tiered relative to obligor customer risk rating;

– credit risk analytical tools: IRB measures are valuable tools deployed in the assessment of customer and portfolio risk; migration of customer risk rating becomes an important indicator in credit monitoring process;

– pricing: customer relationship managers apply a risk adjusted return on capital methodology in risk-weighted assets and profitability calculators;

– portfolio management: regular reports to Risk Management Committee, Audit Committee containing analyses of risk exposures employing IRB risk metrics, e.g. by customer segment and credit quality grade;

– economic capital: IRB risk measures are essential components of the credit risk economic capital model, which are evaluated in the capital adequacy assessment process of the Group;

– stress testing: IRB risk measures are stressed to understand the sensitivities of the Group's capital and business plans under adverse economic environment; and

– risk appetite: IRB risk capital and risk estimates are elements of the risk appetite and internal risk control measures of the Group.

(vi) Credit risk mitigation

The Group's approach when granting credit facilities is on the basis of capacity to repay, rather than primarily rely on credit risk mitigation. Depending on a customer's standing and the type of product, facilities may be provided on unsecured basis. Nevertheless, mitigation of credit risk is an important aspect of effective management and takes in many forms.

The Group's general policy is to promote the use of credit risk mitigation, justified by commercial prudence and good practice as well as capital efficiency. Policies covering the acceptability, structuring, control and valuation with regard to different types of collateral security are established to ensure that they are supported by evidence and continue to fulfil their intended purpose.

The main types of recognised collateral taken by the Group are those as stated in section 80 of the Capital Rules, including (but not limited to) cash on deposit, gold bullion, equities listed in a main index and/or a recognised exchange, collective investment schemes, various recognised debt securities, residential, industrial and commercial property, etc.

The Group's policy provides that netting is only to be applied where it has the legal right to do so. Consistent with the Capital Rules, only bilateral netting arrangements are included for capital adequacy credit risk mitigation calculation.

In terms of the application within IRB approach, credit risk mitigants are considered in two broad categories: first, those which reduce the intrinsic probability of default of an obligor and therefore operate as adjustments to PD estimation, and second, those which affect estimated recoverability of obligations and require adjustment of LGD. The first includes, for example, full parental or group company guarantees; the second, collateral security of various kinds such as cash, equity, properties, fixed assets such as motor vehicles, plant and machinery, stock and debtors, bank and sovereign guarantees, etc.

4. Credit risk under the internal ratings-based approach continued

(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:

	2012	2011
IRB Exposure Class		
Sovereign exposures	–	–
Bank exposures	–	–
Corporate exposures	36,916	31,995
Total EAD	**36,916**	31,995

(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
2012					
Sovereign exposures	**148,797**	–	–	–	**148,797**
Bank exposures	**185,175**	–	–	–	**185,175**
Corporate exposures	**321,125**	**36,916**	–	–	**358,041**
Retail exposures:					
– Residential mortgages to individuals and property-holding shell companies	–	–	**149,518**	–	**149,518**
– Qualifying revolving retail exposures	–	–	**74,855**	–	**74,855**
– Small business retail exposures	–	–	**5,526**	–	**5,526**
– Other retail exposures to individuals	–	–	**9,423**	–	**9,423**
Other exposures	–	–	–	**30,926**	**30,926**
	655,097	**36,916**	**239,322**	**30,926**	**962,261**
2011					
Sovereign exposures	108,082	–	–	–	108,082
Bank exposures	160,679	–	–	–	160,679
Corporate exposures	289,627	31,995	–	–	321,622
Retail exposures:					
– Residential mortgages to individuals and property-holding shell companies	–	–	132,005	–	132,005
– Qualifying revolving retail exposures	–	–	69,412	–	69,412
– Small business retail exposures	–	–	5,881	–	5,881
– Other retail exposures to individuals	–	–	8,795	–	8,795
Other exposures	–	–	–	29,220	29,220
	558,388	31,995	216,093	29,220	835,696

4. Credit risk under the internal ratings-based approach continued

(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.

	2012	2011
Portfolio		
Bank exposures	**3,696**	11,222
Corporate exposures	**104,359**	72,685
Retail exposures	**15,299**	15,566
	123,354	99,473

For the class of sovereign exposures, there were no exposures covered by recognised guarantees.

(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 exposures at default disclosed below in respect of sovereign, bank and corporate exposures have taken into account the effect of recognised collateral and recognised guarantees.

	2012			
	Exposure-weighted average PD %	Exposure-weighted average LGD %	Exposure-weighted average risk-weight %	Exposure at default
Sovereign exposure				
Minimal default risk	**0.01**	**10.16**	**0.72**	**101,052**
Low default risk	**0.07**	**29.77**	**11.35**	**47,745**
				148,797
Bank exposure				
Minimal default risk	**0.04**	**24.08**	**5.18**	**49,391**
Low default risk	**0.08**	**35.71**	**13.46**	**114,819**
Satisfactory default risk	**0.35**	**33.85**	**33.08**	**18,275**
Fair default risk	**0.93**	**33.99**	**56.01**	**2,425**
Moderate default risk	**3.58**	**39.78**	**108.51**	**238**
Significant default risk	**6.35**	**80.44**	**274.19**	**14**
High default risk	**10.00**	**68.49**	**283.55**	**13**
				185,175
Corporate exposure (other than specialised lending)				
Minimal default risk	**0.04**	**39.59**	**14.60**	**31,041**
Low default risk	**0.11**	**43.86**	**26.88**	**94,257**
Satisfactory default risk	**0.39**	**44.76**	**55.26**	**106,378**
Fair default risk	**1.23**	**42.81**	**87.40**	**48,957**
Moderate default risk	**2.74**	**38.33**	**108.71**	**37,104**
Significant default risk	**6.75**	**47.29**	**171.77**	**1,561**
High default risk	**11.31**	**36.39**	**158.37**	**241**
Special management	**18.73**	**22.52**	**124.41**	**492**
Default	**100.00**	**53.17**	**–**	**1,094**
				321,125

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

	2011			
	Exposure-weighted average PD %	Exposure-weighted average LGD %	Exposure-weighted average risk-weight %	Exposure at default
Sovereign exposure				
Minimal default risk	0.01	10.30	0.86	66,686
Low default risk	0.07	45.00	16.34	41,396
				108,082
Bank exposure				
Minimal default risk	0.03	23.97	4.94	39,228
Low default risk	0.08	35.99	13.87	98,901
Satisfactory default risk	0.28	32.82	27.22	21,969
Fair default risk	1.07	38.56	67.77	456
Moderate default risk	2.94	39.05	100.14	88
Significant default risk	5.89	40.72	134.90	30
High default risk	11.29	40.72	176.35	7
				160,679
Corporate exposure (other than specialised lending)				
Minimal default risk	0.04	37.36	13.90	35,156
Low default risk	0.10	43.87	27.62	89,079
Satisfactory default risk	0.39	42.07	51.93	81,908
Fair default risk	1.22	42.06	86.44	36,524
Moderate default risk	2.82	36.80	102.37	42,353
Significant default risk	6.62	47.11	168.85	2,317
High default risk	12.18	34.52	161.18	343
Special management	28.14	29.76	141.50	478
Default	100.00	54.49	–	1,469
				289,627

(ii) Corporate exposures (specialised lending) – analysis by supervisory rating grade

	2012		2011	
	Exposure-weighted average risk-weight %	**Exposure at default**	Exposure-weighted average risk-weight %	Exposure at default
Obligor Grade				
Strong	**66.98**	**32,694**	66.24	24,707
Good	**84.49**	**3,467**	88.44	6,322
Satisfactory	**121.90**	**755**	121.90	960
Weak	**–**	**–**	265.00	6
		36,916		31,995

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
2012					
Strong	**148,865**	**64,578**	**5,460**	**6,992**	**225,895**
Medium	**534**	**10,085**	**51**	**2,333**	**13,003**
Sub-standard	**–**	**185**	**–**	**77**	**262**
Impaired	**119**	**7**	**15**	**21**	**162**
	149,518	**74,855**	**5,526**	**9,423**	**239,322**
2011					
Strong	131,446	59,660	5,775	6,749	203,630
Medium	405	9,427	88	1,969	11,889
Sub-standard	–	318	–	57	375
Impaired	154	7	18	20	199
	132,005	69,412	5,881	8,795	216,093

(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:

	2012		2011	
	Undrawn commitments	**Exposure-weighted average EAD**	Undrawn commitments	Exposure-weighted average EAD
Sovereign exposures	**–**	**–**	–	–
Bank exposures	**590**	**269**	770	292
Corporate exposures	**135,416**	**43,391**	129,997	41,817
	136,006	**43,660**	130,767	42,109

(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.

	2012	2011
Exposure Class		
Sovereign	**–**	–
Bank	**–**	–
Corporate	**243**	465
Residential mortgage	**(28)**	(33)
Qualifying revolving retail	**367**	271
Other retail	**72**	60
	654	763

The actual losses in 2012 decreased primarily due to fewer corporate customers downgraded, partly offset by higher charge off for credit card and personal loans.

4. Credit risk under the internal ratings-based approach continued

(f) Analysis of actual loss and estimates continued

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 2011	31 December 2010
Exposure Class		
Sovereign	14	6
Bank	58	101
Corporate	1,869	2,165
Residential mortgage	77	99
Qualifying revolving retail	430	390
Other retail	130	125
	2,578	2,886

Overall estimated expected losses in 2012 remained stable compared to 2011.

It should be noted that actual loss and expected loss are measured and calculated using different methodologies which may not be directly comparable. The limitation arises mainly from the fundamental differences in the definition of "loss" under expected loss calculation which is derived based on regulatory rules and actual loss includes write-offs and impairment loss allowances.

The tables below set out the comparison of the predicted risk estimates of the Group's credit risk models against actual outcomes of the wholesale and retail exposures.

(i) Wholesale exposures

Risk estimates as at 31 December 2011 against actual outcome for the year 2012

	PD		**LGD**		**EAD**	
	Actual %	**Estimated %**	**Actual %**	**Estimated %**	**Actual %**	**Estimated %**
Sovereign exposure	**–**	**0.05**	**–**	**23.59**	**–**	**100.00**
Bank exposure	**–**	**0.40**	**–**	**30.16**	**–**	**98.68**
Corporate exposure	**0.21**	**1.47**	**34.70**	**43.56**	**38.14**	**76.51**

Risk estimates as at 31 December 2010 against actual outcome for the year 2011

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Sovereign exposure	–	0.06	–	22.47	–	100.00
Bank exposure	–	0.54	–	27.83	–	99.22
Corporate exposure	0.28	1.38	60.69	45.22	39.76	81.29

The actual PD rate is measured by using the number of obligor defaulted during the reporting period whereas the estimated PD rate is the long run average default rate estimated at the beginning of the reporting period. The PD estimated by internal model is calibrated to the Group's long run default experience. Hence, actual default rate in a particular year ("point-in-time") will typically differ from the estimated PD which is the "through the cycle" estimates as economies move above or below cyclical norms.

4. Credit risk under the internal ratings-based approach continued

(f) Analysis of actual loss and estimates continued

(i) Wholesale exposures continued

The estimated LGD is the exposure weighted average LGD for the portfolio, adjusted by a downturn factor, as of the beginning of the reporting period whereas the actual LGD is computed using the resolved default cases accumulated in 2012 which covers cases defaulted before 2012. No default and loss has been observed for Bank and Sovereign exposures during the reporting period.

The estimated EAD% represents the ratio of total model estimated exposure values to total limits for the portfolio at the beginning of the reporting period. The actual EAD% compares the realised EAD of the defaulted and resolved cases accumulated in 2012 which covers cases defaulted before 2012 to the limits 1 year prior to default.

(ii) Retail exposures

Risk estimates as at 31 December 2011 against actual outcome for the year 2012

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Residential mortgages to individuals and property-holding shell companies	**0.17**	**0.50**	**0.79**	**10.61**	**93.13**	**100.00**
Qualifying revolving retail exposures	**0.32**	**0.53**	**84.73**	**91.61**	**87.67**	**93.43**
Small business retail exposures	**0.05**	**0.66**	**1.13**	**8.13**	**97.86**	**100.00**
Other retail exposures to individuals	**2.27**	**2.35**	**68.33**	**87.57**	**77.18**	**99.03**

Remarks: The portfolio which was newly approved to use internal ratings-based approach in 2011 is excluded in the above LGD analysis.

Risk estimates as at 31 December 2010 against actual outcome for the year 2011

	PD		LGD		EAD	
	Actual %	Estimated %	Actual %	Estimated %	Actual %	Estimated %
Residential mortgages to individuals and property-holding shell companies	0.17	0.52	0.66	11.09	92.05	100.00
Qualifying revolving retail exposures	0.31	0.57	83.22	94.43	81.40	86.48
Small business retail exposures	0.26	0.47	0.27	11.93	96.88	100.00
Other retail exposures to individuals	1.97	2.25	90.46	87.50	76.66	93.22

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 2010 which were recovered within 24 months after default. The estimated LGD is the exposure weighted average LGD for the defaulted cases estimated prior to default.

The estimated EAD% represents the ratio of total model estimated EAD to total limits for cases defaulted during 2012 whereas the actual EAD% compares the exposure values of the cases defaulted in 2012 at the time of default against the maximum limit 1 year prior to default.

5. Credit risk under the standardised (credit risk) approach

(a) Ratings from External Credit Assessment Institutions ("ECAIs")

The Group uses the following ECAIs to calculate its capital adequacy requirements under the standardised (credit risk) approach prescribed in the Capital Rules:

– Fitch Ratings

– Moody's Investors Service

– Standard & Poor's Ratings Services, and

– Rating and Investment Information, Inc.

Where exposures have been rated by the above-mentioned ECAIs, they are categorised under the following class of exposures:

– Sovereign exposures

– Public sector entity exposures

– Multilateral development bank exposures

– Bank exposures

– Securities firm exposures

– Corporate exposures

– Collective investment scheme exposures

The process used to map ECAIs issuer ratings or ECAIs issue specific ratings in the Group's banking book is consistent with those prescribed in the Capital Rules.

(b) Credit risk mitigation

As stated in sections 98 and 99 of the Capital Rules, certain guarantees and credit derivative contracts are recognised for credit risk mitigation purposes. The main types of guarantees are from sovereigns, corporate and banks. With corporate guarantees, in order for it to be recognised as a credit risk mitigants, it must have a credit rating of A- or better by Standard & Poor's Ratings Services, Fitch Ratings and Rating and Investment Information, Inc, or a credit rating of A3 or better by Moody's Investors Service.

5. Credit risk under the standardised (credit risk) approach continued

(c) Credit risk exposures under the standardised (credit risk) approach

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			
2012								
On-balance sheet								
Sovereign	–	–	568	–	–	–	–	–
Public sector entity	13,024	12,908	118	1,352	23	1,375	–	–
Multilateral development bank	24,095	24,095	–	–	–	–	–	–
Bank	15	–	15	–	6	6	–	–
Securities firm	33	–	33	–	17	17	–	–
Corporate	5,692	1	4,317	1	4,317	4,318	828	546
Collective investment scheme	39	–	39	–	39	39	–	–
Cash items	–	–	–	–	–	–	–	–
Regulatory retail	2,497	–	1,836	–	1,377	1,377	639	23
Residential mortgage loan	13,818	–	13,779	–	7,227	7,227	37	1
Other exposures which are not past due exposures	4,137	–	1,781	–	1,781	1,781	2,357	–
Past due exposures	219	–	219	–	315	315	2	–
	63,569	37,004	22,705	1,353	15,102	16,455	3,863	570
Off-balance sheet								
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	1,552	–	1,326	–	1,317	1,317	226	22
OTC derivative contracts	223	1	222	–	205	205	1	–
Credit derivative contracts	–	–	–	–	–	–	–	–
Other off-balance sheet exposures not elsewhere specified	–	–	–	–	–	–	–	–
	1,775	1	1,548	–	1,522	1,522	227	22
Total	65,344	37,005	24,253	1,353	16,624	17,977	4,090	592
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

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			
2011								
On-balance sheet								
Sovereign	–	–	756	–	–	–	–	–
Public sector entity	18,574	18,451	125	2,398	25	2,423	–	–
Multilateral development bank	21,613	21,613	–	–	–	–	–	–
Bank	9	–	9	–	4	4	–	–
Securities firm	–	–	–	–	–	–	–	–
Corporate	6,430	–	4,643	–	4,643	4,643	1,065	722
Collective investment scheme	42	–	42	–	42	42	–	–
Cash items	–	–	–	–	–	–	–	–
Regulatory retail	2,256	–	1,469	–	1,102	1,102	753	34
Residential mortgage loan	12,363	–	12,330	–	6,554	6,554	31	2
Other exposures which are not past due exposures	4,734	–	1,923	–	1,923	1,923	2,811	–
Past due exposures	199	–	199	–	280	280	18	–
	66,220	40,064	21,496	2,398	14,573	16,971	4,678	758
Off-balance sheet								
Off-balance sheet exposures other than OTC derivative transactions or credit derivative contracts	3,051	–	2,876	–	2,865	2,865	175	9
OTC derivative contracts	183	2	181	–	175	175	–	–
Credit derivative contracts	–	–	–	–	–	–	–	–
Other off-balance sheet exposures not elsewhere specified	–	–	–	–	–	–	–	–
	3,234	2	3,057	–	3,040	3,040	175	9
Total	69,454	40,066	24,553	2,398	17,613	20,011	4,853	767
Exposures deducted from capital base	–							

* Principal amount or credit equivalent amount, as applicable, net of specific provisions.

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 were no outstanding repo-style transactions and credit derivative contracts at 31 December 2012 (2011: Nil).

(i) Counterparty credit risk exposures under the internal-ratings based approach

	2012	2011
OTC derivative transactions:		
Gross total positive fair value which are not repo-style transactions	**4,551**	3,985
Credit equivalent amount	**8,902**	7,728
Value of recognised collateral by type:		
Debt securities	**–**	–
Others	**198**	–
	198	–
Credit equivalent amount or net credit exposures net of recognised collateral*	**8,902**	7,728
Risk-weighted amount	**2,684**	3,824
Notional amount of recognised credit derivative contracts which provide credit protection	**–**	–

* For OTC derivative contracts, the recognised collateral is reflected in LGD.

6. Counterparty credit risk-related exposures continued

(b) Counterparty credit risk exposures continued

(ii) Counterparty credit risk exposures under the standardised (credit risk) approach

	2012	2011
OTC derivative transactions:		
Gross total positive fair value which are not repo-style transactions	**55**	90
Credit equivalent amount	**223**	183
Value of recognised collateral by type:		
Debt securities	**–**	–
Others	**–**	–
	–	–
Credit equivalent amount or net credit exposures net of recognised collateral held	**222**	183
Risk-weighted amount	**204**	175
Notional amount of recognised credit derivative contracts which provide credit protection	**–**	–

(c) Major classes of exposures by counterparty type

(i) Major classes of exposures under the internal ratings-based approach by counterparty type

	2012			2011		
	Contract amount	**Credit equivalent amount**	**Risk-weighted amount**	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	**–**	**–**	**–**	–	–	–
Public sector entities	**–**	**–**	**–**	–	–	–
Banks	**756,161**	**6,714**	**861**	775,921	4,173	537
Corporates	**129,148**	**2,188**	**1,823**	152,166	3,555	3,287
	885,309	**8,902**	**2,684**	928,087	7,728	3,824

(ii) Major classes of exposures under the standardised (credit risk) approach by counterparty type

	2012			2011		
	Contract amount	**Credit equivalent amount**	**Risk-weighted amount**	Contract amount	Credit equivalent amount	Risk-weighted amount
Sovereign	**–**	**–**	**–**	–	–	–
Public sector entities	**39**	**1**	**–**	39	2	–
Banks	**–**	**–**	**–**	–	–	–
Corporates	**6,275**	**222**	**204**	5,699	181	175
	6,314	**223**	**204**	5,738	183	175

7. Asset securitisation

There was no asset securitisation for which the Group is an originating institution or an investing institution at 31 December 2012 (2011: Nil).

8. Market risk

(a) The Hong Kong Monetary Authority has granted approval under sections 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.

	2012	2011
Market risk calculated by:		
– Internal models approach:		
– VAR	**72**	115
– Stressed VAR*	**101**	–
– Standardised approach:		
– specific interest rate exposures	**23**	48
– equity exposures	**–**	1
Total capital charge for market risk	**196**	164

* Stressed VAR was implemented since 2012 according to Basel 2.5 requirement

Capital charge means an amount of regulatory capital which the Group is required to hold for an exposure to a relevant risk which, if multiplied by 12.5, becomes the risk-weighted amount of that exposure for that risk.

(b) Methodology for valuation of market risk position under internal model approach

VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. A Historic Simulation approach is used to model foreign currency and interest rate risk. Standard 1-day VAR is generated by revaluing the portfolio for each of 500 historical scenarios from one-day market movements, and is derived from a clean two-year time series of historic market risk factor data. Apart from the standard 1-day VAR, the Group has introduced stressed VAR since the start of 2012 according to the Basel 2.5 requirement. Stressed VAR is the measure of VAR using a specific, continuous one-year period of stress for the trading portfolio, assuming a 10-day holding period.

(c) Characteristics and coverage of VAR model

The VAR models cover all material sources of price risk relating to foreign exchange risk and general interest rate risk. Foreign exchange risk factors include, but are not limited to, foreign currency prices and foreign currency option volatility. General interest rate risk factors include, but are not limited to, interest rate curves and interest rate option volatilities.

Historical simulation approach is used for all outright interest rate and foreign exchange in VaR calculation. Standard VAR uses a 99% confidence interval and a one day time horizon based on 500 historical scenarios. The result is then scaled up to a ten day holding period. Stressed VAR uses a 10-day holding period and a 99% confidence interval based on a specific, continuous one-year stress period.

Historical, hypothetical and technical scenario stress testing is performed on positions on a bi-weekly basis. Back-testing of the interest rate and foreign exchange uses clean and hypothetical profits and losses from trading operations and compares these to overall and individual business level value at risk on a daily basis.

9. Operational risk

The Hong Kong Monetary Authority has granted approval under section 25(2) of the Capital Rules for the Group to use the standardised approach to calculate its operational risk.

	2012	2011
Capital charge for operational risk	**3,026**	2,852

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.

	2012	2011
Cumulative realised gains on disposal	**1**	42
Unrealised gains:		
– recognised in reserve but not through the income statement	**273**	174
– 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 2012	**–**	**–**
At 31 December 2011	–	–

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 loans and 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 loans and 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
2012						
Residential mortgages	**150,812**	**137**	**(2)**	**(16)**	**3**	**1**
Commercial, industrial and international trade	**137,259**	**939**	**(662)**	**(558)**	**428**	**274**
Commercial real estate	**72,379**	**8**	**–**	**(5)**	**1**	**–**
Other property-related lending	**85,821**	**54**	**(3)**	**(17)**	**12**	**2**
2011						
Residential mortgages	129,751	108	(2)	(34)	1	–
Commercial, industrial and international trade	114,661	1,272	(884)	(594)	511	339
Commercial real estate	52,745	4	–	(4)	21	–
Other property-related lending	95,236	42	(4)	(22)	6	18

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
2012				
Mainland entities	**40,979**	**8,320**	**49,299**	**–**
Companies and individuals outside Mainland where the credit is granted for use in Mainland	**22,458**	**3,580**	**26,038**	**132**
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	**130**	**–**	**130**	**–**
	63,567	**11,900**	**75,467**	**132**
Exposures incurred by the Bank's mainland subsidiary	**52,730**	**7,950**	**60,680**	**176**
	116,297	**19,850**	**136,147**	**308**
2011				
Mainland entities	30,082	6,789	36,871	–
Companies and individuals outside Mainland where the credit is granted for use in Mainland	11,850	1,813	13,663	282
Other counterparties where the exposure is considered by the Bank to be non-bank Mainland exposure	341	–	341	–
	42,273	8,602	50,875	282
Exposures incurred by the Bank's mainland subsidiary	46,342	10,208	56,550	105
	88,615	18,810	107,425	387

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
2012				
Asia-Pacific excluding Hong Kong:				
– China	**78,682**	**–**	**37,256**	**115,938**
– Japan	**14,763**	**–**	**26,004**	**40,767**
– Other	**46,810**	**1,356**	**16,125**	**64,291**
	140,255	**1,356**	**79,385**	**220,996**
The Americas:				
– United States	**3,997**	**–**	**4,615**	**8,612**
– Other	**9,317**	**1,680**	**18,139**	**29,136**
	13,314	**1,680**	**22,754**	**37,748**
Europe:				
– United Kingdom	**11,091**	**–**	**5,928**	**17,019**
– Other	**20,296**	**5,408**	**13,725**	**39,429**
	31,387	**5,408**	**19,653**	**56,448**
2011				
Asia-Pacific excluding Hong Kong:				
– China	92,136	–	43,076	135,212
– Japan	10,358	–	29,052	39,410
– Other	34,558	2,223	10,328	47,109
	137,052	2,223	82,456	221,731
The Americas:				
– United States	19,388	–	4,116	23,504
– Other	3,827	1,958	12,177	17,962
	23,215	1,958	16,293	41,466
Europe:				
– United Kingdom	10,525	199	3,016	13,740
– Other	19,081	6,732	9,984	35,797
	29,606	6,931	13,000	49,537

15. Foreign currency exposure

At 31 December 2012, the US dollar ("USD") and Chinese renminbi ("RMB") were the currencies in which the Group had non-structural foreign currency positions that were not less than 10 per cent of the total net position in all foreign currencies. The Group also had a RMB structural foreign currency position, which was not less than 10 percent of the total net structural position in all foreign currencies.

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

	Group				
	USD	RMB	EUR	Other foreign currencies	Total foreign currencies
2012					
Non-structural position					
Spot assets	**160,217**	**119,957**	**18,553**	**125,634**	**424,361**
Spot liabilities	**(144,015)**	**(112,827)**	**(10,637)**	**(98,154)**	**(365,633)**
Forward purchases	**301,222**	**83,737**	**7,280**	**27,294**	**419,533**
Forward sales	**(313,787)**	**(90,096)**	**(15,227)**	**(54,697)**	**(473,807)**
Net options position	**160**	**(142)**	**19**	**(11)**	**26**
Net long/(short) non–structural position	**3,797**	**629**	**(12)**	**66**	**4,480**
Structural position	**205**	**30,375**	**–**	**434**	**31,014**
2011					
Non-structural position					
Spot assets	149,152	123,061	9,119	118,208	399,540
Spot liabilities	(128,778)	(124,005)	(11,097)	(99,929)	(363,809)
Forward purchases	265,328	87,981	4,699	30,929	388,937
Forward sales	(284,172)	(85,934)	(3,061)	(49,305)	(422,472)
Net options position	147	(124)	(24)	4	3
Net long/(short) non–structural position	1,677	979	(364)	(93)	2,199
Structural position	206	24,850	–	305	25,361

The above US Dollars foreign currency exposure for 2011 included certain US Dollars currency loans with embedded US Dollars forward contract granted to customers under the bank negotiation with the underlying documentary credit denominated in RMB currency amounted to HK$19,128 million.

Analysis of Shareholders

As at 31 December 2012	Shareholders		Shares of HK$5 each	
	Number	Percentage of total	Number in millions	Percentage of total
Number of shares held				
1 – 500	6,755	33.31	1.7	0.09
501 – 2,000	6,441	31.76	7.9	0.41
2,001 – 5,000	3,385	16.69	11.6	0.61
5,001 – 20,000	2,805	13.83	28.8	1.51
20,001 – 50,000	586	2.89	18.3	0.96
50,001 – 100,000	167	0.82	12.1	0.63
100,001 – 200,000	82	0.40	11.7	0.61
Over 200,000	61	0.30	1,819.7	95.18
	20,282	100.00	1,911.8	100.00
Geographical Distribution				
Hong Kong	19,958	98.40	1,908.7	99.83
Malaysia	68	0.34	0.4	0.02
Canada	53	0.26	0.1	0.01
United States of America	42	0.21	0.3	0.01
Singapore	40	0.20	2.0	0.10
United Kingdom	33	0.16	0.0	0.00
Australia	33	0.16	0.1	0.01
Macau	31	0.15	0.1	0.01
Others	24	0.12	0.1	0.01
	20,282	100.00	1,911.8	100.00

Subsidiaries*

Everlasting International Limited

Fulcher Enterprises Company Limited

Full Wealth Investment Limited *(in members' voluntary liquidation)*

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 Data Services Limited

Hang Seng Finance Limited

Hang Seng Finance (Bahamas) Limited

Hang Seng Financial Information Limited

Hang Seng Futures 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 *(in members' voluntary liquidation)*

High Time Investments Limited

HSI International Limited

Imenson Limited

Mightyway Investments Limited *(in members' voluntary liquidation)*

Silver Jubilee Limited *(in members' voluntary liquidation)*

Yan Nin Development Company Limited

* As defined in Section 2 of Hong Kong Companies Ordinance.

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

Rose W M Lee

Directors

John C C Chan GBS, JP
Marvin K T Cheung GBS, OBE, JP
L Y Chiang JP
Andrew H C Fung JP
Anita Y M Fung
Fred Zuliu Hu
Jenkin Hui
Sarah C Legg
Eric K C Li GBS, OBE, JP
Vincent H S Lo GBS, JP
Dorothy K Y P Sit
Richard Y S Tang BBS, JP
Peter T S Wong JP
Michael W K Wu

Secretary

C C Li

Registered office

83 Des Voeux Road Central, Hong Kong
Telephone: (852) 2198 1111
Facsimile: (852) 2868 4047
Telex: 73311 73323
SWIFT: HASE HK HH
Website: www.hangseng.com

Stock code

The Stock Exchange of Hong Kong Limited: 11

Registrar

Computershare Hong Kong Investor Services Limited
Shops 1712-1716, 17th Floor, Hopewell Centre
183 Queen's Road East, Wanchai, Hong Kong

Depositary*

The Bank of New York Mellon
PO Box 358516
Pittsburgh, PA 15252-8516, USA
Telephone: 1-201-680-6825
Toll free (domestic): 1-888-BNY-ADRS
Website: www.bnymellon.com\shareowner
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 2012

This Annual Report 2012 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 2012 on the Bank's website and wish to receive a printed copy; or

B) receive this Annual Report 2012 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 2012 on the Bank's website have difficulty in reading or gaining access to this Annual Report 2012 via the Bank's website for any reason, the Bank will promptly send this Annual Report 2012 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.

Calendar

2012 Full Year Results

Announcement date	4 March 2013

2012 Fourth Interim Dividend*

Announcement date	4 March 2013
Book close and record date	20 March 2013
Payment date	3 April 2013

2012 Annual Report

to be posted to shareholders in late March 2013

Annual General Meeting

to be held on 16 May 2013

2013 Half Year Results

Announcement date	5 August 2013

2013 Interim Report

to be posted to shareholders in late August 2013

* The Register of Shareholders of the Bank will be closed on Wednesday, 20 March 2013, during which no transfer of shares can be registered. To qualify for the fourth interim dividend, all transfers, accompanied by the relevant share certificates, must be lodged with the Bank's Registrar, Computershare Hong Kong Investor Services Limited, at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, for registration not later than 4:30 pm on Tuesday, 19 March 2013. The fourth interim dividend will be payable on Wednesday, 3 April 2013 to shareholders on the Register of Shareholders of the Bank on Wednesday, 20 March 2013. Shares of the Bank will be traded ex-dividend as from Monday, 18 March 2013.

Proposed dates for 2013:

2013 First Interim Dividend

Announcement date	7 May 2013
Book close and record date	23 May 2013
Payment date	6 June 2013

2013 Second Interim Dividend

Announcement date	5 August 2013
Book close and record date	21 August 2013
Payment date	5 September 2013

2013 Third Interim Dividend

Announcement date	7 October 2013
Book close and record date	24 October 2013
Payment date	7 November 2013

2013 Full Year Results

Announcement date	24 February 2014

2013 Fourth Interim Dividend

Announcement date	24 February 2014
Book close and record date	12 March 2014
Payment date	27 March 2014

Published by Hang Seng Bank Limited

Concept, design and art direction by Lilian Tang Design

Photography by Josiah Leung Photography

Printed in Hong Kong by Best Tri Printing Company Limited

HANG SENG BANK

Hang Seng Bank Limited

83 Des Voeux Road Central, Hong Kong
www.hangseng.com

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