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 accounts made up to dates not earlier than three months prior to 31 December. All significant intra-group transactions have been eliminated on consolidation. The Bank and its subsidiaries and associates are collectively referred as "the Group".

(b) These financial statements have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards (HKFRSs), which is a collective term that includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards (HKASs), and interpretations (Ints) issued by the Hong Kong Institute of Certified Public Accountants (HKICPA), accounting principles generally accepted in Hong Kong and the requirements of the Hong Kong Companies Ordinance. These financial statements also comply with the module on "Financial Disclosure by Locally Incorporated Authorised Institutions" under the Supervisory Policy Manual and the supplement guidance issued by the Hong Kong Monetary Authority. In addition, these financial statements comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. A summary of the principal accounting policies adopted by the Group is set out in note 3.

The HKICPA has issued a number of new and revised HKFRSs that are effective or available for early adoption of accounting periods beginning on or after 1 January 2005. Information on the changes in accounting policies resulting from initial application of these new and revised HKFRSs for the current and prior accounting periods is provided in note 4.

(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 their fair value as explained in the accounting policies set out below:

- financial instruments classified as trading, designated at fair value and available-for-sale (see note 3(g));
- investment property (see note 3(p));
- other leasehold land and buildings, for which the fair values cannot be allocated reliably between the land and buildings elements at the inception of the lease and the entire lease is therefore classified as a finance lease (see note 3(q)); and
- buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold interest in the land at the inception of the lease (see note 3(q)).

(d) The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. In this regard, management believes that the critical accounting policies where judgement is necessarily applied are those which relate to goodwill impairment, loan impairment, valuation of financial instruments, and estimated employee retirement benefit costs of defined benefit schemes. The Group believes that the assumptions that have been made are appropriate and that the financial statements therefore present the financial position and results fairly, in all material respects.

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

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and estimates with a significant risk of material adjustment in next year are discussed in note 5.

(e) Following the adoption of a number of new and revised HKFRSs effective 1 January 2005, comparative figures have been restated to conform with the new accounting policies except for those apply to financial instruments under HKAS 39 "Financial instruments: recognition and measurement". The Group has also taken the advantage of certain exemptions on disclosure requirements in respect of HKFRS 4 "Insurance contracts". In addition, certain comparative figures have also been reclassified to conform with the current year's presentation.

2. NATURE OF BUSINESS

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

3. PRINCIPAL ACCOUNTING POLICIES

(a) Interest income and expense

Interest income and expense for all interest-bearing financial instruments except those classified as held-for-trading or designated at fair value are recognised in "Interest income" and "Interest expense" respectively in the income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the Group that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

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

(b) Non interest income

(i) Fee income

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

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

(ii) Rental income from operating lease

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

(iii) Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

(iv) Net trading income

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends. Income and gains or losses generated from hedging activities that do not qualify for hedge accounting under HKAS 39, are also reported as "Net trading income".

(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, together with interest income, expense and dividends arising on those financial instruments.

(c) Segment reporting

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

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(d) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and 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 are not intended to be sold in the short term and have not been classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment allowances.

(f) Loan impairment

The Group will recognise losses for impaired loans promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are assessed either individually for individually significant loans or collectively for loan portfolios with similar credit risk characteristics.

(i) Individually assessed loans

Impairment allowances are made on individually significant loans when there is objective evidence of impairment as a result of one or more of the following loss events that will impact the estimated future cash flows of the loan.

- adverse changes in the payment status of borrower;
- significant financial difficulty of the obligor;
- a breach of contract, such as a default or delinquency in interest or principal payments;
- the Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a concession that the Group would not otherwise consider;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation; and
- observable data indicating that there is a measurable decrease in the estimated future cash flows of the borrower's business operation.

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

- the Group's aggregate exposure to the borrower;
- the viability of the borrower's business model and capability to 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 security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain and make payments in the relevant foreign currency if loans are not in local currency; and
- where available, the secondary market price for the debt.

Impairment allowances of an individually assessed loan are measured as the difference between the carrying value and the present value of estimated future cash flows discounted at the original effective interest rate of the individual loan.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(f) Loan impairment (continued)

(ii) Collectively assessed loans

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

– in respect of losses which have been incurred but have not yet been identified as loans subject to individual assessment for impairment (see section (i)); and

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

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of loss has been identified individually, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment allowance. This allowance covers loans that are impaired at the balance sheet date but which will not be individually identified as such until some time in the future. The collective impairment allowance is determined after taking into account:

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

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

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

Homogeneous groups of loans

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

(iii) Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

(iv) Reversals of impairment

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

(v) Repossessed assets

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

(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. Purchase and sale of these financial instruments are recognised using trade date accounting.

(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 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 related interest income and expense and dividends, are recognised in the income statement within "Net trading income" as they arise. Upon disposal or repurchase, the difference between the net sale proceeds or the net payment and the carrying value is included in the income statement.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments (continued)

(ii) Financial instruments designated at fair value

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

- eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases; or
- 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; or
- 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 are recognised in the income statement as they arise, together with the related interest income and expense and dividends, 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 and held-to-maturity investments

Financial instruments intended to be held on a continuing basis are classified as available-for-sale, unless they are designated at fair value (see note 3(g)(ii)) or classified as held-to-maturity.

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

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

(h) Derivative financial instruments and hedge accounting

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

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

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

The method of recognising the resulting fair value gains or losses depends on whether the derivative is held for trading, or is designated as a hedging instrument, and if so, the nature of the risk being hedged. The Group designates certain derivatives as either (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ("fair value hedge"); (ii) hedges of highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ("cash flow hedges"). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value or cash flow hedges provided certain criteria are met.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(h) Derivative financial instruments and hedge accounting (continued)

(i) Hedge accounting

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

(ii) Fair value hedge

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

If the hedging relationship no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to the income statement over the residual period to maturity.

(iii) Cash flow hedges

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

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

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

(iv) Hedge effectiveness testing

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

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

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

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

(v) Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair value of any derivatives that do not qualify for hedge accounting are recognised immediately in the income statement and reported in "Net trading income", except where derivative contracts are used 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".

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(i) 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 "Deposit 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 "Advances to customers" where the counterparty is a non-bank.

(j) 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.

(k) 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.

(l) Determination of fair value

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

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

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

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

(m) Subsidiaries

A subsidiary, in accordance with the Hong Kong Companies Ordinance, is a company 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. Subsidiaries are considered to be controlled if the Bank has the power, directly or indirectly, to govern the financial and operating policies, so as to obtain benefits from their activities.

An investment in a subsidiary is 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.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(n) Associates

An associate is an entity over which the Group or the Bank has the ability to significantly influence, but not control over its management, including participation in the financial and operating policy decision.

An investment in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition, post tax results of the associate for the year, together with any impairment loss on goodwill relating to the investment in associate recognised for the year.

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

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

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

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

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

(ii) Intangible assets include the value of in-force long-term assurance business, acquired software licences and capitalised development costs of computer software programmes. The value of in-force long-term assurance business is stated at a valuation determined annually in consultation with independent actuaries using the methodology as described in note 3(z). 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.

(p) Investment property

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

Investment properties are stated in the balance sheet at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement.

(q) Premises, plant and equipment

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

– land held under operating leases and buildings thereon, where the fair value of the leasehold interest in the land and buildings cannot be measured separately at the inception of the lease and the building is not clearly held under an operating lease; and

– buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold interest in the land at the inception of the lease.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(q) Premises, plant and equipment (continued)

Revaluations are performed by professionally qualified valuers with sufficient regularity to ensure that the carrying amount of these assets does not differ materially from that which would be determined using fair value at the balance sheet date.

Surpluses arising on revaluation, are credited firstly to the income statement to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same property, and are thereafter taken to "Premises revaluation reserve". Deficits arising on revaluation, are firstly set off against any previous revaluation surpluses included in the "Premises revaluation reserve" in respect of the same property, and are thereafter to the income statement.

Depreciation is calculated to write off the valuation of the property over their estimated useful lives as follows:

– freehold land is not depreciated;

– leasehold land is depreciated over the unexpired terms of the leases; and

– buildings and improvements thereto are depreciated at the greater of 2 per cent per annum on the straight-line basis or over the unexpired terms of the leases.

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

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

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

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

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

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

(s) Finance and operating leases

Leases which transfer substantially all the risks and rewards of ownership to the lessees are classified as finance leases. Leases which do not transfer substantially all the risks and rewards of ownership to the lessees are classified as operating leases, with the exceptions of land and building held under a leasehold interest as set out in notes 3(p) & 3(q).

(i) Finance leases

Where the Group is a lessor under finance leases, an amount representing the net investment in the lease is included in the balance sheet as loans and advances to customers. Hire purchase contracts having the characteristics of a finance lease are accounted for in the same manner as finance leases. Impairment allowances are accounted for in accordance with the accounting policies set out in note 3(f).

Where the Group acquires the use of assets under finance leases, the amount representing the fair value of the leased asset, or, if lower, the present value of the minimum payments of such assets is included in fixed assets and the corresponding liabilities, net of finance charges, are recorded as obligations under finance leases. Depreciation is provided at rates which write off the cost or valuation of the assets over the term of the relevant lease or, where it is likely the Group will obtain ownership of the asset, the life of the asset, as set out in note 3(q). Impairment allowances are accounted for in accordance with the accounting policy as set out in note 3(t). 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.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(s) Finance and operating leases (continued)

(ii) Operating leases

Where the Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable. Rental revenue arising from operating lease is recognised in accordance with the Group's revenue recognition policies as set out in note 3(b)(ii).

(t) Impairment of assets

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

The accounting policies on impairment losses on loans and receivables and goodwill are set out in notes 3(f) and 3(o) 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

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

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

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

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

(iii) Other assets

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following 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.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(t) Impairment of assets (continued)

(iii) Other assets (continued)

Calculation of recoverable amount

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

Recognition of impairment losses

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

Reversals of impairment losses

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

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

(u) Income tax

- Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised directly in equity, in which case they are recognised in equity.
- Current tax 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.
- Deferred tax assets and liabilities arise from deductible and taxable differences between the carrying amounts of assets and liabilities for financial reporting purpose and their tax bases respectively. 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 at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised. Deferred tax assets and liabilities are not discounted. 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.
- Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities if, and only if, the Group has the legally enforceable right to set off current tax assets against current tax liabilities. The principle of offsetting usually applies to income tax levied by the same tax authority on same taxable entity.

(v) 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.

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(v) Employee benefits (continued)

(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 and taking into account the amount of net actuarial losses required to be recognised. Any actuarial gains and losses are fully recognised in the statement of changes in equity.

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.

(w) Equity compensation plans

Where shares are awarded to an employee of the Group as bonuses with a vesting period, the cost of shares awarded is amortised over the vesting period from the date the shares are awarded. Shares purchased for such purpose are classified as available-for-sale securities and reported under "Financial investments".

For share options, the compensation expense is spread over the vesting period from the date they are granted. The compensation expense is determined by reference to the fair value of the options on grant date, and the impact of any non-market vesting conditions such as option lapses. Where the Group is not charged by HSBC Holdings plc for the share options issued by HSBC Holdings plc to employees of the Group, the corresponding amount is credited to "Other reserves".

The Group has taken advantage of the transitional provision in HKFRS 2 "Share-based payment" and applied the treatment described above to shares and options granted after 7 November 2002 which had not been vested at 1 January 2005.

(x) Translation of foreign currencies

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

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

(y) 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.

3. Principal accounting policies (continued)

(z) Insurance contracts

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

A contract issued by the Group that transfers financial risk, without significant insurance risk, is classified as an investment contract, and is accounted for as a financial instrument. The financial assets held by the Group for the purpose of meeting liabilities under insurance and investment contracts are classified and accounted for based on their classification as set out in notes 3(d) to 3(h).

Insurance contracts are accounted for as follows:

Net earned insurance premium

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

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

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

Claims and reinsurance recoveries

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

Gross insurance claims for life assurance reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. The technical reserves for non-linked liabilities (long-term business provision) are calculated based on actuarial principles. The technical reserves for linked liabilities are at least the element of any surrender or transfer value which is calculated by reference to the relevant fund or funds or index.

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

Value of long-term assurance business

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

The value of the in-force long-term assurance business is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as recent experience and general economic conditions. Movements in the value of in-force long-term assurance business are included in other operating income on a gross of tax basis. The value of in-force long-term assurance business is reported under "Intangible assets" in the balance sheet.

(aa) Investment contracts

Customer liabilities under unit-linked investment contracts and the linked financial assets are measured at fair value, and the movements in fair value are recognised in the income statement in "Net income from financial instruments designated at fair value".

Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Investment management fee receivables are recognised in the income statement over the period of the provision of the investment management services.

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

3. PRINCIPAL ACCOUNTING POLICIES (continued)

(ab) 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.

(ac) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or other entities which are under the significant influence of related parties of the Group and post employment benefit scheme. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and its holding companies, directly or indirectly, including any directors (whether executive or otherwise) and Executive Committee members of the Bank and its holding companies.

4. CHANGES IN ACCOUNTING POLICIES

The HKICPA has issued a number of new and revised HKFRSs that are effective for accounting periods beginning on or after 1 January 2005.

The accounting policies of the Group and/or the Bank after the adoption of these new and revised HKFRSs are set out in note 3. The following summaries the significant changes in accounting policies for the current and prior accounting periods reflected in these financial statements.

The Group has adopted the "Amendment to HKAS 39 Financial Instruments: Recognition and Measurement: The Fair Value Option" with effect from 1 January 2005, ahead of its effective date.

The Group has also adopted the "Amendment to HKAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures" with effect from 1 January 2005, ahead of its effective date.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(a) Restatement of prior year and opening balances

The tables below disclose the adjustments that have been made in accordance with the transitional provisions of the respective HKFRSs to each of the line items in:

(i) the Group's consolidated income statement for the year ended 31 December 2004

(ii) the Group's consolidated balance sheet at 31 December 2004 and restatement of opening balances at 1 January 2005

(iii) the Bank's balance sheet at 31 December 2004 and restatement of opening balances at 1 January 2005

The Group's consolidated income statement for the year ended 31 December 2004

		Effect of changes in accounting policies for 2004					
Figures in HK$m	As reported	HKFRS 2	HKAS 17	HKAS 38	Others*	Change in presentation HKAS 27/ HKAS 30	Restated
Interest income	12,471	–	–	–	5	306	12,782
Interest expense	(2,781)	–	–	–	–	4	(2,777)
Net interest income	9,690	–	–	–	5	310	10,005
Fee income	3,749	–	–	–	(19)	111	3,841
Fee expense	(409)	–	–	–	(1)	(6)	(416)
Net fee income	3,340	–	–	–	(20)	105	3,425
Dealing profits	1,025	–	–	–	–	(1,025)	–
Net trading income	–	–	–	–	(16)	1,129	1,113
Insurance underwriting profits	1,310	–	–	–	–	(1,310)	–
Dividend income	96	–	–	–	(22)	15	89
Net earned insurance premiums	–	–	–	–	(52)	4,472	4,420
Other operating income	592	–	–	–	37	144	773
Total operating income	16,053	–	–	–	(68)	3,840	19,825
Net insurance claims incurred & movement in policyholder liabilities	–	–	–	–	68	(3,840)	(3,772)
Net operating income before loan impairment (charges)/releases and other credit risk provisions	16,053	–	–	–	–	–	16,053
Loan impairment (charges)/releases and other credit risk provisions	814	–	–	–	(37)	–	777
Net operating income	16,867	–	–	–	(37)	–	16,830
Employee compensation and benefits	(2,187)	(47)	–	–	–	–	(2,234)
General and administrative expenses	–	–	(15)	–	–	(1,719)	(1,734)
Depreciation of premises, plant and equipment	(317)	–	53	8	–	–	(256)
Amortisation of intangible assets	–	–	–	(8)	–	–	(8)
Operating expenses	(1,719)	–	–	–	–	1,719	–
Total operating expenses	(4,223)	(47)	38	–	–	–	(4,232)
Operating profit	12,644	(47)	38	–	(37)	–	12,598
Profit on disposal of fixed assets and financial investment	432	–	–	–	10	–	442
Net surplus on property revaluation	148	–	(2)	–	–	–	146
Share of profits from associates	143	–	–	–	9	(55)	97
Profit before tax	13,367	(47)	36	–	(18)	(55)	13,283
Tax expenses	(1,764)	–	(5)	–	3	55	(1,711)
Profit for the year	11,603	(47)	31	–	(15)	–	11,572
Profit attributable to minority interests	(208)	–	–	–	–	–	(208)
Profit attributable to shareholders	11,395	(47)	31	–	(15)	–	11,364

* Others includes HKFRS 3, HKFRS 4, HKFRS 5, HKAS 19 and others.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(a) Restatement of prior year and opening balances (continued)

The Group's consolidated balance sheet at 31 December 2004 and restatement of opening balances at 1 January 2005

		Effect of changes in accounting policies for the balances at 31 December 2004								
Figures in HK$m	As reported	HKFRS 2	HKAS 17	HKAS 38	HKAS 40/ HK(SIC)–Int21	Others*	Change in presentation HKAS 27/ HKAS 30	Restated	HKAS 39	Opening balance at 1 January 2005
Assets										
Cash and short-term funds	68,198	–	–	–	–	–	(68,198)	–	–	–
Cash and balances with banks and other financial institutions	–	–	–	–	–	–	7,248	7,248	–	7,248
Placings with banks maturing after one month	16,231	–	–	–	–	–	(16,231)	–	–	–
Placings with and advances to banks and other financial institutions	–	–	–	–	–	–	75,079	75,079	–	75,079
Certificates of deposit	33,590	–	–	–	–	–	(33,590)	–	–	–
Securities held for dealing purposes	1,866	–	–	–	–	–	(1,866)	–	–	–
Trading assets	–	–	–	–	–	–	4,232	4,232	12,505	16,737
Financial assets designated at fair value	–	–	–	–	–	–	–	–	4,292	4,292
Derivative financial instruments	–	–	–	–	–	–	1,684	1,684	94	1,778
Advances to customers	251,873	–	–	–	–	(320)	–	251,553	293	251,846
Amounts due from immediate holding company and fellow subsidiaries	4,598	–	–	–	–	–	(4,598)	–	–	–
Long–term investments	138,025	–	–	–	–	–	(138,025)	–	–	–
Financial investments	–	–	–	–	–	(36)	184,742	184,706	(15,791)	168,915
Investments in associates	2,397	–	–	–	(107)	9	–	2,299	–	2,299
Tangible fixed assets	11,469	–	–	–	–	–	(11,469)	–	–	–
Investment properties	–	–	–	–	–	–	3,383	3,383	–	3,383
Premises, plant and equipment	–	–	(2,511)	(17)	–	–	8,086	5,558	–	5,558
Interest in leasehold land held for own use under operating lease	–	–	609	–	–	–	–	609	–	609
Intangible assets	–	–	–	17	–	–	1,249	1,266	–	1,266
Other assets	20,378	–	–	–	–	174	(11,222)	9,330	(256)	9,074
	548,625	–	(1,902)	–	(107)	(173)	504	546,947	1,137	548,084

4. CHANGES IN ACCOUNTING POLICIES (continued)

(a) Restatement of prior year and opening balances (continued)

The Group's consolidated balance sheet at 31 December 2004 and restatement of opening balances at 1 January 2005 (continued)

Figures in HK$m	As reported	Effect of changes in accounting policies for the balances at 31 December 2004: HKFRS 2	HKAS 17	HKAS 38	HKAS 40/ HK(SIC)–Int21	Others*	Change in presentation HKAS 27/ HKAS 30	Restated	HKAS 39	Opening balance at 1 January 2005
Liabilities										
Current, savings and other deposit accounts	463,416	–	–	–	–	–	(15,956)	447,460	(7,276)	440,184
Deposits from banks	8,631	–	–	–	–	–	3,303	11,934	–	11,934
Trading liabilities	–	–	–	–	–	–	5,840	5,840	10,701	16,541
Derivative financial instruments	–	–	–	–	–	–	1,273	1,273	977	2,250
Certificates of deposit and other debt securities in issue	–	–	–	–	–	–	16,055	16,055	(3,443)	12,612
Amounts due to immediate holding company and fellow subsidiaries	3,928	–	–	–	–	–	(3,928)	–	–	–
Other liabilities	28,613	–	–	–	–	(9,235)	(7,638)	11,740	(1,075)	10,665
Liabilities to customers under investment contracts	–	–	–	–	–	540	–	540	–	540
Liabilities to customers under insurance contracts	–	–	–	–	–	8,656	–	8,656	–	8,656
Deferred tax and current tax liabilities	–	–	(333)	–	467	(21)	1,555	1,668	202	1,870
	504,588	–	(333)	–	467	(60)	504	505,166	86	505,252
Capital resources										
Minority interests	852	–	–	–	–	–	–	852	(14)	838
Share capital	9,559	–	–	–	–	–	–	9,559	–	9,559
Retained profits	21,395	(66)	(66)	–	2,709	(116)	–	23,856	533	24,389
Other reserves	8,598	66	(1,503)	–	(3,283)	3	–	3,881	532	4,413
Proposed dividends	3,633	–	–	–	–	–	–	3,633	–	3,633
Shareholders' funds	43,185	–	(1,569)	–	(574)	(113)	–	40,929	1,065	41,994
	44,037	–	(1,569)	–	(574)	(113)	–	41,781	1,051	42,832
	548,625	–	(1,902)	–	(107)	(173)	504	546,947	1,137	548,084

* Others includes HKFRS 3, HKFRS 4, HKFRS 5, HKAS 19 and others.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(a) Restatement of prior year and opening balances (continued)

The Bank's balance sheet at 31 December 2004 and restatement of opening balances at 1 January 2005

		Effect of changes in accounting policies for the balances at 31 December 2004								
Figures in HK$m	As reported	HKFRS 2	HKAS 17	HKAS 38	HKAS 40/ HK(SIC)–Int21	Others*	Change in presentation HKAS 30	Restated	HKAS 39	Opening balance at 1 January 2005
Assets										
Cash and short-term funds	41,548	–	–	–	–	–	(41,548)	–	–	–
Cash and balances with banks and other financial institutions	–	–	–	–	–	–	7,225	7,225	–	7,225
Placings with banks maturing after one month	7,321	–	–	–	–	–	(7,321)	–	–	–
Placings with and advances to banks and other financial institutions	–	–	–	–	–	–	37,171	37,171	–	37,171
Certificates of deposit	29,957	–	–	–	–	–	(29,957)	–	–	–
Securities held for dealing purposes	1,800	–	–	–	–	–	(1,800)	–	–	–
Trading assets	–	–	–	–	–	–	4,147	4,147	8,088	12,235
Financial assets designated at fair value	–	–	–	–	–	–	–	–	2,593	2,593
Derivative financial instruments	–	–	–	–	–	–	1,684	1,684	36	1,720
Advances to customers	198,917	–	–	–	–	(127)	–	198,790	236	199,026
Amounts due from immediate holding company and fellow subsidiaries	2,749	–	–	–	–	–	(2,749)	–	–	–
Amounts due from subsidiaries	109,324	–	–	–	–	–	–	109,324	–	109,324
Long-term investments	107,114	–	–	–	–	–	(107,114)	–	–	–
Financial investments	–	–	–	–	–	–	141,725	141,725	(9,694)	132,031
Investments in subsidiaries	2,004	–	–	–	–	–	–	2,004	–	2,004
Investments in associates	1,634	–	–	–	–	–	–	1,634	–	1,634
Tangible fixed assets	8,587	–	–	–	–	–	(8,587)	–	–	–
Investment properties	–	–	–	–	–	–	2,046	2,046	–	2,046
Premises, plant and equipment	–	–	(2,511)	(17)	–	–	6,541	4,013	–	4,013
Interest in leasehold land held for own use under operating lease	–	–	609	–	–	–	–	609	–	609
Intangible assets	–	–	–	17	–	–	–	17	–	17
Other assets	9,575	–	–	–	–	28	(1,463)	8,140	(213)	7,927
	520,530	–	(1,902)	–	–	(99)	–	518,529	1,046	519,575

4. CHANGES IN ACCOUNTING POLICIES (continued)

(a) Restatement of prior year and opening balances (continued)

The Bank's balance sheet at 31 December 2004 and restatement of opening balances at 1 January 2005 (continued)

Figures in HK$m	As reported	HKFRS 2	HKAS 17	HKAS 38	HKAS 40/ HK(SIC)–Int21	Others*	Change in presentation HKAS 30	Restated	HKAS 39	Opening balance at 1 January 2005
		Effect of changes in accounting policies for the balances at 31 December 2004								
Liabilities										
Current, savings and other deposit accounts	453,992	–	–	–	–	–	(15,945)	438,047	(7,276)	430,771
Deposits from banks	8,631	–	–	–	–	–	3,301	11,932	–	11,932
Trading liabilities	–	–	–	–	–	–	5,840	5,840	10,699	16,539
Derivative financial instruments	–	–	–	–	–	–	1,272	1,272	905	2,177
Certificates of deposit and other debt securities in issue	–	–	–	–	–	–	16,110	16,110	(3,443)	12,667
Amounts due to immediate holding company and fellow subsidiaries	3,898	–	–	–	–	–	(3,898)	–	–	–
Amounts due to subsidiaries	1,136	–	–	–	–	–	–	1,136	–	1,136
Other liabilities	20,562	–	–	–	–	15	(7,915)	12,662	(1,019)	11,643
Liabilities to customers under investment contracts	–	–	–	–	–	–	–	–	–	–
Liabilities to customers under insurance contracts	–	–	–	–	–	–	–	–	–	–
Deferred tax and current tax liabilities	–	–	(333)	–	351	(21)	1,235	1,232	206	1,438
	488,219	–	(333)	–	351	(6)	–	488,231	72	488,303
Capital resources										
Share capital	9,559	–	–	–	–	–	–	9,559	–	9,559
Retained profits	13,229	(66)	(66)	–	1,656	(93)	–	14,660	509	15,169
Other reserves	5,890	66	(1,503)	–	(2,007)	–	–	2,446	465	2,911
Proposed dividends	3,633	–	–	–	–	–	–	3,633	–	3,633
Shareholders' funds	32,311	–	(1,569)	–	(351)	(93)	–	30,298	974	31,272
	32,311	–	(1,569)	–	(351)	(93)	–	30,298	974	31,272
	520,530	–	(1,902)	–	–	(99)	–	518,529	1,046	519,575

* Others includes HKFRS 5, HKAS 19 and others.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(b) Estimated effect of change in accounting policies on the current period

The following table provides estimates of the extent to which each of the major items in the consolidated income statement and the net assets of the consolidated balance sheet for the year ended 31 December 2005 upon adoption of the new accounting standards, where it is practicable to make such estimates.

	Estimated effect of changes in accounting policies for 2005							
Figures in HK$m	HKFRS 2	HKAS 17	HKAS 38	HKAS 39	HKAS 40/ HK(SIC)– Int21	Others*	Change in presentation HKAS 27/ HKAS 30	Total
Increase/(decrease) in								
Net interest income	–	–	–	203	–	–	730	933
Other operating income	–	–	–	(316)	–	1	(730)	(1,045)
Loan impairment charges and other credit risk provisions	–	–	–	20	–	1	–	21
Total operating expenses	64	(48)	(56)	(7)	–	–	–	(47)
Net surplus on property revaluation	–	–	–	–	1,160	–	–	1,160
Share of profits from associates	–	–	–	–	112	16	(196)	(68)
Profit before tax	(64)	48	56	(126)	1,272	16	(196)	1,006
Tax expenses	–	–	10	–	203	–	(196)	17
Profit for the year	(64)	48	46	(126)	1,069	16	–	989
Increase/(decrease) in								
Net assets at 31 December 2005	–	(2,005)	46	(489)	(801)	106	–	(3,143)

* Others includes HKFRS 3, HKFRS 4, HKFRS 5, HKAS 19 and others.

(c) HKFRS 2: Share-Based Payment ("HKFRS 2")

The Group made awards of, and granted options in respect of, shares of HSBC Holdings plc, as part of employees' compensation. In prior years, no compensation cost was recognised for share options granted at fair value or at not more than 20 per cent discount to fair value.

With effect from 1 January 2005, and in accordance with HKFRS 2, the Group adopted a new policy for share-based payments as set out in detail in note 3(w). Under the new policy, the fair value of share options granted is recognised as "Staff costs" and, where the Group was not charged by HSBC Holdings plc for the share options issued by HSBC Holdings plc to employees of the Group, the corresponding amount is recorded in "Other reserves".

The new accounting policy has been applied retrospectively with comparatives restated, except for the transitional provisions set out in HKFRS 2 (see note 3(w)).

(d) HKFRS 3: Business Combinations ("HKFRS 3")

Goodwill

In prior years, positive goodwill arising from the acquisition of a subsidiary and an associate was amortised over its estimated life, usually taken as 20 years, on a straight-line basis in the income statement.

With effect from 1 January 2005, and in accordance with HKFRS 3, the Group has adopted a new policy for goodwill. Under the new policy, positive goodwill is not amortised but is tested for impairment at each balance sheet date at the cash-generating unit level by comparing the present value of the expected future cash flows from a business with the carrying value of its net assets, including attributable goodwill, in accordance with HKAS 36 "Impairment of Assets".

The change in accounting policy has been applied retrospectively with comparatives restated.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(e) HKFRS 4: Insurance Contracts ("HKFRS 4")

In prior years, all policies issued by insurance subsidiaries on long-term assurance contracts were accounted for as insurance contracts. Investment income on assets backing policyholder liabilities was reported in accordance with the nature of investment income in the 2004 income statement as restated. Allocation of such income to policyholders was reported as "Net insurance claims incurred and movement in policyholder liabilities".

With effect from 1 January 2005, and in accordance with HKFRS 4, a contract under which the Group accepts significant insurance risk from another party (the policyholder) is classified as an insurance contract whereas a contract issued by the Group that transfers financial risk, without significant insurance risk, is classified as an investment contract, and accounted for as a financial instrument in accordance with HKAS 39. Details of the accounting policies on insurance and investment contracts are set out in notes 3(z) and 3(aa).

The change in accounting policy on insurance contracts has been applied retrospectively with comparatives restated except the Group has taken the advantage of certain exemptions on disclosure requirements.

(f) HKFRS 5: Non-Current Assets Held for Sale and Discontinued Operations ("HKFRS 5")

In prior years, collateral assets repossessed for recovery of non-performing advances were reported as advances. The carrying value was adjusted to the net realisable value of the repossessed assets and classified as non-performing assets.

With effect from 1 January 2005, and in accordance with HKFRS 5, non-current assets acquired in exchange for advances in order to achieve an orderly realisation are reported as "Non-current assets held for sale". The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying value of the advance disposed of, net of impairment allowances, at the date of the exchange. Further details of the new accounting policy are set out in note 3(f)(v).

The change in accounting policy has been applied retrospectively with comparatives restated.

(g) HKAS 17: Leasing ("HKAS 17")

Leasehold land for own use

In prior years, leasehold premises were stated at fair market value, as valued by professionally qualified valuers. The apportionment of the value between the land and building elements was made by estimating the net replacement cost of the building as the value of the building element, and taking the residual figures as the value of the land element.

With effect from 1 January 2005, and in accordance with HKAS 17, the Group has adopted a new policy for leasehold land and buildings held for own use. Under the new policy, where leasehold interest in the land is held for own use and the fair value of the leasehold interest in land and building thereon could be measured separately at the time the lease was first entered into by the Group, the leasehold interest in land is accounted for as operating lease. Where the fair value of leasehold interest in land and the building thereon cannot be separately measured, the leasehold interest in land and building thereon are accounted for together as a finance lease. Details of the accounting policies on leasehold interest in land and finance and operating leases are set out in notes 3(q), 3(r) and 3(s).

The change in accounting policy has been applied retrospectively with comparatives restated.

(h) HKAS 19: Employee Benefits ("HKAS 19")

In prior years, the Group implemented HKSSAP 34 (which is materially equivalent to HKAS 19) in relation to the accounting for pensions, and adopted the corridor approach for the recognition of actuarial gains and losses.

With effect from 1 January 2005, and in accordance with HKAS 19, the Group has changed its policy to fully recognise actuarial gains and losses in the statement of changes in equity.

The change in accounting policy has been applied retrospectively with comparatives restated.

(i) HKAS 21: The Effects of Changes in Foreign Exchange Rates ("HKAS 21")

In prior years, 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 were accounted for as exchange differences under retained profits.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(i) HKAS 21: The Effects of Changes in Foreign Exchange Rates ("HKAS 21") (continued)

With effect from 1 January 2005, and in accordance with HKAS 21, exchange differences arising from the re-translation of opening foreign currency net investments and the related cost of hedging, if any, and exchange differences arising from re-translation of the result for the year from the average rate to the exchange rate ruling at the year-end, are accounted for in a separate foreign exchange reserve in equity.

The change in accounting policy has been applied retrospectively with comparatives restated.

(j) HKAS 27: Consolidated and Separate Financial Statements ("HKAS 27") HK(SIC) Interpretation 12 "Consolidation – Special Purpose Entities" ("HK(SIC)-Int 12")

Life insurance subsidiary

In prior years, on consolidation of the life insurance subsidiary, long-term assurance assets and liabilities attributable to policyholders were recognised in aggregate under "Other assets" and "Other liabilities" respectively. Income from long-term assurance assets was reported together with net earned insurance premiums, less net insurance claims and movement in policyholder liabilities, as "Other operating income" in the income statement.

With effect from 1 January 2005, and in accordance with HKAS 27, life insurance subsidiary accounts are consolidated line-by-line.

The change in accounting policy has been applied retrospectively with comparatives restated.

(k) HKAS 38: Intangible Assets ("HKAS 38")

In prior years, costs incurred for development of IT software for internal use were expensed as incurred.

With effect from 1 January 2005, and in accordance with HKAS 38, costs incurred in the development phase of a project to produce application software for internal use are capitalised and amortised over the estimated useful life. Details of the new accounting policy are set out in note 3(o).

The change in accounting policy has been applied prospectively as the amount of software development cost qualifying for capitalisation before 2005 was immaterial.

(l) HKAS 32: Financial Instruments: Disclosure and Presentation ("HKAS 32") and HKAS 39: Financial Instruments: Recognition and Measurement ("HKAS 39")

With effect from 1 January 2005, and in accordance with HKAS 32, the Group has provided additional disclosures of terms, conditions, accounting policies, risk and fair values of financial instruments throughout the notes to the financial statements. In accordance with HKAS 39, the Group has adopted a new accounting policy relating to financial instruments with details set out in notes 3(g) and 3(h).

(i) Impairment of loans and advances

In prior years, there were two basic types of provisions for bad and doubtful debts, specific and general.

Specific provisions represented the quantification of actual and inherent losses from individually identified accounts and homogeneous portfolios of assets. The amount of specific provision raised for an individually identified account represented the Group's estimate of the amount needed to reduce the carrying value of the asset to the expected ultimate net realisable value, taking into account the factors including the financial standing of the customer, likelihood of repayment, likely dividend available on liquidation or bankruptcy and realisable value of any collateral net of disposal costs. Specific provisions for portfolio of small homogeneous loans were made using the roll rate methodology or similar formulaic approach.

General provisions augmented specific provisions and provided cover for loans that were impaired at the balance sheet date but which would not be individually identified as such until some time in the future. General provisions were determined taking into account the structure and risk characteristics of the Group's loan portfolio and the expected loss of the individual components based primarily on the historical loss experience and management's judgement on the current economic and credit conditions.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(l) HKAS 32: Financial Instruments: Disclosure and Presentation ("HKAS 32") and HKAS 39: Financial Instruments: Recognition and Measurement ("HKAS 39") (continued)

(i) Impairment of loans and advances (continued)

With effect from 1 January 2005, the Group recognises loan impairment losses in accordance with HKAS 39, as set out in note 3(f). Loan impairment losses are either calculated on individually assessed accounts or on collective assessment basis in respect of (a) portfolios of small homogeneous loans; or (b) losses which have been incurred but have not yet been identified on loans subject to individual assessment for impairment. The methodologies used for the individual or on a collective assessment under HKAS 39 are in principle consistent with those used under the previous loan provisioning approach.

(ii) Financial instruments

In prior years, the Group classified its financial instruments into "securities held for dealing purposes" and "long-term investment". All financial instruments were carried at cost or amortised cost, net of impairment provisions, for diminution in value except for securities held for trading purposes and long term equity investments which were carried at fair value. Gains and losses from changes in fair value were recognised in income statement in respect of securities held for trading and were in the investment revaluation reserve in respect of long term equity investments.

With effect from 1 January 2005, and in accordance with HKAS 39, financial instruments are classified into one of the following categories: trading assets and liabilities, financial assets designated at fair value, available-for-sale financial assets and held-to-maturity investments. The accounting policies for each categories are set out in note 3(g).

On 1 January 2005, the Group has re-designated certain debt securities previously described as "Held-to-maturity debt securities" to "Available-for-sale securities", "Trading assets" and "Financial assets designated at fair value".

(iii) Derivative financial instruments and hedge accounting

In prior years, accounting for derivatives was dependent upon whether the transactions were undertaken for trading or non-trading purposes. Trading transactions included transactions undertaken for market-making, to service customers' needs, or for proprietary purposes, together with any related hedges. Transactions were marked to market through the income statement as "Net trading income". Non-trading transactions were those undertaken for hedging purposes as part of the Group's risk management strategy against cash flows, assets, liabilities or positions, and were accounted for on an equivalent basis to the underlying assets, liabilities or net positions. The income and expense of non-trading interest rate derivatives were recognised on an accrual basis in "Net interest income".

With effect from 1 January 2005, and in accordance with HKAS 39, derivatives are carried at their fair value. The method of recognising the resulting fair value gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. Details of the new accounting policy on derivatives and hedge accounting are set out in note 3(h).

The change in accounting policy was reflected by way of opening balance adjustments to certain reserves and re-designation of financial instruments. Comparative amounts have not been restated as this is prohibited by the transitional arrangements in HKAS 39.

(m) HKAS 40: Investment Property ("HKAS 40") HKAS 12: Income Taxes – HK(SIC) Interpretation 21 "Income Taxes – Recovery of Revalued Non-Depreciable Assets" ("HK(SIC)-Int 21")

In prior years, investment properties were carried at a valuation assessed by professional valuers on the basis of open market value. Surpluses arising on revaluation on a portfolio basis were credited to the investment property revaluation reserve. Deficits arising on revaluation on a portfolio basis were firstly set off against any previous revaluation surplus and thereafter taken to the income statement. Deferred tax was provided to the extent that the tax allowances already given would be clawed back if the properties were disposed of at their carrying value.

With effect from 1 January 2005, and in accordance with HKAS 40, investment properties are carried at fair value with the changes in fair value recognised directly in the income statement (in "net surplus on property revaluation"). Deferred tax is provided on revaluation surplus of investment properties in accordance with HK(SIC)-Int 21 on HKAS 12.

The change in accounting policies was reflected by way of prior year adjustment, and as permitted by HKAS 40, no restatement of comparative figures of 2004 was made.

4. CHANGES IN ACCOUNTING POLICIES (continued)

(n) HKAS 24: Related Party Disclosures ("HKAS 24")

In prior years, parties were considered to be related to the Group if the Group had the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence.

With effect from 1 January 2005, and in accordance with HKAS 24, the definition of related party has been expanded and this has affected the identification of related parties and some other related party disclosures. The scope has been expanded such that related parties include entities that are under the significant influence of a related party that is an individual (i.e. key management personnel, significant shareholders and/or their close family members) and post-employment benefit scheme which are for the benefit of employees of the Group or of any entity that is a related party of the Group. The clarification of the definition of related parties has resulted in more detailed disclosures on related parties transactions. Additionally, the new accounting standard requires the disclosure of the compensation of key management personnel.

The change in accounting policy has been applied retrospectively with comparatives restated.

(o) Change in presentation (HKAS 1: Presentation of Financial Statements ("HKAS 1") and HKAS 30: Disclosure in Financial Statements of Banks and Similar Financial Institutions ("HKAS 30"))

In prior years, there were no specific accounting standards governing the presentation of the financial statements of banks. Management, having regard to the overall clarity and the disclosure requirements of the Hong Kong Monetary Authority, exercised its judgement in deciding on the relative prominence given to each item presented on the face of the income statement and balance sheets.

With effect from 1 January 2005, and in accordance with HKAS 1 and HKAS 30, the Group has changed its presentation of certain items on the face of the income statement and the balance sheets:

- Share of profit of associates is stated net of tax to arrive at the Group's profit and loss before tax.
- Treasury bills (including Exchange Fund Bills) and certificates of deposit held are included in the four categories of financial instruments under HKAS 39.
- Placements with banks and other financial institutions maturing within one month are included in placements with banks and other financial institutions.
- Interest income, interest expense, and dividend income arising from trading assets and trading liabilities are reclassified from "Interest income", "Interest expense", "Other operating income" and "Fee income" respectively to "Net trading income". Similar income and expenses arising from financial instruments designated at fair value are reclassified from the relevant captions to "Net income from financial instruments designated at fair value".

These changes in presentation have been applied retrospectively except for those under HKAS 39.

5. ACCOUNTING ESTIMATES AND JUDGEMENTS

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

(a) Key sources of estimation uncertainty

Impairment allowances on loans and advances

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

5. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

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

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

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

(ii) Held-to-maturity investments

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

(iii) Income taxes

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

6. POSSIBLE IMPACTS OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE ANNUAL ACCOUNTING PERIOD ENDED 31 DECEMBER 2005

Up to the date of issue of these financial statements, the HKICPA has issued the following amendments, new standards and interpretations which are not yet effective for the accounting period ended 31 December 2005 and which have not been adopted in these accounts:

	Effective for accounting periods beginning on or after
HK(IFRIC)-Int 4: Determining whether an arrangement contains a lease	1 January 2006
Amendments to HKAS 39 Financial instruments: recognition and measurement	
– Cash flow hedge accounting of forecast intragroup transactions	1 January 2006
– Financial guarantee contracts	1 January 2006
Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:	
– HKAS 1: Presentation of financial statements	1 January 2006
– HKAS 27: Consolidated and separate financial statements	1 January 2006
– HKFRS 3: Business combinations	1 January 2006
HKFRS 7: Financial instruments: disclosures	1 January 2007
Amendment to HKAS 1 Presentation of financial statements: capital disclosures	1 January 2007

The Group is in the process of making an assessment of the impacts of these amendments, new standards and new interpretations in the period of initial applications. The Group anticipates that the adoption of the new standards is unlikely to have a significant impact on the Group's results of operations and financial position. HKFRS 7 requires more detailed qualitative and quantitative disclosure, primarily on fair value information and risk management, and this would affect only the level of details in the disclosure of the financial information, with no material impact on the financial statements or on the Group's accounting policies.

7. OPERATING PROFIT

The operating profit for the year is stated after taking account of:

(a) Interest income

	2005	2004 restated
Interest income on listed investments	216	1,045
Interest income on unlisted investments	6,118	3,013
Interest income on impaired financial assets	20	–
Other interest income	12,675	8,724
	19,029	12,782

(b) Interest expense

	2005	2004 restated
Interest expense on debt securities in issue maturing after five years	100	50
Interest expense on customer accounts maturing after five years	–	6
Interest expense on subordinated liabilities	36	–
Other interest expense	7,825	2,721
	7,961	2,777

(c) Net fee income

	2005	2004 restated
– stockbroking and related services	493	560
– retail investment products and funds under management	916	1,388
– insurance	116	101
– account services	225	214
– private banking	174	111
– remittances	141	125
– cards	705	598
– credit facilities	117	268
– trade services	375	360
– other	132	116
Fee income	3,394	3,841
Fee expense	(520)	(416)
	2,874	3,425

7. OPERATING PROFIT (continued)

(d) Net trading income

	2005	2004 restated
Dealing profits:		
– foreign exchange	785	975
– securities, derivatives and other trading activities	100	49
– income from insurance fund assets	–	89
	885	1,113
Interest income on trading assets:		
– listed investments	26	–
– unlisted investments	597	–
	623	–
Interest expense on trading liabilities:		
– interest expense on debt securities in issue maturing after five years	(26)	–
– interest expense on structured deposits maturing after five years	(17)	–
– other interest expense	(886)	–
	(929)	–
	579	1,113

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

	2005	2004
Net unrealised gain or loss arising from change in fair value	(57)	–
Interest income on financial instruments designated at fair value:		
– listed investments	4	–
– unlisted investments	57	–
	61	–
Interest expense on financial instruments designated at fair value:		
– subordinated liabilities	(22)	–
– other interest expense	(5)	–
	(27)	–
Dividend income:		
– listed investments	22	–
– unlisted investments	3	–
	25	–
	2	–

7. OPERATING PROFIT (continued)

(f) Dividend income

	2005	2004 restated
Dividend income:		
– listed investments	**48**	59
– unlisted investments	**12**	30
	60	89

(g) Net earned insurance premiums

2005	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Gross written premiums	**474**	**7,492**	**5**	**7,971**
Movement in unearned premiums	**19**	**–**	**–**	**19**
Gross earned premiums	**493**	**7,492**	**5**	**7,990**
Gross written premiums ceded to reinsurers	**(103)**	**(14)**	**–**	**(117)**
Reinsurers' share of movement in unearned premiums	**(8)**	**–**	**–**	**(8)**
Reinsurers' share of gross earned premiums	**(111)**	**(14)**	**–**	**(125)**
Net earned insurance premiums	**382**	**7,478**	**5**	**7,865**

2004	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Gross written premiums	519	3,864	174	4,557
Movement in unearned premiums	(15)	–	–	(15)
Gross earned premiums	504	3,864	174	4,542
Gross written premiums ceded to reinsurers	(106)	(14)	–	(120)
Reinsurers' share of movement in unearned premiums	(2)	–	–	(2)
Reinsurers' share of gross earned premiums	(108)	(14)	–	(122)
Net earned insurance premiums	396	3,850	174	4,420

(h) Other operating income

	2005	2004 restated
Rental income from investment properties	**207**	202
Change in value of in-force long-term assurance business	**316**	255
Other	**275**	316
	798	773

7. OPERATING PROFIT (continued)

(i) Net insurance claims incurred and movement in policyholder liabilities

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

2004	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
Claims, benefits and surrenders paid	129	337	8	474
Movement in provisions	16	3,138	160	3,314
Gross claims incurred and movement in policyholder liabilities	145	3,475	168	3,788
Reinsurers' share of claims, benefits and surrenders paid	(20)	(3)	–	(23)
Reinsurers' share of movement in provisions	7	–	–	7
Reinsurers' share of claims incurred and movement in policyholder liabilities	(13)	(3)	–	(16)
Net insurance claims incurred and movement in policyholder liabilities	132	3,472	168	3,772

7. OPERATING PROFIT (continued)

(j) Loan impairment (charges)/releases and other credit risk provisions

	Group 2005	Group 2004 restated	Bank 2005	Bank 2004 restated
Loan impairment (charges)/releases (note 20(b))				
– individually assessed	**(309)**	–	**(433)**	–
– collectively assessed				
– portfolio basis	**(122)**	–	**(123)**	–
– loans not individually identified as impaired	**(187)**	–	**(159)**	–
Net (charges)/releases for bad and doubtful debts (note 20(c))				
– specific provisions				
– individually assessed	**–**	141	**–**	115
– portfolio assessed	**–**	(176)	**–**	(178)
– general provisions	**–**	812	**–**	581
	(618)	777	**(715)**	518
Of which:				
– new and additional	**(1,070)**	(463)	**(1,022)**	(390)
– releases	**351**	1,131	**229**	850
– recoveries	**101**	109	**78**	58
	(618)	777	**(715)**	518

(k) Total operating expenses

	2005	2004 restated
Employee compensation and benefits:		
– salaries and other costs	**2,074**	2,017
– retirement benefit costs		
– defined benefit scheme (note 44(a))	**107**	148
– defined contribution scheme (note 44(b))	**30**	21
– share-based payments (note 45)	**70**	48
	2,281	2,234
General and administrative expenses:		
– rental expenses	**207**	193
– other premises and equipment	**751**	677
– other operating expenses	**1,018**	864
	1,976	1,734
Depreciation of premises, plant and equipment (note 25(a))	**280**	256
Amortisation of intangible assets (note 27(b))	**9**	8
	4,546	4,232
Cost efficiency ratio	**28.0%**	26.4%
Staff numbers by region*		
Hong Kong	**7,425**	7,228
Mainland and others	**420**	314
Total	**7,845**	7,542

* Full-time equivalent

7. OPERATING PROFIT (continued)

(l) The emoluments of the five highest paid individuals

(i) The aggregate emoluments

	2005	2004 restated
Salaries, allowances and benefits in kind	**14**	20
Retirement scheme contributions	**2**	2
Discretionary bonuses	**6**	5
Share-based payments	**2**	1
	24	28

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

HK$	**2005** Number of Individuals	2004 Number of Individuals
3,000,001 – 3,500,000	**–**	1
3,500,001 – 4,000,000	**1**	1
4,000,001 – 4,500,000	**2**	–
5,500,001 – 6,000,000	**2**	1
6,000,001 – 6,500,000	**–**	1
9,000,001 – 9,500,000	**–**	1
	5	5

The emoluments of the five highest paid individuals set out above include the emoluments of three (2004: three) Executive Directors. Their respective directors' emoluments are included in note 7(m).

7. OPERATING PROFIT (continued)

(m) Directors' emoluments

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

	Fees '000	Salaries, allowances and benefits in kind '000	Pension and pension contribution(3) '000	Discretionary Bonuses '000	Share-based payments(4) '000	Total **2005** '000	Total 2004 '000 restated
Executive Directors							
Mr Vincent H C Cheng (Ceased to be Vice-Chairman and Chief Executive on 25 May 05)	59(1)	2,009	150	3,750	–	5,968	9,286
Mr Raymond C F Or (Appointed as Vice-Chairman and Chief Executive on 25 May 05)	140(1)	3,030	294	–	–	3,464	80
Mr Roger K H Luk (Resigned on 6 Dec 04)	–	–	–	–	–	–	6,417
Mr Joseph C Y Poon	125	3,139	270	71	–	3,605	194
Mr W K Mok	125	3,750	406	470	1,011	5,762	5,509
Mr Patrick K W Chan (Appointed on 7 Dec 05)	10	173	19	45	26	273	–
Non-Executive Directors							
Mr M R P Smith (Appointed on 22 Apr 05)	139(1)	–	–	–	–	139	–
Mr D G Eldon (Retired on 21 Apr 05)	61(1)	–	–	–	–	61	135
The Honourable Lee Quo–Wei (Retired on 22 Apr 04)	–	–	–	–	–	–	45
Mr S J Glass	125(1)	–	–	–	–	125	80
Mr John C C Chan (2)	163	–	–	–	–	163	80
Dr Y T Cheng (2)	125	–	–	–	–	125	80
Dr Marvin K T Cheung (2)	195	–	–	–	–	195	53
Mr Jenkin Hui (2)	151	–	–	–	–	151	80
Mr Peter T C Lee (2)	151	–	–	–	–	151	80
Dr Eric K C Li (2)	225	–	–	–	–	225	80
Dr Vincent H S Lo	125	–	–	–	–	125	80
Dr David W K Sin (2)	125	–	–	–	–	125	80
Mr Richard Y S Tang (2)	195	–	–	–	–	195	80
Mr Peter T S Wong (Appointed on 25 May 05)	76(1)	–	–	–	–	76	–
Past Directors	–	–	2,077	–	–	2,077	2,207
	2,315	12,101	3,216	4,336	1,037	23,005	24,646
2004 (restated)	1,327	15,025	3,511	3,980	803		

Notes :

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

(2) Independent Non-Executive Director.

(3) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.077 million in 2005. The Bank made contributions during 2005 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.

(4) The above emoluments include the value of share option granted to certain directors under the Group share option plan as estimated at the date of grant and the fair value of restricted share under the Group restricted share plan. The details of these benefits in kind are also set out in note 45.

7. OPERATING PROFIT (continued)

(n) Auditors' remuneration

	Group		Bank	
	2005	2004	**2005**	2004
Statutory audit services	**11**	9	**8**	7
Non-statutory audit services	**7**	5	**7**	5
	18	14	**15**	12

8. PROFIT ON DISPOSAL OF FIXED ASSETS AND FINANCIAL INVESTMENTS

	2005	2004 restated
Profit on disposal of available-for-sale securities:		
– realisation of amounts previously recognised in reserves at 1 January	**611**	–
– net losses arising in current year	**(153)**	–
	458	–
Profit on disposal of long-term financial investments:		
– realisation of amounts previously recognised in reserves at 1 January	**–**	371
– net gains arising in current year	**–**	41
	–	412
Profit less loss on disposal of fixed assets	**19**	30
	477	442

9. NET SURPLUS ON PROPERTY REVALUATION

	2005	2004 restated
Surplus of revaluation on investment properties (note 24(a))	**1,160**	–
Reversal of revaluation deficit on premises (note 25(a))	**153**	146
	1,313	146

10. TAX EXPENSES

(a) Taxation in the consolidated income statement represents:

	2005	2004 restated
Current tax – provision for Hong Kong profits tax		
Tax for the year	**1,501**	1,522
Current tax – taxation outside Hong Kong		
Tax for the year	**12**	7
Deferred tax		
Origination and reversal of temporary differences (note 35(b))	**282**	182
Total tax expenses	**1,795**	1,711
Effective tax rate	**13.4%**	12.9%

The current tax provision is based on the estimated assessable profit for 2005, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 17.5 per cent (the same rate as in 2004). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used.

10. TAX EXPENSES (continued)

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

	2005	2004 restated
Profit before tax	13,358	13,283
Notional tax on profit before tax, calculated at Hong Kong tax rate of 17.5% (2004: 17.5%)	2,338	2,325
Tax effect of :		
– different tax rates in other countries/areas	(291)	(269)
– non-deductible expenses	38	28
– share of results of associates	(88)	(17)
– non-taxable income	(198)	(237)
– previous tax losses utilized in current year	–	(6)
– investment in partnerships	–	(101)
– others	(4)	(12)
Actual charge for taxation	1,795	1,711

11. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to shareholders, HK$10,080 million (2004: HK$10,987 million) has been dealt with in the accounts of the Bank.

Reconciliation of the above amount to the Bank's profit for the year:

	2005	2004 restated
Amount of consolidated profit attributable to shareholders dealt with in the Bank's accounts	9,423	9,909
Dividends declared during the year by subsidiaries from retained profits	657	1,078
The Bank's profit for the year (note 38)	10,080	10,987

12. EARNINGS PER SHARE

The calculation of earnings per share in 2005 is based on earnings of HK$11,342 million (HK$11,364 million in 2004) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2004).

13. DIVIDENDS PER SHARE

(a) Dividends attributable to the year

	2005		2004	
	per share HK$	HK$ million	per share HK$	HK$ million
First interim	1.10	2,103	1.10	2,103
Second interim	1.10	2,103	1.10	2,103
Third interim	1.10	2,103	1.10	2,103
Fourth interim	1.90	3,633	1.90	3,633
	5.20	9,942	5.20	9,942

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

	2005	2004
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK$1.90 per share (2004: Third interim dividend of HK$1.80 per share)	3,633	3,441

14. SEGMENTAL ANALYSIS

(a) By customer group

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

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

2005	Personal Financial Services	Commercial Banking	Corporate & Institutional Banking	Treasury	Other	Inter-segment elimination	Total
Net interest income	7,100	1,587	612	858	514	397	11,068
Net fee income	2,101	666	79	(21)	49	–	2,874
Net trading income	367	134	6	503	–	(431)	579
Net income/(loss) from financial instruments designated at fair value	(33)	–	–	5	(4)	34	2
Dividend income	5	5	–	–	50	–	60
Net earned insurance premiums	7,642	223	–	–	–	–	7,865
Other operating income	562	25	4	–	207	–	798
Inter-segment income	–	–	–	–	308	(308)	–
Total operating income	17,744	2,640	701	1,345	1,124	(308)	23,246
Net insurance claims incurred and movement in policyholder liabilities	(6,964)	(50)	–	–	–	–	(7,014)
Net operating income before loan impairment (charges)/releases and other credit risk provisions	10,780	2,590	701	1,345	1,124	(308)	16,232
Loan impairment (charges)/releases and other credit risk provisions	232	(803)	(47)	–	–	–	(618)
Net operating income	11,012	1,787	654	1,345	1,124	(308)	15,614
Total operating expenses*	(3,086)	(903)	(142)	(157)	(258)	–	(4,546)
Inter-segment expenses	(258)	(40)	(5)	(5)	–	308	–
Operating profit	7,668	844	507	1,183	866	–	11,068
Profit on disposal of fixed assets and financial investments	–	–	–	(217)	694	–	477
Net surplus on property revaluation	–	–	–	–	1,313	–	1,313
Share of profits from associates	18	234	–	106	142	–	500
Profit before tax	7,686	1,078	507	1,072	3,015	–	13,358
Share of pre-tax profit	57.5%	8.1%	3.8%	8.0%	22.6%	–	100.0%
Operating profit excluding inter-segment transactions	7,926	884	512	1,188	558	–	11,068
Operating profit excluding loan impairment (charges)/releases and other credit risk provisions	7,436	1,647	554	1,183	866	–	11,686
* Depreciation/amortisation included in operating expenses	(103)	(13)	(3)	(2)	(168)	–	(289)
Total assets	152,086	54,319	77,514	266,645	30,256	–	580,820
Total liabilities	372,941	77,249	31,672	33,541	21,687	–	537,090
Investments in associates	116	1,454	–	657	702	–	2,929
Capital expenditure incurred during the year	107	20	7	2	95	–	231

14. SEGMENTAL ANALYSIS (continued)

(a) By customer group (continued)

2004	Personal Financial Services	Commercial Banking	Corporate & Institutional Banking	Treasury	Other	Inter-segment elimination	Total
Net interest income	6,016	1,332	596	1,854	207	–	10,005
Net fee income	2,465	731	208	(19)	40	–	3,425
Net trading income	276	125	7	706	(1)	–	1,113
Dividend income	28	6	–	–	55	–	89
Net earned insurance premiums	4,177	243	–	–	–	–	4,420
Other operating income	531	27	2	1	212	–	773
Inter-segment income	–	–	–	–	320	(320)	–
Total operating income	13,493	2,464	813	2,542	833	(320)	19,825
Net insurance claims incurred and movement in policyholder liabilities	(3,691)	(81)	–	–	–	–	(3,772)
Net operating income before loan impairment releases and other credit risk provisions	9,802	2,383	813	2,542	833	(320)	16,053
Loan impairment releases and other credit risk provisions	51	596	130	–	–	–	777
Net operating income	9,853	2,979	943	2,542	833	(320)	16,830
Total operating expenses*	(2,826)	(850)	(122)	(158)	(276)	–	(4,232)
Inter-segment expenses	(256)	(53)	(6)	(5)	–	320	–
Operating profit	6,771	2,076	815	2,379	557	–	12,598
Profit on disposal of fixed assets and financial investments	–	–	–	(4)	446	–	442
Net surplus on property revaluation	–	–	–	–	146	–	146
Share of profits from associates	4	45	–	20	28	–	97
Profit before tax	6,775	2,121	815	2,395	1,177	–	13,283
Share of pre-tax profit	51.0%	16.0%	6.1%	18.0%	8.9%	–	100.0%
Operating profit excluding inter-segment transactions	7,027	2,129	821	2,384	237	–	12,598
Operating profit excluding loan impairment releases and other credit risk provisions	6,720	1,480	685	2,379	557	–	11,821
*Depreciation/amortisation included in operating expenses	(104)	(18)	(2)	(2)	(138)	–	(264)
Total assets	142,579	46,684	77,353	256,368	23,963	–	546,947
Total liabilities	353,062	77,680	25,150	21,553	27,721	–	505,166
Investments in associates	94	1,123	–	491	591	–	2,299
Capital expenditure incurred during the year	104	17	2	2	23	–	148

14. SEGMENTAL ANALYSIS (continued)

(b) By geographical region

The geographical regions in this analysis are classified by the location of the principal operations of the subsidiary companies or, in the case of the Bank itself, by the location of the branches responsible for reporting the results or advancing the funds.

	2005	%	2004 restated	%
Total operating income				
Hong Kong	21,377	92	18,105	91
Americas	1,644	7	1,594	8
Mainland and other	225	1	126	1
	23,246	100	19,825	100
Profit before tax				
Hong Kong	11,253	84	11,590	87
Americas	1,614	12	1,566	12
Mainland and other	491	4	127	1
	13,358	100	13,283	100
Capital expenditure incurred during the year				
Hong Kong	206	89	143	97
Americas	–	–	–	–
Mainland and other	25	11	5	3
	231	100	148	100
Total assets				
Hong Kong	497,406	86	460,612	84
Americas	60,845	10	69,675	13
Mainland and other	22,569	4	16,660	3
	580,820	100	546,947	100
Total liabilities				
Hong Kong	520,260	97	490,665	97
Americas	9,395	2	9,315	2
Mainland and other	7,435	1	5,186	1
	537,090	100	505,166	100
Contingent liabilities and commitments				
Hong Kong	137,536	97	123,563	98
Americas	–	–	–	–
Mainland and other	3,973	3	2,925	2
	141,509	100	126,488	100

15. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY

The maturity analysis is based on the remaining period at the balance sheet date to the contractual maturity date, with the exception of the trading portfolios that may be sold before maturity and accordingly recorded as "Repayable on demand".

	Group						
2005	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Undated	Total
Assets							
Cash and balances with banks and other financial institutions	9,201	–	–	–	–	–	9,201
Placings with and advances to banks and other financial institutions	11,824	52,661	4,597	204	–	–	69,286
Trading assets	12,600	–	–	–	–	–	12,600
Financial assets designated at fair value	–	52	113	1,601	2,262	1,999	6,027
Derivative financial instruments	1,246	106	105	233	25	–	1,715
Advances to customers	14,330	26,348	33,457	91,279	95,266	–	260,680
Financial investments	–	14,214	35,010	126,831	12,528	1,321	189,904
Investments in associates	–	–	–	–	–	2,929	2,929
Investment properties	–	–	–	–	–	4,273	4,273
Premises, plant and equipment	–	–	–	–	–	6,750	6,750
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	594	594
Intangible assets	–	–	–	–	–	1,636	1,636
Other assets	8,589	4,589	1,360	28	6	653	15,225
	57,790	97,970	74,642	220,176	110,087	20,155	580,820
Liabilities							
Current, savings and other deposit accounts	233,907	190,206	5,916	966	–	–	430,995
Deposits from banks	1,664	10,370	9	–	–	–	12,043
Trading liabilities	45,804	–	–	–	–	–	45,804
Financial liabilities designated at fair value	–	–	–	–	994	(27)	967
Derivative financial instruments	1,307	22	81	346	36	–	1,792
Certificates of deposit and other debt securities in issue	–	233	1,952	7,788	50	–	10,023
Other liabilities	6,706	6,661	442	48	99	182	14,138
Liabilities to customers under investment contracts	–	–	–	–	–	561	561
Liabilities to customers under insurance contracts	–	–	–	–	–	15,335	15,335
Deferred tax and current tax liabilities	370	2	78	–	–	1,471	1,921
Subordinated liabilities	–	–	–	–	3,511	–	3,511
	289,758	207,494	8,478	9,148	4,690	17,522	537,090

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

	Group						
2004	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Undated	Total
Assets							
Cash and balances with banks and other financial institutions	7,248	–	–	–	–	–	7,248
Placings with and advances to banks and other financial institutions	4,897	63,926	6,002	254	–	–	75,079
Trading assets	4,232	–	–	–	–	–	4,232
Derivative financial instruments	1,684	–	–	–	–	–	1,684
Advances to customers	13,691	24,734	31,478	94,906	86,744	–	251,553
Financial investments	521	16,918	37,321	114,135	12,881	2,930	184,706
Investments in associates	–	–	–	–	–	2,299	2,299
Investment properties	–	–	–	–	–	3,383	3,383
Premises, plant and equipment	–	–	–	–	–	5,558	5,558
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	609	609
Intangible assets	–	–	–	–	–	1,266	1,266
Other assets	5,055	2,641	1,172	341	44	77	9,330
	37,328	108,219	75,973	209,636	99,669	16,122	546,947
Liabilities							
Current, savings and other deposit accounts	304,442	128,899	7,725	5,741	653	–	447,460
Deposits from banks	2,325	9,609	–	–	–	–	11,934
Trading liabilities	5,840	–	–	–	–	–	5,840
Derivative financial instruments	1,273	–	–	–	–	–	1,273
Certificates of deposit and other debt securities in issue	–	865	7,697	6,736	757	–	16,055
Other liabilities	5,328	5,313	340	261	267	231	11,740
Liabilities to customers under investment contracts	–	–	–	–	–	540	540
Liabilities to customers under insurance contracts	–	–	–	–	–	8,656	8,656
Deferred tax and current tax liabilities	–	217	297	–	–	1,154	1,668
	319,208	144,903	16,059	12,738	1,677	10,581	505,166

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

	Bank						
2005	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Undated	Total
Assets							
Cash and balances with banks and other financial institutions	9,173	–	–	–	–	–	9,173
Placings with and advances to banks and other financial institutions	9,258	36,027	1,031	204	–	–	46,520
Trading assets	9,153	–	–	–	–	–	9,153
Financial assets designated at fair value	–	–	50	1,442	151	4	1,647
Derivative financial instruments	1,226	106	101	165	25	–	1,623
Advances to customers	14,031	25,367	29,649	77,191	68,872	–	215,110
Amounts due from subsidiaries	47,713	43,616	–	–	–	1,932	93,261
Financial investments	–	12,031	28,366	98,008	3,656	59	142,120
Investments in subsidiaries	–	–	–	–	–	2,104	2,104
Investments in associates	–	–	–	–	–	1,634	1,634
Investment properties	–	–	–	–	–	2,644	2,644
Premises, plant and equipment	–	–	–	–	–	4,798	4,798
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	594	594
Intangible assets	–	–	–	–	–	71	71
Other assets	8,282	3,951	1,067	8	–	528	13,836
	98,836	121,098	60,264	177,018	72,704	14,368	544,288
Liabilities							
Current, savings and other deposit accounts	232,765	181,890	5,897	966	–	–	421,518
Deposits from banks	1,664	10,370	9	–	–	–	12,043
Trading liabilities	45,804	–	–	–	–	–	45,804
Financial liabilities designated at fair value	–	–	–	–	994	(27)	967
Derivative financial instruments	1,288	22	80	345	36	–	1,771
Certificates of deposit and other debt securities in issue	–	233	1,952	7,825	50	–	10,060
Amounts due to subsidiaries	419	1,014	–	–	–	–	1,433
Other liabilities	6,702	6,626	436	20	–	1,328	15,112
Deferred tax and current tax liabilities	370	2	46	–	–	885	1,303
Subordinated liabilities	–	–	–	–	3,511	–	3,511
	289,012	200,157	8,420	9,156	4,591	2,186	513,522

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

	Bank						
2004	Repayable on demand	Three months or less but not on demand	Three months to one year	One year to five years	Over five years	Undated	Total
Assets							
Cash and balances with banks and other financial institutions	7,225	–	–	–	–	–	7,225
Placings with and advances to banks and other financial institutions	4,275	30,902	1,740	254	–	–	37,171
Trading assets	4,147	–	–	–	–	–	4,147
Derivative financial instruments	1,684	–	–	–	–	–	1,684
Advances to customers	13,190	23,496	26,939	76,639	58,526	–	198,790
Amounts due from subsidiaries	55,826	51,454	–	–	–	2,044	109,324
Financial investments	–	12,911	32,239	89,785	6,789	1	141,725
Investments in subsidiaries	–	–	–	–	–	2,004	2,004
Investments in associates	–	–	–	–	–	1,634	1,634
Investment properties	–	–	–	–	–	2,046	2,046
Premises, plant and equipment	–	–	–	–	–	4,013	4,013
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	609	609
Intangible assets	–	–	–	–	–	17	17
Other assets	4,860	2,079	864	83	21	233	8,140
	91,207	120,842	61,782	166,761	65,336	12,601	518,529
Liabilities							
Current, savings and other deposit accounts	303,521	120,429	7,703	5,741	653	–	438,047
Deposits from banks	2,323	9,609	–	–	–	–	11,932
Trading liabilities	5,840	–	–	–	–	–	5,840
Derivative financial instruments	1,272	–	–	–	–	–	1,272
Certificates of deposit and other debt securities in issue	–	899	7,697	6,757	757	–	16,110
Amounts due to subsidiaries	187	949	–	–	–	–	1,136
Other liabilities	5,435	5,252	186	225	170	1,394	12,662
Deferred tax and current tax liabilities	–	211	255	–	–	766	1,232
	318,578	137,349	15,841	12,723	1,580	2,160	488,231

16. CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Cash in hand	**4,772**	5,037	**4,772**	5,037
Balances with central banks	**303**	692	**303**	692
Balances with banks and other financial institutions	**4,126**	1,519	**4,098**	1,496
	9,201	7,248	**9,173**	7,225

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

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Placings with and advances to banks and other financial institutions maturing within one month	**54,338**	57,597	**38,054**	29,846
Placings with and advances to banks and other financial institutions maturing after one month	**14,948**	17,482	**8,466**	7,325
	69,286	75,079	**46,520**	37,171

18. TRADING ASSETS

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Treasury bills	**2,594**	2,347	**2,594**	2,347
Certificates of deposit	**538**	19	**453**	–
Other debt securities	**9,440**	1,822	**6,078**	1,756
Debt securities	**12,572**	4,188	**9,125**	4,103
Equity shares	**28**	44	**28**	44
	12,600	4,232	**9,153**	4,147
Debt securities:				
– listed in Hong Kong	**767**	693	**767**	693
– listed outside Hong Kong	**–**	7	**–**	–
	767	700	**767**	693
– unlisted	**11,805**	3,488	**8,358**	3,410
	12,572	4,188	**9,125**	4,103
Equity shares:				
– listed in Hong Kong	**17**	10	**17**	10
– unlisted	**11**	34	**11**	34
	28	44	**28**	44
	12,600	4,232	**9,153**	4,147
Debt securities				
Issued by public bodies:				
– central governments and central banks	**5,625**	4,027	**5,488**	4,027
– other public sector entities	**1,489**	2	**653**	1
	7,114	4,029	**6,141**	4,028
Issued by other bodies:				
– banks and other financial institutions	**2,836**	78	**1,172**	–
– corporate entities	**2,622**	81	**1,812**	75
	5,458	159	**2,984**	75
	12,572	4,188	**9,125**	4,103
Equity shares				
Issued by corporate entities	**28**	44	**28**	44
	12,600	4,232	**9,153**	4,147

18. TRADING ASSETS (continued)

Following the adoption of HKAS 39 in 2005, certain held-to-maturity debt securities were re-designated as trading assets on 1 January 2005. There was no such re-designation in 2004 as retrospective application of HKAS 39 is not permitted.

The fair value of these re-designated trading assets was HK$12,505 million at 1 January 2005 and the carrying value of these assets at 31 December 2004 was HK$12,291 million.

19. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Bank	
	2005	2004	**2005**	2004
Certificates of deposit	194	–	88	–
Other debt securities	4,075	–	1,559	–
Debt securities	4,269	–	1,647	–
Equity shares	1,758	–	–	–
	6,027	–	1,647	–
Debt securities:				
– listed in Hong Kong	100	–	99	–
– listed outside Hong Kong	22	–	–	–
	122	–	99	–
– unlisted	4,147	–	1,548	–
	4,269	–	1,647	–
Equity shares:				
– listed in Hong Kong	732	–	–	–
– listed outside Hong Kong	979	–	–	–
	1,711	–	–	–
– unlisted	47	–	–	–
	1,758	–	–	–
	6,027	–	1,647	–
Debt securities				
Issued by public bodies:				
– central governments and central banks	865	–	854	–
– other public sector entities	295	–	241	–
	1,160	–	1,095	–
Issued by other bodies:				
– banks and other financial institutions	2,937	–	409	–
– corporate entities	172	–	143	–
	3,109	–	552	–
	4,269	–	1,647	–
Equity shares				
Issued by corporate entities	1,758	–	–	–
	6,027	–	1,647	–

19. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE (continued)

Financial assets are designated at fair value at inception, usually together with the related liabilities or derivative financial instruments, primarily for the purpose of eliminating or significantly reducing the accounting mismatch. The figures also include those financial assets of the insurance funds designated at fair value for backing policyholder liabilities.

Following the adoption of HKAS 39 in 2005, certain financial assets were re-designated as financial assets at fair value on 1 January 2005. There was no such re-designation in 2004 as retrospective application of HKAS 39 is not permitted.

The carrying amount of financial assets designated at fair value at 1 January 2005 was HK$4,292 million and these assets were classified as following at 31 December 2004.

Classified as:	
Held-to-maturity securities	2,429
Financial assets of insurance funds	1,768
Carrying amount at 31 December 2004	4,197

20. ADVANCES TO CUSTOMERS

(a) Advances to customers

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Gross advances to customers	**261,714**	252,564	**215,982**	199,530
Less:				
Loans impairment allowances (note 20(b))				
– individually assessed	**(524)**	–	**(453)**	–
– collectively assessed	**(510)**	–	**(419)**	–
Provisions for bad and doubtful debts (note 20(c))				
– specific provisions				
– individually assessed	–	(692)	–	(484)
– portfolio assessed	–	(30)	–	(30)
– general provisions	–	(289)	–	(226)
	260,680	251,553	**215,110**	198,790
Included in advances to customers are:				
– trade bills	**3,024**	3,053	**3,024**	3,053
Less:				
– loans impairment allowances	**(14)**	–	**(14)**	–
– provisions for bad and doubtful debts	–	(8)	–	(8)
	3,010	3,045	**3,010**	3,045

20. ADVANCES TO CUSTOMERS (continued)

(a) Advances to customers (continued)

Total loans impairment allowances / total provisions as a percentage of gross advances to customers are as follows:

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
	%	%	**%**	%
Loans impairment allowances				
– individually assessed	**0.20**	–	**0.21**	–
– collectively assessed				
– portfolio basis	**0.01**	–	**0.01**	–
– loans not individually identified as impaired	**0.18**	–	**0.18**	–
Total loans impairment allowances	**0.39**	–	**0.40**	–
Provisions for bad and doubtful debts				
– specific provisions				
– individually assessed	**–**	0.27	**–**	0.24
– portfolio assessed	**–**	0.01	**–**	0.02
– general provisions	**–**	0.12	**–**	0.11
Total provisions	**–**	0.40	**–**	0.37

(b) Loans impairment allowances against advances to customers

	Group			
		Collectively assessed		
2005	Individually assessed	Portfolio basis	Loans not individually identified as impaired	Total
At 1 January 2005 (restated)	692	30	289	1,011
Amounts written off	(510)	(166)	–	(676)
Recoveries of advances written off in previous years	53	48	–	101
New impairment allowances charged to income statement (note 7(j))	707	176	187	1,070
Impairment allowances released to income statement (note 7(j))	(398)	(54)	–	(452)
Unwind of discount of loans impairment allowances	(20)	–	–	(20)
At 31 December 2005	524	34	476	1,034

20. ADVANCES TO CUSTOMERS (continued)

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

	Bank			
		Collectively assessed		
2005	Individually assessed	Portfolio basis	Loans not individually identified as impaired	Total
At 1 January 2005 (restated)	**484**	**30**	**226**	**740**
Amounts written off	**(486)**	**(166)**	**–**	**(652)**
Recoveries of advances written off in previous years	**31**	**47**	**–**	**78**
New impairment allowances charged to income statement (note 7(j))	**687**	**176**	**159**	**1,022**
Impairment allowances released to income statement (note 7(j))	**(254)**	**(53)**	**–**	**(307)**
Unwind of discount of loans impairment allowances	**(9)**	**–**	**–**	**(9)**
At 31 December 2005	**453**	**34**	**385**	**872**

(c) Provisions against advances to customers

	Group			
	Specific Provision			
2004	Individually assessed	Portfolio assessed	General provision	Total
At 1 January 2004 (restated)	1,238	26	1,101	2,365
Amounts written off	(480)	(206)	–	(686)
Recoveries of advances written off in previous years	75	34	–	109
New provisions charged to income statement (note 7(j))	253	210	–	463
Provisions released to income statement (note 7(j))	(394)	(34)	(812)	(1,240)
At 31 December 2004 (restated)	692	30	289	1,011

	Bank			
	Specific Provision			
2004	Individually assessed	Portfolio assessed	General provision	Total
At 1 January 2004 (restated)	909	25	807	1,741
Amounts written off	(336)	(205)	–	(541)
Recoveries of advances written off in previous years	26	32	–	58
New provisions charged to income statement (note 7(j))	180	210	–	390
Provisions released to income statement (note 7(j))	(295)	(32)	(581)	(908)
At 31 December 2004 (restated)	484	30	226	740

20. ADVANCES TO CUSTOMERS (continued)

(d) Impaired advances/non-performing advances to customers and allowances

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Gross impaired advances	1,433		1,043	
Loans impairment allowances	(558)		(487)	
Net impaired advances	875		556	
Loans impairment allowances as a percentage of gross impaired advances	38.9%		46.7%	
Gross impaired advances as a percentage of gross advances to customers	0.5%		0.5%	
Gross non-performing advances		1,793		1,048
Specific provisions		(722)		(514)
Net non-performing advances		1,071		534
Specific provisions as a percentage of gross non-performing advances		40.3%		49.0%
Gross non-performing advances as a percentage of gross advances to customers		0.7%		0.5%

Impaired loans and advances are mainly individually assessed loans with objective evidence of impairment. Impairment allowances are made to write down the carrying value of the advances to the discounted value of future recoverable amounts, including the realisation of collateral.

Advances are designated as non-performing as soon as management has doubts as to the ultimate recoverability of principal or interest. Except in certain limited circumstances, all advances on which principal or interest is overdue for more than three months are classified as non-performing. Non-performing advances also include advances that are not yet overdue for more than three months but are considered doubtful.

(e) Overdue advances

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

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

20. ADVANCES TO CUSTOMERS (continued)

(e) Overdue advances (continued)

	Group		Bank	
2004	restated	%	restated	%
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– six months or less but over three months	587	0.2	230	0.1
– one year or less but over six months	304	0.1	124	0.1
– over one year	430	0.2	266	0.1
	1,321	0.5	620	0.3

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

(f) Rescheduled advances

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

	Group		Bank	
		%		%
2005	**361**	**0.1**	**176**	**0.1**
2004 (restated)	1,512	0.6	1,257	0.6

Rescheduled advances to customers are stated net of any advances that have subsequently become overdue for over three months and are included in overdue advances to customers set out in note 20(e) above.

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

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area which is different from that of the counterparty. At 31 December 2005, over 90 per cent of the Group's advances to customers, including related impaired advances and overdue advances, were classified under Hong Kong (position unchanged from that at 31 December 2004).

20. ADVANCES TO CUSTOMERS (continued)

(h) Gross advances to customers by industry sector

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

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	**16,446**	12,818	**16,168**	12,020
– property investment	**45,964**	44,732	**43,656**	41,745
– financial concerns	**968**	3,996	**961**	3,986
– stockbrokers	**221**	314	**221**	314
– wholesale and retail trade	**5,562**	5,460	**5,546**	5,419
– manufacturing	**7,761**	4,384	**7,633**	4,217
– transport and transport equipment	**11,919**	11,173	**3,173**	2,984
– other	**21,628**	22,010	**20,518**	20,615
	110,469	104,887	**97,876**	91,300
Individuals				
– advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**22,879**	26,386	**782**	927
– advances for the purchase of other residential properties	**81,318**	79,987	**71,055**	66,702
– credit card advances	**7,735**	6,534	**7,735**	6,534
– other	**7,563**	7,122	**7,478**	6,992
	119,495	120,029	**87,050**	81,155
Total gross advances for use in Hong Kong	**229,964**	224,916	**184,926**	172,455
Trade finance	**15,874**	15,539	**15,874**	12,651
Gross advances for use outside Hong Kong	**15,876**	12,109	**15,182**	14,424
Gross advances to customers (note 20(a))	**261,714**	252,564	**215,982**	199,530

(i) Net investments in finance leases

Advances to customers include net investments in equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases. The contracts usually run for an initial period of 5 to 20 years, with an option for acquiring the leased asset at nominal value at the end of the lease period. The total minimum lease payments receivable and their present value at the year-end are as follows:

	Group	
	2005	2004
Finance leases	**82**	68
Hire purchase contracts	**9,569**	8,955
	9,651	9,023

20. ADVANCES TO CUSTOMERS (continued)

(i) Net investments in finance leases (continued)

2005	Group Present value of minimum lease payments receivable	Group Interest income relating to future periods	Group Total minimum lease payments receivable
Amounts receivable:			
– within one year	**808**	**451**	**1,259**
– after one year but within five years	**2,283**	**1,485**	**3,768**
– after five years	**6,591**	**2,624**	**9,215**
	9,682	**4,560**	**14,242**
Loans impairment allowances	**(31)**		
Net investments in finance leases and hire purchase contracts	**9,651**		

2004	Group Present value of minimum lease payments receivable	Group Interest income relating to future periods	Group Total minimum lease payments receivable
Amounts receivable:			
– within one year	897	205	1,102
– after one year but within five years	2,553	605	3,158
– after five years	5,584	828	6,412
	9,034	1,638	10,672
Provision for bad and doubtful debt	(11)		
Net investments in finance leases and hire purchase contracts	9,023		

At 31 December 2005, the Bank has finance leases with a present value amounting to HK$0.6 million (2004: Nil). There was no hire purchase contracts maintained by the Bank at the balance sheet date (2004: Nil).

21. FINANCIAL INVESTMENTS

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Available-for-sale at fair value:				
– debt securities	**177,813**	–	**142,067**	–
– equity shares	**1,360**	–	**53**	–
Long-term equity shares at fair value	**–**	1,838	**–**	2
Other financial investments attributable to policyholders:				
– debt securities at fair value	**–**	676	**–**	–
– equity shares at fair value	**–**	1,092	**–**	–
Held-to-maturity debt securities at amortised cost	**10,731**	181,100	**–**	141,723
	189,904	184,706	**142,120**	141,725
Fair value of held-to-maturity debt securities	**10,778**	182,577	**–**	142,708
Treasury bills	**4,816**	4,280	**4,816**	3,923
Certificates of deposit	**27,048**	35,424	**23,118**	30,688
Other debt securities	**156,680**	142,072	**114,133**	107,112
Debt securities	**188,544**	181,776	**142,067**	141,723
Equity shares	**1,360**	2,930	**53**	2
	189,904	184,706	**142,120**	141,725
Debt securities:				
– listed in Hong Kong	**3,008**	5,757	**2,967**	5,720
– listed outside Hong Kong	**1,947**	28,497	**836**	1,629
	4,955	34,254	**3,803**	7,349
– unlisted	**183,589**	147,522	**138,264**	134,374
	188,544	181,776	**142,067**	141,723
Equity shares:				
– listed in Hong Kong	**1,049**	2,040	**–**	–
– listed outside Hong Kong	**186**	503	**–**	–
	1,235	2,543	**–**	–
– unlisted	**125**	387	**53**	2
	1,360	2,930	**53**	2
	189,904	184,706	**142,120**	141,725
Fair value of listed financial investments	**6,209**	36,927	**3,803**	7,451

21. FINANCIAL INVESTMENTS (continued)

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Debt securities				
Issued by public bodies:				
– central governments and central banks	**15,981**	20,134	**15,030**	18,934
– other public sector entities	**8,667**	13,932	**7,010**	9,780
	24,648	34,066	**22,040**	28,714
Issued by other bodies:				
– banks and other financial institutions	**149,557**	128,051	**109,405**	98,074
– corporate entities	**14,339**	19,659	**10,622**	14,935
	163,896	147,710	**120,027**	113,009
	188,544	181,776	**142,067**	141,723
Equity shares				
Issued by corporate entities	**1,360**	2,930	**53**	2
	189,904	184,706	**142,120**	141,725

There was no disposal on held-to-maturity debt securities during the year (2004: Debt securities intended to be held to maturity with an amortised cost of HK$233 million were disposed of prior to maturity and the related loss recognised was HK$5 million).

On adoption of HKAS 39 on 1 January 2005, with the exception of the portfolio of debt securities for life insurance funds, the Group has re-designated all held-to-maturity debt securities with carrying amount of HK$175,002 million at 31 December 2004 as available-for-sale securities, trading assets and financial assets designated at fair value with the carrying amount at 1 January 2005 as follows:

	Group
Available-for-sale financial assets	160,979
Trading assets	12,505
Financial assets designated at fair value	2,524
Carrying amount at 1 January 2005	176,008

In addition, the financial investments attributable to policyholders were re-designated as financial assets designated at fair value with the carrying amount of HK$1,768 million at 1 January 2005.

There was no such re-designation in 2004 as retrospective application of HKAS 39 is not permitted.

22. INVESTMENTS IN SUBSIDIARIES

The principal subsidiaries of the Bank are:

Name of company	Place of incorporation	Principal activities	Issued equity capital
Hang Seng Finance Limited	Hong Kong	Lending	HK$1,000,000,000
Hang Seng Credit Limited	Hong Kong	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	Trustee service	HK$3,000,000
Hang Seng (Nominee) Limited	Hong Kong	Nominee service	HK$100,000
Hang Seng Life Limited	Hong Kong	Retirement benefits and life assurance	HK$470,000,000
Hang Seng Insurance Company Limited	Hong Kong	General insurance	HK$84,184,570
Hang Seng Asset Management Pte Ltd	Singapore	Fund management	SG$2,000,000
Hang Seng Investment Management Limited	Hong Kong	Fund management	HK$10,000,000
Haseba Investment Company Limited	Hong Kong	Investment holding	HK$6,000
Hang Seng Securities Limited	Hong Kong	Stockbroking	HK$26,000,000
Yan Nin Development Company Limited	Hong Kong	Investment holding	HK$100,000
HSI Services Limited	Hong Kong	Compilation and dissemination of the Hang Seng share index	HK$10,000
Hang Seng Real Estate Management Limited	Hong Kong	Property management	HK$10,000

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

23. INVESTMENTS IN ASSOCIATES

	Group		Bank	
	2005	2004 restated	**2005**	2004
Unlisted investments, at cost	–	–	**1,634**	1,634
Share of net assets	**2,611**	1,988	–	–
Goodwill	**318**	311	–	–
	2,929	2,299	**1,634**	1,634

The principal associates are:

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

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

23. INVESTMENTS IN ASSOCIATES (continued)

In accordance with HKAS 28, an associate is an entity over which the investor has significant influence, including the power to participate in the financial and operating policy decisions without controlling the management of the investee. Usually a holding of less than 20 per cent is presumed not to have significant influence, unless such influence can be clearly demonstrated, and is treated on an investment basis, with the holding recognised at cost and dividends accounted for as declared.

The Group's investment in Industrial Bank Co., Ltd. (IB) has been accounted for as an associate using the equity method as the Group has representation in both the Board and Executive Committee of IB, and the ability to participate in the decision making process. The Group has recognised its share of IB's net profit from 1 October 2004 to 30 September 2005 based on the most up-to-date accounts available which were prepared in accordance with International Financial Reporting Standards.

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

	2005	2004
Assets	**70,537**	45,925
Liabilities	**(67,926)**	(43,937)
Total operating income	**1,632**	425
Total operating expenses	**(1,132)**	(328)
Profit for the year	**500**	97
Contingent liabilities	**14,783**	10,125

24. INVESTMENT PROPERTIES

The Group's investment properties are stated at fair value as valued by an independent professional valuer on at least an annual basis. The most recent valuation was performed by DTZ Debenham Tie Leung Limited, at 30 September 2005, who confirmed that there had been no material change in valuations at 31 December 2005. The valuation was carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

(a) Investment properties

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
At 1 January	**3,383**	2,956	**2,046**	1,820
Disposals	**(116)**	(150)	**(95)**	(143)
Surplus on revaluation credited to:				
– retained profits	**–**	618	**–**	409
– income statement (note 9)	**1,160**	–	**802**	–
Transfers to premises (note 25(a))	**(154)**	(41)	**(109)**	(40)
At 31 December	**4,273**	3,383	**2,644**	2,046
Leaseholds				
Held in Hong Kong				
– long leases (over 50 years unexpired)	**2,442**	1,903	**1,536**	1,128
– medium leases (10 to 50 years unexpired)	**1,830**	1,479	**1,107**	917
Held outside Hong Kong				
– medium leases (10 to 50 years unexpired)	**1**	1	**1**	1
	4,273	3,383	**2,644**	2,046

24. INVESTMENT PROPERTIES (continued)

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

Rental income receivable from operating leases amounted to HK$207 million in 2005 (2004: HK$202 million). There was no contingent rental recognised during the year (2004: Nil). The direct operating expenses arising from investment properties were HK$27 million in 2005 (2004: HK$27 million). Of this amount, HK$25 million (2004: HK$24 million) was the direct operating expenses from investment properties that generated rental income.

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

	Group		Bank	
	2005	2004	**2005**	2004
Less than one year	**175**	167	**119**	106
Five years or less but over one year	**77**	108	**57**	77
	252	275	**176**	183

25. PREMISES, PLANT AND EQUIPMENT

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 September 2005, who confirmed that there had been no material change in valuations at 31 December 2005. 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		
2005	Premises	Plant and Equipment	Total
Cost or valuation:			
At 1 January 2005 (as previously reported)	7,673	2,741	10,414
Change in accounting policies	(2,511)	(103)	(2,614)
At 1 January 2005 (restated)	5,162	2,638	7,800
Exchange adjustments	2	2	4
Additions	–	167	167
Disposals	(49)	(113)	(162)
Elimination of accumulated depreciation on revalued premises	(120)	–	(120)
Surplus on revaluation			
– credited to premises revaluation reserve	1,046	–	1,046
– credited to income statement (note 9)	153	–	153
Transfer from investment property (note 24(a))	154	–	154
At 31 December 2005	6,348	2,694	9,042
Accumulated depreciation:			
At 1 January 2005 (as previously reported)	–	(2,328)	(2,328)
Change in accounting policies	–	86	86
At 1 January 2005 (restated)	–	(2,242)	(2,242)
Charge for the year (note 7(k))	(120)	(160)	(280)
Written off on disposal	–	110	110
Elimination of accumulated depreciation on revalued premises	120	–	120
At 31 December 2005	–	(2,292)	(2,292)
Net book value at 31 December 2005	6,348	402	6,750

25. PREMISES, PLANT AND EQUIPMENT (continued)

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

		Bank	
2005	Premises	Plant and Equipment	Total
Cost or valuation:			
At 1 January 2005 (as previously reported)	6,131	2,718	8,849
Change in accounting policies	(2,511)	(103)	(2,614)
At 1 January 2005 (restated)	3,620	2,615	6,235
Exchange adjustments	2	2	4
Additions	–	166	166
Disposals	(49)	(113)	(162)
Elimination of accumulated depreciation on revalued premises	(83)	–	(83)
Surplus on revaluation			
– credited to premises revaluation reserve	788	–	788
– credited to income statement	11	–	11
Transfer from investment property (note 24 (a))	109	–	109
At 31 December 2005	4,398	2,670	7,068
Accumulated depreciation:			
At 1 January 2005 (as previously reported)	–	(2,308)	(2,308)
Change in accounting policies	–	86	86
At 1 January 2005 (restated)	–	(2,222)	(2,222)
Charge for the year	(83)	(158)	(241)
Written off on disposal	–	110	110
Elimination of accumulated depreciation on revalued premises	83	–	83
At 31 December 2005	–	(2,270)	(2,270)
Net book value at 31 December 2005	4,398	400	4,798

		Group	
2004	Premises	Plant and Equipment	Total
Cost or valuation:			
At 1 January 2004 (as previously reported)	6,181	2,642	8,823
Change in accounting policies	(1,967)	(96)	(2,063)
At 1 January 2004 (restated)	4,214	2,546	6,760
Exchange adjustments	1	–	1
Additions	–	139	139
Disposals	(4)	(47)	(51)
Elimination of accumulated depreciation on revalued premises	(99)	–	(99)
Surplus on revaluation			
– credited to premises revaluation reserve	863	–	863
– credited to income statement (note 9)	146	–	146
Transfer from investment property (note 24(a))	41	–	41
At 31 December 2004 (restated)	5,162	2,638	7,800

25. PREMISES, PLANT AND EQUIPMENT (continued)

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

		Group	
2004	Premises	Plant and Equipment	Total
Accumulated depreciation:			
At 1 January 2004 (as previously reported)	–	(2,214)	(2,214)
Change in accounting policies	–	79	79
At 1 January 2004 (restated)	–	(2,135)	(2,135)
Charge for the year (note 7(k))	(99)	(157)	(256)
Written off on disposal	–	50	50
Elimination of accumulated depreciation on revalued premises	99	–	99
At 31 December 2004 (restated)	–	(2,242)	(2,242)
Net book value at 31 December 2004 (restated)	5,162	396	5,558

		Bank	
2004	Premises	Plant and Equipment	Total
Cost or valuation:			
At 1 January 2004 (as previously reported)	4,947	2,620	7,567
Change in accounting policies	(1,967)	(96)	(2,063)
At 1 January 2004 (restated)	2,980	2,524	5,504
Additions	–	138	138
Disposals	(4)	(47)	(51)
Elimination of accumulated depreciation on revalued premises	(71)	–	(71)
Surplus on revaluation			
– credited to premises revaluation reserve	662	–	662
– credited to income statement	13	–	13
Transfer from investment property (note 24(a))	40	–	40
At 31 December 2004 (restated)	3,620	2,615	6,235
Accumulated depreciation:			
At 1 January 2004 (as previously reported)	–	(2,194)	(2,194)
Change in accounting policies	–	79	79
At 1 January 2004 (restated)	–	(2,115)	(2,115)
Charge for the year	(71)	(156)	(227)
Written off on disposal	–	49	49
Elimination of accumulated depreciation on revalued premises	71	–	71
At 31 December 2004 (restated)	–	(2,222)	(2,222)
Net book value at 31 December 2004 (restated)	3,620	393	4,013

25. PREMISES, PLANT AND EQUIPMENT (continued)

(b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Leaseholds				
Held in Hong Kong				
– long leases (over 50 years unexpired)	**1,984**	1,393	**1,339**	911
– medium leases (10 to 50 years unexpired)	**4,293**	3,700	**2,988**	2,640
Held outside Hong Kong				
– long leases (over 50 years unexpired)	**3**	3	**3**	3
– medium leases (10 to 50 years unexpired)	**68**	66	**68**	66
	6,348	5,162	**4,398**	3,620

(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	
	2005	2004 restated	**2005**	2004 restated
Cost less accumulated depreciation at 31 December	**2,181**	2,084	**1,098**	1,019

26. INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASE

In accordance with the Tenth Schedule of the Hong Kong Companies Ordinance, the Group has an interest in leasehold land in Hong Kong held for own use under operating lease. The lease is a medium term lease with 10 to 50 years unexpired. The net book value are as follows:

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
At 1 January	**609**	623	**609**	623
Amortisation of prepaid operating lease payment	**(15)**	(14)	**(15)**	(14)
At 31 December	**594**	609	**594**	609

27. INTANGIBLE ASSETS

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Value of in-force long-term assurance business	**1,565**	1,249	**–**	–
Internal developed application software	**56**	–	**56**	–
Other intangible assets	**15**	17	**15**	17
	1,636	1,266	**71**	17

27. INTANGIBLE ASSETS (continued)

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

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
At 1 January	**1,249**	994	**–**	–
Addition from current year new business	**521**	483	**–**	–
Change in assumption on in-force business	**(55)**	(60)	**–**	–
Movement from in-force business	**(150)**	(168)	**–**	–
At 31 December	**1,565**	1,249	**–**	–

The key assumptions used in the computation of present value of in-force long-term assurance business are as follows:

	2005	2004
Risk free rate	**4.19%**	3.55%
Risk discount rate	**11.0%**	13.5%
Expenses inflation	**3.0%**	3.0%
Average lapse rate		
– 1st year	**5.0%**	10.0%
– 2nd year onwards	**2.0%**	2.0%

(b) Movement of internal developed application software and other intangible assets

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Cost:				
At 1 January	**103**	96	**103**	96
Additions	**64**	8	**64**	8
Disposals	**(3)**	(1)	**(3)**	(1)
At 31 December	**164**	103	**164**	103
Accumulated amortisation:				
At 1 January	**86**	79	**86**	79
Charge for the year (note 7(k))	**9**	8	**9**	8
Written off on disposals	**(2)**	(1)	**(2)**	(1)
At 31 December	**93**	86	**93**	86
Net book value at 31 December	**71**	17	**71**	17

28. OTHER ASSETS

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Items in the course of collection from other banks	**8,068**	4,456	**8,068**	4,456
Prepayments and accrued income	**3,016**	2,420	**2,383**	1,900
Deferred tax assets (note 35)	**9**	11	**–**	–
Non current assets held for sale	**216**	320	**110**	127
Acceptances and endorsements	**2,371**	–	**2,371**	–
Other accounts	**1,545**	2,123	**904**	1,657
	15,225	9,330	**13,836**	8,140

For the purpose of these financial statements, acceptances and endorsements are recognised on the balance sheet at 31 December 2005 in "Other assets" and "Other liabilities" in accordance with HKAS 39.

29. CURRENT, SAVINGS AND OTHER DEPOSIT ACCOUNTS

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Current, savings and other deposit accounts:				
– as per consolidated balance sheet	**430,995**	447,460	**421,518**	438,047
– structured deposits reported as trading liabilities (note 30)	**24,422**	–	**24,422**	–
	455,417	447,460	**445,940**	438,047
By type:				
– demand and current accounts	**27,248**	36,148	**27,248**	36,148
– savings accounts	**188,839**	251,192	**188,839**	251,192
– time and other deposits	**239,330**	160,120	**229,853**	150,707
	455,417	447,460	**445,940**	438,047

On adoption of HKAS 39 on 1 January 2005, a total of HK$7,276 million structured deposits at 31 December 2004 was re-designated as trading liabilities with the carrying amount of HK$7,266 million at 1 January 2005.

30. TRADING LIABILITIES

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Certificates of deposit and other debt securities in issue	**13,616**	–	**13,616**	–
Structured deposits (note 29)	**24,422**	–	**24,422**	–
Short positions in securities	**7,766**	5,840	**7,766**	5,840
	45,804	5,840	**45,804**	5,840

On adoption of HKAS 39 on 1 January 2005, trading liabilities included those designated structured deposits, structured certificates of deposit and other debt securities in issue with the carrying amount of HK$10,701 million at 1 January 2005.

31. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

	Group		Bank	
	2005	2004	**2005**	2004
4.125% callable fixed rate subordinated notes	**967**	–	**967**	–

During the year, the Group designated on initial recognition of subordinated notes with nominal value of HK$1,000 million at fair value. At 31 December 2005, the difference between the carrying amount and the contractual amount payable at maturity amounted to HK$33 million. The amount of change in the fair value that is not attributable to changes in a benchmark interest rate was HK$0.4 million.

32. CERTIFICATES OF DEPOSIT AND OTHER DEBT SECURITIES IN ISSUE

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Certificates of deposit and other debt securities in issue:				
– as per consolidated balance sheet	**10,023**	16,055	**10,060**	16,110
– structured certificates of deposit and other debt securities in issue reported as trading liabilities (note 30)	**13,616**	–	**13,616**	–
	23,639	16,055	**23,676**	16,110
By type:				
– Certificates of deposit in issue	**22,525**	15,409	**22,562**	15,464
– Other debt securities in issue	**1,114**	646	**1,114**	646
	23,639	16,055	**23,676**	16,110

On adoption of HKAS 39 on 1 January 2005, a total of HK$3,443 million structured certificates of deposits and other debt securities in issue at 31 December 2004 was re-designated as trading liabilities with the carrying amount of HK$3,435 million at 1 January 2005.

33. OTHER LIABILITIES

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Items in the course of transmission to other banks	**6,517**	6,136	**6,517**	6,136
Accruals	**1,653**	2,303	**1,572**	2,093
Acceptances and endorsements	**2,371**	–	**2,371**	–
Other	**3,597**	3,301	**4,652**	4,433
	14,138	11,740	**15,112**	12,662

For the purpose of these financial statements, acceptances and endorsements are recognised on the balance sheet at 31 December 2005 in "Other assets" and "Other liabilities" in accordance with HKAS 39.

34. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS

	Group			Group		
	2005			2004		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
Non-life insurance provisions						
Unearned premiums	174	(47)	127	199	(55)	144
Notified claims	156	(23)	133	162	(21)	141
Claims incurred but not reported	58	(17)	41	62	(19)	43
	388	(87)	301	423	(95)	328
Other	34	(77)	(43)	36	(75)	(39)
Policyholder liabilities						
Life (non-linked)	14,727	(1)	14,726	8,005	(1)	8,004
Life (linked)	186	–	186	192	–	192
	14,913	(1)	14,912	8,197	(1)	8,196
	15,335	(165)	15,170	8,656	(171)	8,485

The movement of liabilities under insurance contracts during the year ended 31 December 2005 was as follows:

(a) Non-life insurance

	Group		
2005	Gross	Reinsurance	Net
Unearned premium provision			
At 1 January	199	(55)	144
Gross written premiums	474	(103)	371
Gross earned premiums	(493)	111	(382)
Exchange and other movements	(6)	–	(6)
At 31 December	174	(47)	127
Notified and incurred but not reported claims			
At 1 January			
– notified claims	162	(21)	141
– claims incurred but not reported	62	(19)	43
	224	(40)	184
Claims paid	(107)	(11)	(118)
Claims incurred	98	9	107
Exchange and other movements	(1)	2	1
	(10)	–	(10)
At 31 December			
– notified claims	156	(23)	133
– claims incurred but not reported	58	(17)	41
	214	(40)	174
	388	(87)	301

34. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(b) Policyholder liabilities

	Group		
2005	Gross	Reinsurance	Net
Life (non-linked)			
At 1 January	**8,005**	**(1)**	**8,004**
Benefits paid	**(205)**	**8**	**(197)**
Claims incurred and movement in policyholders liabilities	**6,926**	**(8)**	**6,918**
Exchange and other movements	**1**	**–**	**1**
At 31 December	**14,727**	**(1)**	**14,726**
Life (linked)			
At 1 January	**192**	**–**	**192**
Benefits paid	**(17)**	**–**	**(17)**
Claims incurred and movement in policyholders liabilities	**11**	**–**	**11**
At 31 December	**186**	**–**	**186**
	14,913	**(1)**	**14,912**

The movement of liabilities under insurance contracts during the year ended 31 December 2004 was as follows:

(a) Non-life insurance

	Group		
2004	Gross	Reinsurance	Net
Unearned premium provision			
At 1 January	189	(58)	131
Gross written premiums	519	(106)	413
Gross earned premiums	(504)	108	(396)
Exchange and other movements	(5)	1	(4)
At 31 December	199	(55)	144
Notified and incurred but not reported claims			
At 1 January			
– notified claims	160	(35)	125
– claims incurred but not reported	53	(12)	41
	213	(47)	166
Claims paid	(129)	(20)	(149)
Claims incurred	145	27	172
Exchange and other movements	(5)	–	(5)
	11	7	18
At 31 December			
– notified claims	162	(21)	141
– claims incurred but not reported	62	(19)	43
	224	(40)	184
	423	(95)	328

34. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(b) Policyholder liabilities

2004	Group Gross	Group Reinsurance	Group Net
Life (non-linked)			
At 1 January	4,637	(3)	4,634
Benefits paid	(142)	5	(137)
Claims incurred and movement in policyholders liabilities	3,475	(3)	3,472
Exchange and other movements	35	–	35
At 31 December	8,005	(1)	8,004
Life (linked)			
At 1 January	32	–	32
Benefits paid	(8)	–	(8)
Claims incurred and movement in policyholders liabilities	168	–	168
At 31 December	192	–	192
	8,197	(1)	8,196

35. DEFERRED TAX AND CURRENT TAX LIABILITIES

(a) Deferred tax and current tax assets and liabilities represent in the balance sheet as follows:

	Group **2005**	Group 2004 restated	Bank **2005**	Bank 2004 restated
Included in "Other assets":				
Current taxation recoverable	**14**	2	**–**	–
Deferred taxation (note 28)	**9**	11	**–**	–
	23	13	**–**	–
Included in "Deferred tax and current tax liabilities":				
Provision for Hong Kong profits tax	**441**	508	**412**	463
Provision for taxation outside Hong Kong	**8**	6	**6**	3
Deferred taxation	**1,472**	1,154	**885**	766
	1,921	1,668	**1,303**	1,232

35. DEFERRED TAX AND CURRENT TAX LIABILITIES (continued)

(b) Deferred tax assets and liabilities recognised

The major components of deferred tax (assets)/liabilities recognised in the balance sheets and the movements during the year are as follows:

	Group						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Impairment losses on financial assets	Fair value adjustments for available-for-sale financial assets	Cash flow hedges	Other	Total
At 1 January 2005							
– as previously reported	21	869	(50)	16	–	174	1,030
– prior year adjustments due to change in accounting policies	–	133	–	–	–	(20)	113
– as restated, before opening balance adjustments	21	1,002	(50)	16	–	154	1,143
– opening adjustment on adoption of HKAS 39	–	–	–	97	2	68	167
At 1 January 2005 (restated)	21	1,002	(50)	113	2	222	1,310
Charged/(credited) to income statement (note 10(a))	27	209	(33)	–	–	79	282
Charged/(credited) to reserves	–	175	–	(243)	(95)	34	(129)
At 31 December 2005	48	1,386	(83)	(130)	(93)	335	1,463
At 1 January 2004							
– as previously reported	20	667	(192)	18	–	78	591
– prior year adjustments due to change in accounting policies	–	155	–	–	–	38	193
At 1 January 2004 (restated)	20	822	(192)	18	–	116	784
Charged/(credited) to income statement (note 10(a))	1	(54)	142	–	–	93	182
Charged/(credited) to reserves	–	234	–	(2)	–	(55)	177
At 31 December 2004 (restated)	21	1,002	(50)	16	–	154	1,143

35. DEFERRED TAX AND CURRENT TAX LIABILITIES (continued)

(b) Deferred tax assets and liabilities recognised (continued)

	Bank						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Impairment losses on financial assets	Fair value adjustments for available-for-sale financial assets	Cash flow hedges	Other	Total
At 1 January 2005							
– as previously reported	34	804	(39)	–	–	(30)	769
– prior year adjustments due to change in accounting policies	–	17	–	–	–	(20)	(3)
– as restated, before opening balance adjustments	34	821	(39)	–	–	(50)	766
– opening adjustment on adoption of HKAS 39	–	–	–	97	2	63	162
At 1 January 2005 (restated)	34	821	(39)	97	2	13	928
Charged/(credited) to income statement	14	118	(28)	–	–	17	121
Charged/(credited) to reserves	–	130	–	(232)	(95)	33	(164)
At 31 December 2005	48	1,069	(67)	(135)	(93)	63	885
At 1 January 2004							
– as previously reported	33	591	(141)	–	–	(56)	427
– prior year adjustments due to change in accounting policies	–	75	–	–	–	38	113
At 1 January 2004 (restated)	33	666	(141)	–	–	(18)	540
Charged/(credited) to income statement	1	(7)	102	–	–	23	119
Charged/(credited) to reserves	–	162	–	–	–	(55)	107
At 31 December 2004 (restated)	34	821	(39)	–	–	(50)	766

(c) Deferred tax assets not recognised

At balance sheet date, the Group has not recognised deferred tax assets in respect of tax losses of subsidiaries amounted to HK$34 million (2004: HK$34 million) which are considered unlikely to be utilised. The tax losses do not expire under current tax legislation.

(d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised in 2005 (2004: Nil).

36. SUBORDINATED LIABILITIES

		Group		Bank	
		2005	2004	**2005**	2004
Nominal value	Description				
Amount owed to third parties					
HK$1,500 million	Callable floating rate subordinated notes due June 2015	1,495	–	1,495	–
HK$1,000 million	4.125% callable fixed rate subordinated notes due June 2015	967	–	967	–
Amount owed to HSBC Group undertakings					
US$260 million	Callable floating rate subordinated loan debt due December 2015	2,016	–	2,016	–
		4,478	–	4,478	–
Representing:					
– measured at amortised cost		3,511	–	3,511	–
– designated at fair value (note 31)		967	–	967	–
		4,478	–	4,478	–

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

The floating rate notes of HK$1,500 million bear interest at the rate of three-month HIBOR plus 0.35 per cent, payable quarterly from the issue date to the call option date. Thereafter, if the notes are not redeemed on the call option date, the interest rate will be reset to three-month HIBOR plus 0.85 per cent, payable quarterly.

The fixed rate notes of HK$1,000 million bear interest at the rate of 4.125 per cent per annum, payable semi-annually from the issue date to the call option date. The notes, if not redeemed on the call option date, will become floating rate notes bearing interest at the rate of three-month HIBOR plus 0.825 per cent payable quarterly.

The fixed rate notes are reported as financial liabilities designated at fair value together with the interest rate swap transacted to manage the interest rate risk.

The floating rate subordinated loan debt of US$260 million bears interest at the rate of three-month LIBOR plus 0.31 per cent, payable quarterly from the issue date to the call option date. Thereafter, if the loan is not repaid on the call option date, the interest rate will be reset to three-month LIBOR plus 0.81 per cent, payable quarterly.

37. SHARE CAPITAL

Authorised:

The authorised share capital of the Bank is HK$11,000 million (2004: HK$11,000 million) divided into 2,200 million shares (2004: 2,200 million shares) of HK$5 each.

	2005	2004
Issued and fully paid:		
1,911,842,736 shares (2004: 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 (2004: Nil).

38. RESERVES

2005	Group	Bank	Associates
Retained profits	26,052	15,562	1,097
Premises revaluation reserve	3,543	2,844	–
Cash flow hedges reserve	(483)	(446)	–
Available-for-sale investments reserve	(17)	(635)	167
Capital redemption reserve	99	99	–
Other reserves	185	150	31
Total reserves	29,379	17,574	1,295

Retained profits

	Group	Bank	Associates
At 1 January 2005			
– as previously reported	21,395	13,229	156
– prior year adjustments due to change in accounting policies	2,461	1,431	516
– as restated, before opening balance adjustments	23,856	14,660	672
– opening balance adjustments on adoption of HKAS 39	533	509	–
At 1 January 2005 (restated)	24,389	15,169	672
Exchange and other adjustments	(2)	–	–
Profit attributable to shareholders	11,342	10,080	500
Dividends	(9,942)	(9,942)	(75)
Transfer from premises revaluation reserve			
– depreciation on revaluation surplus	58	48	–
– realisation of revaluation surplus on disposal of premises	49	49	–
Actuarial gains on defined benefit plans	158	158	–
At 31 December 2005	26,052	15,562	1,097

Premises revaluation reserve, net of deferred tax

	Group	Bank	Associates
At 1 January 2005			
– as previously reported	4,281	3,784	–
– prior year adjustments due to change in accounting policies	(1,503)	(1,503)	–
At 1 January 2005 (restated)	2,778	2,281	–
Unrealised surplus on revaluation	863	651	–
Transfer to retained profits			
– depreciation on revaluation surplus	(58)	(48)	–
– realisation of revaluation surplus on disposal of premises	(40)	(40)	–
At 31 December 2005	3,543	2,844	–

38. RESERVES (continued)

2005	Group	Bank	Associates
Investment properties revaluation reserve			
At 1 January 2005			
– as previously reported	3,283	2,007	–
– prior year adjustments due to change in accounting policies	(3,283)	(2,007)	–
At 1 January 2005 (restated) and 31 December 2005	–	–	–
Cash flow hedges reserve			
At 1 January 2005			
– as previously reported	–	–	–
– opening balance adjustments for the adoption of HKAS 39	9	9	–
At 1 January 2005 (restated)	9	9	–
Change in fair value	(492)	(455)	–
At 31 December 2005	(483)	(446)	–
Available-for-sale reserve			
At 1 January 2005			
– transfer from long-term equity investment revaluation reserve	935	–	–
– opening balance adjustments for the adoption of HKAS 39	523	456	–
At 1 January 2005 (restated)	1,458	456	–
Change in fair value	(988)	(1,264)	167
Transfer to income statement on disposal	(487)	173	–
At 31 December 2005	(17)	(635)	167
Capital redemption reserve			
At 1 January and 31 December 2005	99	99	–
Other reserves			
At 1 January 2005			
– as previously reported	–	–	–
– prior year adjustments due to change in accounting policies	69	66	–
At 1 January 2005 (restated)	69	66	–
Foreign exchange reserve	50	20	31
Employees' options granted cost free by ultimate holding company	64	64	–
Others	2	–	–
At 31 December 2005	185	150	31
Total reserves at 31 December 2005	29,379	17,574	1,295

38. RESERVES (continued)

2004	Group restated	Bank restated	Associates restated
Retained profits	23,856	14,660	672
Premises revaluation reserve	2,778	2,281	–
Long-term equity investment revaluation reserve	935	–	–
Capital redemption reserve	99	99	–
Other reserves	69	66	–
Total reserves	27,737	17,106	672

Retained profits

	Group restated	Bank restated	Associates restated
At 1 January 2004			
– as previously reported	19,720	11,943	90
– prior year adjustments due to change in accounting policies	2,255	1,522	379
At 1 January 2004 (restated)	21,975	13,465	469
Exchange and other adjustments	6	2	–
Profit attributable to shareholders	11,364	10,987	97
Dividends	(9,942)	(9,942)	(21)
Transfer from premises revaluation reserve			
– depreciation on revaluation surplus	46	41	–
– realisation of revaluation surplus on disposal of premises	2	2	–
Realisation of revaluation surplus on disposal of investment property	26	25	–
Unrealised surplus on investment properties	637	338	127
Actuarial losses on defined benefit plans	(258)	(258)	–
At 31 December 2004 (restated)	23,856	14,660	672

Premises revaluation reserve, net of deferred tax

	Group restated	Bank restated	Associates restated
At 1 January 2004			
– as previously reported	3,123	2,787	–
– prior year adjustments due to change in accounting policies	(1,009)	(1,009)	–
At 1 January 2004 (restated)	2,114	1,778	–
Unrealised surplus on revaluation	712	546	–
Transfer to retained profits			
– depreciation charge on revaluation	(46)	(41)	–
– realisation on disposal of premises properties	(2)	(2)	–
At 31 December 2004 (restated)	2,778	2,281	–

38. RESERVES (continued)

2004	Group restated	Bank restated	Associates restated
Investment properties revaluation reserve			
At 1 January 2004			
– as previously reported	2,690	1,774	459
– prior year adjustments due to change in accounting policies	(2,690)	(1,774)	(459)
At 1 January 2004 (restated) and 31 December 2004 (restated)	–	–	–
Long-term equity investment revaluation reserve, net of deferred tax			
At 1 January 2004	1,009	–	–
Unrealised surplus on revaluation	332	–	–
Revaluation gain recognised in income statement on disposal of long-term equity investments	(406)	–	–
At 31 December 2004	935	–	–
Capital redemption reserve			
At 1 January and 31 December 2004	99	99	–
Other reserves			
At 1 January 2004			
– as previously reported	–	–	–
– prior year adjustments due to change in accounting policies	20	20	–
At 1 January 2004 (restated)	20	20	–
Employees' options granted cost free by ultimate holding company	46	46	–
Others	3	–	–
At 31 December 2004 (restated)	69	66	–
Total reserves at 31 December 2004 (restated)	27,737	17,106	672

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

The Bank and its banking subsidiaries operate under regulatory jurisdictions which require the maintenance of minimum capital adequacy ratios and which could therefore potentially restrict the amount of retained profits which can be distributed to shareholders.

In accordance with the HKMA guideline "Impact of the New Hong Kong Accounting Standards on Authorised Institutions' Capital Base and Regulatory Reporting", the Group has earmarked a "Regulatory reserve" of HK$510 million (2004: Nil) from retained profits.

39. RECONCILIATION OF CASH FLOW STATEMENT

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

	2005	2004 restated
Operating profit	**11,068**	12,598
Net interest income	**(11,068)**	(10,005)
Dividend income	**(60)**	(89)
Loans impairment charges/(releases) and other credit risk provisions	**618**	(777)
Depreciation	**280**	256
Amortisation of intangible assets	**9**	8
Amortisation of available-for-sale investments	**12**	–
Amortisation of held-to-maturity debt securities	**–**	426
Advances written off net of recoveries	**(575)**	(577)
Interest received	**13,578**	9,369
Interest paid	**(7,443)**	(2,646)
Operating profit before changes in working capital	**6,419**	8,563
Change in placings with and advances to banks maturing after one month	**2,534**	2,658
Change in trading assets	**3,983**	(2,541)
Change in financial assets designated at fair value	**1,060**	–
Change in derivative financial instruments	**(395)**	(88)
Change in advances to customers	**(8,857)**	(21,244)
Change in available-for-sale investments	**8,113**	–
Change in held-to-maturity debt securities	**–**	(1,590)
Change in other assets	**(11,929)**	(4,000)
Change in current, savings and other deposit accounts	**(9,189)**	15,307
Change in deposits from banks	**110**	8,938
Change in trading liabilities	**29,263**	4,326
Change in certificates of deposit and other debt securities in issue	**(2,589)**	8,168
Change in other liabilities	**9,423**	4,955
Elimination of exchange differences and other non-cash items	**315**	(4,904)
Cash generated from operating activities	**28,261**	18,548
Taxation paid	**(1,421)**	(925)
Net cash inflow from operating activities	**26,840**	17,623

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

	2005	2004 restated
Cash and balances with banks and other financial institutions	**9,201**	7,248
Placings with and advances to banks and other financial institutions maturing within one month	**53,294**	57,071
Treasury bills	**3,018**	47
Certificates of deposit	**–**	2,685
	65,513	67,051

40. CONTINGENT LIABILITIES, COMMITMENTS AND DERIVATIVES

(a) Contract amount, credit equivalent amount and risk-weighted amount

	Group		
2005	Contract amount	Credit equivalent amount	Risk-weighted amount
Contingent liabilities:			
Guarantees	4,133	3,907	3,131
Commitments:			
Documentary credits and short-term trade-related transactions	7,402	1,480	1,480
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	109,369	–	–
– one year and over	20,385	10,193	9,158
Other	220	220	220
	137,376	11,893	10,858
Exchange rate contracts:			
Spot and forward foreign exchange	188,088	1,426	333
Other exchange rate contracts	15,176	193	48
	203,264	1,619	381
Interest rate contracts:			
Interest rate swaps	161,083	1,472	308
Other interest rate contracts	4,255	20	4
	165,338	1,492	312
Other derivative contracts	1,194	86	17

	Bank		
2005	Contract amount	Credit equivalent amount	Risk-weighted amount
Contingent liabilities:			
Guarantees	4,533	4,308	3,531
Commitments:			
Documentary credits and short-term trade-related transactions	7,402	1,480	1,480
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	109,089	–	–
– one year and over	20,205	10,103	9,068
Other	44	44	44
	136,740	11,627	10,592
Exchange rate contracts:			
Spot and forward foreign exchange	191,433	1,459	349
Other exchange rate contracts	15,176	193	48
	206,609	1,652	397
Interest rate contracts:			
Interest rate swaps	151,982	1,343	282
Other interest rate contracts	4,255	20	4
	156,237	1,363	286
Other derivative contracts	1,194	86	17

40. CONTINGENT LIABILITIES, COMMITMENTS AND DERIVATIVES (continued)

(a) Contract amount, credit equivalent amount and risk-weighted amount (continued)

2004 (restated)	Group Contract amount	Credit equivalent amount	Risk-weighted amount
Contingent liabilities:			
Guarantees	7,039	6,764	3,429
Commitments:			
Documentary credits and short-term trade-related transactions	9,020	1,844	1,805
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	86,714	–	–
– one year and over	23,677	11,839	10,460
Other	38	38	38
	119,449	13,721	12,303
Exchange rate contracts:			
Spot and forward foreign exchange	138,269	1,066	298
Other exchange rate contracts	23,158	323	106
	161,427	1,389	404
Interest rate contracts:			
Interest rate swaps	120,603	1,421	347
Other interest rate contracts	5,067	15	6
	125,670	1,436	353
Other derivative contracts	1,373	46	23

2004 (restated)	Bank Contract amount	Credit equivalent amount	Risk-weighted amount
Contingent liabilities:			
Guarantees	7,440	7,164	3,830
Commitments:			
Documentary credits and short-term trade-related transactions	9,020	1,844	1,805
Undrawn formal standby facilities, credit lines and other commitments to lend:			
– under one year	85,910	–	–
– one year and over	23,400	11,700	10,321
Other	17	17	17
	118,347	13,561	12,143
Exchange rate contracts:			
Spot and forward foreign exchange	141,384	1,098	314
Other exchange rate contracts	23,158	323	106
	164,542	1,421	420
Interest rate contracts:			
Interest rate swaps	113,692	1,336	330
Other interest rate contracts	5,067	15	6
	118,759	1,351	336
Other derivative contracts	1,373	46	23

40. CONTINGENT LIABILITIES, COMMITMENTS AND DERIVATIVES (continued)

(a) Contract amount, credit equivalent amount and risk-weighted amount (continued)

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

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

For the purpose of these financial statements, acceptances and endorsements are recognised on the balance sheet at 31 December 2005 in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Third Schedule, these acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies.

Off-balance sheet financial instruments arise from futures, forward, swap and option transactions undertaken in the foreign exchange, interest rate and equity markets.

The contract amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date and do not represent amounts at risk. The credit equivalent amount of these instruments is measured as the sum of positive marked-to-market values and the potential future credit exposure in accordance with the Third Schedule of the Hong Kong Banking Ordinance.

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

	Group **2005**		Group 2004	
	Trading/ designated at fair value	Hedging	Trading	Non-trading
Contract amounts:				
Interest rate contracts	**102,233**	**63,105**	54,755	70,915
Exchange rate contracts	**203,264**	**–**	161,117	310
Other derivative contracts	**1,194**	**–**	1,373	–
	306,691	**63,105**	217,245	71,225
Derivative assets:				
Interest rate contracts	**481**	**454**	519	–
Exchange rate contracts	**776**	**–**	1,160	–
Other derivative contracts	**4**	**–**	5	–
	1,261	**454**	1,684	–
Derivative liabilities:				
Interest rate contracts	**998**	**457**	477	–
Exchange rate contracts	**310**	**–**	796	–
Other derivative contracts	**27**	**–**	–	–
	1,335	**457**	1,273	–

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

In addition to the above, the Bank enters into guarantees and letters of support on behalf of other Group entities in the normal course of business.

41. ASSETS PLEDGED AS SECURITY FOR LIABILITIES

At 31 December 2005, liabilities of the Group amounting to HK$7,858 million (2004: HK$5,697 million) and of the Bank amounting to HK$7,858 million (2004: HK$5,697 million) were secured by the deposit of assets, mainly related to sale and repurchase arrangements. The amounts of assets pledged by the Group to secure these liabilities was HK$7,997 million (2004: HK$5,742 million) and by the Bank was HK$7,997 million (2004: HK$5,742 million) respectively and mainly comprised items included in "Trading assets" and "Financial investments". In addition, the amount of debt securities deposited with central depositories by the Group to facilitate the settlement processes was HK$6,780 million (2004: HK$7,980 million) and by the Bank was HK$6,780 million (2004: HK$7,980 million) respectively.

42. CAPITAL COMMITMENTS

	Group		Bank	
	2005	2004	**2005**	2004
Expenditure authorised and contracted for	**113**	81	**111**	77

43. 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	
	2005	2004	**2005**	2004
Within one year	**191**	163	**191**	163
Between one and five years	**409**	130	**409**	129
	600	293	**600**	292

44. 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 80 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS was closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The Group makes contributions to these schemes in accordance with the recommendation of qualified actuary based on annual actuarial valuations. The latest annual actuarial valuations at 31 December 2005 was performed by E Chiu, fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Ltd, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the balance sheet at year-end and retirement benefits costs recognised in the income statement for the year in respect of these defined benefit schemes are set out below.

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

		Group and Bank	
2005	HSBDBS	HSBPS	HSBNTBS
Present value of funded obligations	3,571	167	4
Fair value of scheme assets	(3,947)	(221)	(31)
Net assets recognised in the balance sheet	(376)	(54)	(27)
Obligations covered by plan assets (%)	111	132	775

44. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

	Group and Bank		
2004 (restated)	HSBDBS	HSBPS	HSBNTBS
Present value of funded obligations	3,663	182	4
Fair value of scheme assets	(3,737)	(220)	(32)
Net assets recognised in the balance sheet	(74)	(38)	(28)
Obligations covered by plan assets (%)	102	121	800

The scheme assets of HSBDBS included ordinary shares issued by HSBC Holdings plc with a fair value of HK$168 million (2004: HK$174 million). Other than that, the scheme assets of HSBPS did not include any financial instruments issued by the Bank and its ultimate holding company at 31 December 2005 (2004: Nil).

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

	Group and Bank		
2005	HSBDBS	HSBPS	HSBNTBS
At 1 January (restated)	**(74)**	**(38)**	**(28)**
Contributions paid	**(225)**	**(8)**	**–**
Net expense recognised in the income statement	**108**	**(1)**	**–**
Actuarial (gains)/losses	**(185)**	**(7)**	**1**
Net assets at 31 December	**(376)**	**(54)**	**(27)**

	Group and Bank		
2004	HSBDBS	HSBPS	HSBNTBS
At 1 January			
– as previously reported	(37)	(37)	(28)
– change in accounting policies	(215)	–	–
At 1 January (restated)	(252)	(37)	(28)
Contributions paid	(276)	(9)	–
Net expense recognised in the income statement	147	1	–
Actuarial losses	307	7	–
Net assets at 31 December (restated)	(74)	(38)	(28)

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

	Group		
2005	HSBDBS	HSBPS	HSBNTBS
Current service cost	**187**	**1**	**–**
Interest cost	**148**	**7**	**–**
Expected return on scheme assets	**(227)**	**(9)**	**–**
Net expense for the year (note 7(k))	**108**	**(1)**	**–**
Actual return on scheme assets	**294**	**10**	**–**

44. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

		Group	
2004	HSBDBS	HSBPS	HSBNTBS
Current service cost	178	1	–
Interest cost	170	10	–
Expected return on scheme assets	(201)	(10)	–
Net expense for the year (note 7(k))	147	1	–
Actual return on scheme assets	284	8	–

(iv) The principal actuarial assumptions used as at 31 December 2005 (expressed as weighted averages) are as follows:

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

		Group and Bank	
	HSBDBS	HSBPS	HSBNTBS
2004	%	%	%
Discount rate	4.0	5.0	5.0
Expected rate of return on scheme assets	6.0	4.5	2.0
Expected rate of salary increases	3.0	3.0	3.0
Expected rate of pension increases	–	3.0	–

(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:

	2005	2004
Amounts charged to the income statement (note 7(k))	**30**	21

45. SHARE-BASED PAYMENTS

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

45. SHARE-BASED PAYMENTS (continued)

(a) Savings-Related Share Option Plan (Equity-settled)

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

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

	2005		2004	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
At 1 January	**5.93**	**5,671**	5.55	8,098
Granted in the year	**6.68**	**1,551**	6.47	2,024
Exercised in the year	**6.07**	**(1,301)**	5.66	(4,133)
Less: Lapsed in the year	**5.93**	**(355)**	5.55	(318)
At 31 December	**6.10**	**5,566**	5.93	5,671
Amounts charged to the income statement (note 7(k))		**44**		30
Options vested at 31 December		**–**		12

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

Exercise period	Exercise price £	**2005** Number ('000)	2004 Number ('000)
1 Aug 2005 to 31 Jan 2006	6.32	**–**	1
1 Aug 2007 to 31 Jan 2008	6.47	**–**	1,569
1 Aug 2008 to 31 Jan 2009	5.35	**–**	3
1 Aug 2008 to 31 Jan 2009	6.68	**1,234**	–
1 Aug 2009 to 31 Jan 2010	6.47	**–**	451
1 Aug 2010 to 31 Jan 2011	6.68	**317**	–
		1,551	2,024

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

Exercise period	Exercise price £	Proceeds received (£'000)	**2005** Number ('000)	2004 Number ('000)
1 Aug 2004 to 31 Jan 2005	5.40	17,935	**–**	3,322
1 Aug 2004 to 31 Jan 2005	6.75	5,475	**–**	811
1 Aug 2004 to 31 Jan 2005	5.40	41	**8**	–
1 Aug 2004 to 31 Jan 2005	6.75	26	**4**	–
1 Aug 2005 to 31 Jan 2006	6.03	6,686	**1,108**	–
1 Aug 2005 to 31 Jan 2006	6.32	1,143	**181**	–
			1,301	4,133

45. SHARE-BASED PAYMENTS (continued)

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

(iv) Terms of share options at balance sheet date

Exercise period	Exercise price £	**2005** Number ('000)	2004 Number ('000)
1 Aug 2004 to 31 Jan 2005	5.40	–	8
1 Aug 2004 to 31 Jan 2005	6.75	–	4
1 Aug 2005 to 31 Jan 2006	6.03	–	1,118
1 Aug 2005 to 31 Jan 2006	6.32	–	188
1 Aug 2006 to 31 Jan 2007	6.75	**95**	98
1 Aug 2006 to 31 Jan 2007	5.35	**1,795**	1,919
1 Aug 2007 to 31 Jan 2008	6.32	**32**	32
1 Aug 2007 to 31 Jan 2008	6.47	**1,401**	1,500
1 Aug 2008 to 31 Jan 2009	5.35	**334**	358
1 Aug 2008 to 31 Jan 2009	6.68	**1,176**	–
1 Aug 2009 to 31 Jan 2010	6.47	**431**	446
1 Aug 2010 to 31 Jan 2011	6.68	**302**	–
		5,566	5,671

(b) Executive/Group Share Option Plan (Equity-settled)

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

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

	2005		2004	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
At 1 January	**7.76**	**5,935**	6.35	5,239
Granted in the year	**n.a.**	–	8.18	1,421
Exercised in the year	**7.45**	**(617)**	7.06	(519)
Less: Lapsed in the year	**7.76**	**(287)**	6.35	(206)
At 31 December	**7.80**	**5,031**	7.76	5,935
Amounts charged to the income statement (note 7(k))		**20**		16
Options vested at 31 December		**2,803**		2,475

45. SHARE-BASED PAYMENTS (continued)

(b) Executive/Group Share Option Plan (Equity-settled) (continued)

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

Exercise period	Exercise price £	**2005** Number ('000)	2004 Number ('000)
1 Apr 1999 to 31 Mar 2006	3.33	–	9
24 Mar 2000 to 23 Apr 2007	5.02	–	8
16 Mar 2001 to 15 Mar 2008	6.28	–	8
29 Mar 2002 to 28 Mar 2009	6.38	–	30
3 Apr 2003 to 2 Apr 2010	7.46	–	5
23 Apr 2004 to 22 Apr 2011	8.71	–	5
7 May 2005 to 6 May 2012	8.41	–	5
30 Apr 2007 to 29 Apr 2017	8.28	–	1,351
		–	1,421

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

Exercise period	Exercise price £	Proceeds received (£'000)	**2005** Number ('000)	2004 Number ('000)
1 Apr 1999 to 31 Mar 2006	3.33	30	**9**	–
16 Mar 2001 to 15 Mar 2008	6.28	47	**8**	–
29 Mar 2002 to 28 Mar 2009	6.38	1,359	**213**	279
3 Apr 2003 to 2 Apr 2010	7.46	981	**131**	166
23 Apr 2004 to 22 Apr 2011	8.71	911	**105**	71
30 Aug 2004 to 29 Aug 2011	8.23	–	–	3
7 May 2005 to 6 May 2012	8.41	1,269	**151**	–
			617	519

(iv) Terms of share options at balance sheet date

Exercise period	Exercise price £	**2005** Number ('000)	2004 Number ('000)
1 Apr 1999 to 31 Mar 2006	3.33	–	9
24 Mar 2000 to 23 Apr 2007	5.02	**8**	8
16 Mar 2001 to 15 Mar 2008	6.28	–	8
29 Mar 2002 to 28 Mar 2009	6.38	**544**	765
3 Apr 2003 to 2 Apr 2010	7.46	**516**	652
23 Apr 2004 to 22 Apr 2011	8.71	**896**	1,033
7 May 2005 to 6 May 2012	8.41	**839**	1,012
2 May 2006 to 1 May 2013	6.91	**1,047**	1,156
30 Apr 2007 to 29 Apr 2017	8.28	**1,181**	1,292
		5,031	5,935

45. SHARE-BASED PAYMENTS (continued)

(c) Calculation of fair values

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. When modelling options with vesting dependent on HSBC's Total Shareholder Return over a period, these performance targets are incorporated into the model using Monte-Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2005 are as follows:

	Executive/ Group Share Option Plan	3-year Savings-Related Share Option Plan	5-year Savings-Related Share Option Plan
Risk-free interest rate (%)	4.6	4.3	4.3
Expected life (years)	7.8	3.0	5.0
Expected volatility (%)	20.0	20.0	20.0

The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan and Savings-Related Share Option Plan awards. Expected life is not a single input parameter but a function of various behavioural assumptions. Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options. Expected dividend yield was based on historic levels of dividend growth.

(d) Restricted Share Plan

Conditional awards under the Restricted Share Plan have been in operation since 1996. Upto and including 2004, restricted shares are granted with vesting criteria subject to attaining the HSBC Group targets. Commencing 2005, the award is generally granted with a vesting period of 3 years from the year of award. The fair value of the shares awarded is charged to the income statement as share compensation cost over the period the performance conditions applied.

	2005 Number ('000)	2004 Number ('000)
At 1 January	**459**	379
Additions during the year	**141**	152
Less: Released in the year	**(48)**	(72)
Less: Lapsed in the year	**(202)**	–
At 31 December	**350**	459
Amounts charged to the income statement (note 7(k))	**6**	2

The weighted average purchase price for shares purchased for conditional awards under the Restricted Share Plan is £8.07 (2004: £7.91). The closing price of the HSBC Holdings plc share at 31 December 2005 was £9.33 (2004: £8.79).

The weighted average remaining vesting period as at 31 December 2005 was 2.10 years (2004: 2.61 years).

46. 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 include accrued interest and overdue interest on these assets. Claims are classified according to the location of the counterparties after taking into account the transfer of risk. For a claim guaranteed by a party situated in a country different from the counterparty, the risk will be transferred to the country of the guarantor. For a claim on the branch of a bank or other financial institution, the risk will be transferred to the country where its head office is situated. Claims on individual countries or areas, after risk transfer, amounting to 10 per cent or more of the aggregate cross border claims are shown as follows:

2005	Banks & other financial institutions	Sovereign & public sector entities	Other	Total
Asia Pacific excluding Hong Kong:				
– Australia	23,961	144	712	24,817
– Other	38,140	1,447	6,882	46,469
	62,101	1,591	7,594	71,286
The Americas:				
– Canada	16,229	3,976	1,677	21,882
– Other	13,182	2,460	10,712	26,354
	29,411	6,436	12,389	48,236
Western Europe:				
– United Kingdom	23,008	–	7,842	30,850
– Other	81,089	1,430	6,207	88,726
	104,097	1,430	14,049	119,576

2004	Banks & other financial institutions	Sovereign & public sector entities	Other	Total
Asia Pacific excluding Hong Kong:				
– Australia	21,429	62	1,223	22,714
– Other	26,222	1,530	5,432	33,184
	47,651	1,592	6,655	55,898
The Americas:				
– Canada	19,748	4,957	1,556	26,261
– Other	11,320	2,744	10,252	24,316
	31,068	7,701	11,808	50,577
Western Europe:				
– United Kingdom	23,794	16	5,945	29,755
– Other	76,926	2,063	5,711	84,700
	100,720	2,079	11,656	114,455

47. CAPITAL ADEQUACY RATIOS

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

	2005	2004
Adjusted total capital ratio	**12.8%**	12.0%
Adjusted tier 1 capital ratio	**10.4%**	10.8%

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

	2005	2004
Total capital ratio	**12.8%**	12.1%
Tier 1 capital ratio	**10.4%**	10.8%

In accordance with the HKMA guideline "Impact of the New Hong Kong Accounting Standards on Authorised Institutions' Capital Base and Regulatory Reporting", the Group has earmarked a "Regulatory reserve" of HK$510 million from retained profits (2004: Nil). This regulatory reserve is included as tier 2 capital together with the Bank's collective impairment allowances.

48. LIQUIDITY RATIO

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

	2005	2004
The Bank and its major banking subsidiaries	**45.1%**	47.2%

49. MATERIAL RELATED-PARTY TRANSACTIONS

(a) Immediate holding company and fellow subsidiary companies

In 2005, the Group entered into transactions with its immediate holding company and fellow subsidiary companies in the ordinary course of its interbank activities including the acceptance and placement of interbank deposits, correspondent banking transactions and off-balance sheet transactions. The activities were priced at the relevant market rates at the time of the transactions.

The Group used the IT of, and shared an automated teller machine network with, its immediate holding company and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group also maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator and the Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies. The premiums, commissions and other fees on these transactions are determined on an arm's length basis.

49. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(a) Immediate holding company and fellow subsidiary companies (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	
	2005	2004 restated	**2005**	2004 restated	**2005**	2004 restated
Interest income	**159**	82	**8**	1	**3**	–
Interest expense	**(208)**	(78)	**(38)**	(13)	**(1)**	–
Other operating income/(expense)	**44**	86	**(3)**	(2)	**–**	–
Operating expenses	**(633)**	(527)	**(127)**	(83)	**(10)**	(8)
Amounts due from:						
Cash and balances with banks and other financial institutions	**46**	12	**672**	1,215	**1**	–
Placings with and advances to banks and other financial institutions	**2,785**	2,416	**710**	–	**78**	31
Trading assets	**50**	–	**–**	–	**–**	–
Derivative financial instruments	**101**	134	**44**	43	**–**	–
Financial assets designated at fair value	**2,299**	–	**–**	–	**–**	–
Advances to customers	**–**	–	**–**	–	**233**	233
Financial investments	**1,135**	1,728	**–**	–	**–**	–
Other assets	**27**	46	**2**	1	**–**	–
	6,443	4,336	**1,428**	1,259	**312**	264
Amounts due to:						
Current, savings and other deposit accounts	**41**	33	**126**	132	**14**	17
Deposits from banks	**4,972**	3,241	**164**	60	**–**	–
Derivative financial instruments	**411**	211	**77**	97	**–**	–
Subordinated liabilities	**2,016**	–	**–**	–	**–**	–
Other liabilities	**286**	115	**75**	42	**–**	–
	7,726	3,600	**442**	331	**14**	17
Derivative contracts:						
Contract amount	**35,364**	20,194	**12,308**	15,074	**–**	–
Credit equivalent amount	**355**	343	**106**	141	**–**	–
Risk-weighted amount	**71**	69	**21**	28	**–**	–

49. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

	Bank							
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Subsidiaries		Associates	
	2005	2004 restated	**2005**	2004 restated	**2005**	2004	**2005**	2004 restated
Amounts due from:								
Cash and balances with banks and other financial institutions	**30**	3	**671**	1,213	**–**	–	**1**	–
Placings with and advances to banks and other financial institutions	**1,909**	581	**710**	1,196	**–**	–	**78**	31
Trading assets	**50**	–	**–**	–	**–**	–	**–**	–
Derivative financial instruments	**101**	134	**24**	43	**–**	–	**–**	–
Financial assets designated at fair value	**–**	–	**–**	–	**–**	–	**–**	–
Advances to customers	**–**	–	**–**	–	**–**	–	**–**	–
Amounts due from subsidiaries	**–**	–	**–**	–	**93,261**	109,324	**–**	–
Financial investments	**325**	731	**–**	–	**–**	–	**–**	–
Other assets	**13**	44	**1**	–	**–**	–	**–**	–
	2,428	1,493	**1,406**	2,452	**93,261**	109,324	**79**	31
Amounts due to:								
Current, savings and other deposit accounts	**41**	33	**126**	132	**–**	–	**14**	17
Deposits from banks	**4,972**	3,241	**164**	60	**–**	–	**–**	–
Derivative financial instruments	**411**	211	**58**	97	**–**	–	**–**	–
Subordinated liabilities	**2,016**	–	**–**	–	**–**	–	**–**	–
Amounts due to subsidiaries	**–**	–	**–**	–	**1,433**	1,136	**–**	–
Other liabilities	**269**	107	**74**	18	**–**	–	**–**	–
	7,709	3,592	**422**	307	**1,433**	1,136	**14**	17
Derivative contracts:								
Contract amount	**35,364**	20,194	**8,848**	10,647	**–**	–	**–**	–
Credit equivalent amount	**355**	343	**73**	96	**–**	–	**–**	–
Risk-weighted amount	**71**	69	**15**	19	**–**	–	**–**	–

49. 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 7(m) and certain highest paid employees as disclosed in note 7(l), is as follows:

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Short-term employee benefits	**19**	20	**19**	20
Post-employment benefits	**3**	4	**3**	4
Equity compensation benefits	**1**	1	**1**	1
	23	25	**23**	25

(c) Material transactions with key management personnel

During the year, the Bank provided credit facilities and accepted deposits to 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 is as follows:

	Group		Bank	
	2005	2004 restated	**2005**	2004 restated
Interest received	**440**	152	**387**	137
Interest paid	**90**	9	**90**	9
Fees and exchange income received	**18**	34	**18**	34
Loans and advances	**13,166**	11,725	**15,836**	14,140
Deposits	**3,830**	2,983	**3,830**	2,983
Undrawn commitments	**6,130**	4,912	**6,130**	4,912
Maximum aggregate amount of loans and advances during the year	**19,599**	17,903	**18,593**	16,766

(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	
	2005	2004	**2005**	2004
Aggregate amount of relevant transactions outstanding at 31 December	**61**	18	**61**	18
Maximum aggregate amount of relevant transactions during the year	**107**	62	**107**	62

(e) Associates

The Group maintains an interest-free shareholders' loan to an associate. The balance at 31 December 2005 was HK$233 million (2004: HK$233 million).

(f) Ultimate holding company

In 2005, no transaction was conducted with the Bank's ultimate holding company (same as 2004).

50. FINANCIAL RISK MANAGEMENT

This section presents information about the Group's exposure to and its management and control of risks, in particular, the primary risks associated with its use of financial instruments:

– credit risk: loss resulting from customer or counterparty default and arises on credit exposure in all forms, including settlement risk;

– liquidity risk: risk that the Group is unable to meet its payment obligations as they fall due;

– market risk: exposure to market variables such as interest rates, exchange rates and equity markets; and

– operational risk: is the risk of economic loss arising from fraud, unauthorised activities, error, omission, inadequate or failed internal process, people and systems inefficiency, systems failure or from external events. It is inherent to every business organization and covers a wide spectrum of issues.

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

(a) Credit risk

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, treasury and leasing activities. The Group has dedicated standards, policies and procedures in place to control and monitor all such risks.

The Credit Risk Management ("CRM") function is mandated to provide centralised management of credit risk through:

– formulating credit policies on approval process, post disbursement monitoring, recovery process and large exposure;

– issuing guidelines on lending to specified market sectors, industries and products; the acceptability of specific classes of collateral or risk mitigations and valuation parameters for collateral;

– undertaking an independent review and objective assessment of credit risk;

– controlling exposures to industries, counterparties, countries and portfolio types etc. by setting limits;

– maintaining facility grading process;

– 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.

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is also paid to problem loans. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Loans impairment allowances are made promptly where necessary and be consistent with established guidelines. Management regularly performs an assessment of the adequacy of the established impairment 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.

Master netting arrangements

The Group further restricts its exposure to credit losses by entering into master netting arrangements with counterparties with which it undertakes a significant volume of transactions. Master netting arrangements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by a master netting arrangement to the extent that if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting arrangements can change substantially within a short period, as it is affected by each transaction subject to the arrangement.

50. 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 14 and credit risk concentration of respective financial assets is disclosed in notes 18 to 21.

(b) Liquidity risk

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

The Group has established policies and procedures to monitor and control its liquidity position on a daily basis by adopting a cash flow management approach. The Group always maintains a stock of high quality liquid assets to ensure the availability of sufficient cash flow to meet its financial commitments, including customer deposits on maturity and undrawn facilities, over a specified future period. The liquidity management process is monitored by the Asset and Liability Management Committee ("ALCO") and is reported to the Executive Committee and the Board of Directors.

Analysis of assets and liabilities by remaining maturity is disclosed in note 15.

(c) Market risk

Market risk is the risk that foreign exchange rates, interest rates or equity and commodity prices will move and result in profits or losses to the Group. The Group's market risk arises from customer-related business and from position taking.

Market risk is managed within risk limits approved by the Board of Directors. Risk limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value-at-risk ("VAR") limits at a portfolio level. 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.

(i) Foreign exchange exposure

The Group's foreign exchange exposures mainly comprise foreign exchange dealing by Treasury and currency exposures originated by its banking business. The latter are transferred to Treasury where they are centrally managed within foreign exchange position limits approved by the Board of Directors. Structural foreign exchange positions arising from capital investment in subsidiaries and branches outside Hong Kong, mainly in US dollar and renminbi as set out below, are managed by ALCO.

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(i) Foreign exchange exposure (continued)

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

	Group			
2005	USD	RMB	Other foreign currencies	Total foreign currencies
Non-structural position				
Spot assets	193,149	5,955	98,115	297,219
Spot liabilities	(168,513)	(6,008)	(97,661)	(272,182)
Forward purchases	84,026	439	40,291	124,756
Forward sales	(104,960)	(300)	(40,772)	(146,032)
Net options position	(77)	–	75	(2)
Net long non-structural position	3,625	86	48	3,759
% of total net non-structural position	96.4%	2.3%	1.3%	100.0%
Structural positions	1,035	2,043	107	3,185
% of total net structural position	32.5%	64.1%	3.4%	100.0%

	Bank			
2005	USD	RMB	Other foreign currencies	Total foreign currencies
Non-structural position				
Spot assets	153,467	5,955	63,853	223,275
Spot liabilities	(128,831)	(6,008)	(63,399)	(198,238)
Forward purchases	84,026	439	40,291	124,756
Forward sales	(104,960)	(300)	(40,772)	(146,032)
Net options position	(77)	–	75	(2)
Net long non-structural position	3,625	86	48	3,759
% of total net non-structural position	96.4%	2.3%	1.3%	100.0%
Structural positions	1,035	2,043	107	3,185
% of total net structural position	32.5%	64.1%	3.4%	100.0%

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(i) Foreign exchange exposure (continued)

	Group			
2004	USD	RMB	Other foreign currencies	Total foreign currencies
Non-structural position				
Spot assets	173,071	2,664	112,074	287,809
Spot liabilities	(171,698)	(2,400)	(94,709)	(268,807)
Forward purchases	68,726	207	28,826	97,759
Forward sales	(69,795)	(192)	(46,148)	(116,135)
Net options position	(37)	–	37	–
Net long non-structural position	267	279	80	626
% of total net non-structural position	42.7%	44.6%	12.7%	100.0%
Structural positions	850	1,998	108	2,956
% of total net structural position	28.8%	67.6%	3.6%	100.0%

	Bank			
2004	USD	RMB	Other foreign currencies	Total foreign currencies
Non-structural position				
Spot assets	128,169	2,664	70,054	200,887
Spot liabilities	(126,796)	(2,400)	(52,689)	(181,885)
Forward purchases	68,726	207	28,826	97,759
Forward sales	(69,795)	(192)	(46,148)	(116,135)
Net options position	(37)	–	37	–
Net long non-structural position	267	279	80	626
% of total net non-structural position	42.7%	44.6%	12.7%	100.0%
Structural positions	850	1,998	108	2,956
% of total net structural position	28.8%	67.6%	3.6%	100.0%

(ii) Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios as well as structural interest rate exposures. Structural interest rate risk arises from the differing repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts. Structural interest rate risks were transferred to Treasury based on contractual or behavioural maturity directly or through the ALCO book.

Treasury manages interest rate risks within the limits approved by the Board of Directors and under the monitoring of ALCO.

Interest rate sensitivity analysis is useful in managing the interest rate risk of non-trading portfolio. The tables on pages 178 to 181 disclose the mismatching of the dates on which interest receivable on assets and payable on liabilities are next reset to market rates on a contractual basis, or, if earlier, the dates on which the instruments mature. Actual reset dates may differ from contractual dates owing to prepayments and the exercise of options. At 31 December 2005, it is estimated that a general increase one percentage point in interest rates would decrease the Group's profit before tax by approximately HK$248 million so far as the effect on interest-bearing financial instruments is concerned.

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(ii) Interest rate exposure (continued)

Interest rate sensitivity analysis

	Group						
2005	up to 3 months	More than 3 months and up to 6 months	More than 6 months and up to 12 months	More than 12 Months	Non-interest earning/ bearing	Trading Book	Total
Assets							
Cash and balances with banks and other financial institutions	4,320	–	–	–	4,881	–	9,201
Placings with and advances to banks and other financial institutions	64,919	3,332	1,031	4	–	–	69,286
Trading assets	–	–	–	–	28	12,572	12,600
Financial assets designated at fair value	51	75	37	4,106	1,758	–	6,027
Derivative financial instruments	–	–	–	–	470	1,245	1,715
Advances to customers	240,688	9,024	4,970	5,547	451	–	260,680
Financial investments	97,920	11,210	13,750	65,664	1,360	–	189,904
Investments in associates	–	–	–	–	2,929	–	2,929
Investment properties	–	–	–	–	4,273	–	4,273
Premises, plant and equipment	–	–	–	–	6,750	–	6,750
Interest in leasehold land held for own use under operating lease	–	–	–	–	594	–	594
Intangible assets	–	–	–	–	1,636	–	1,636
Other assets	4	–	–	–	15,221	–	15,225
Total assets	407,902	23,641	19,788	75,321	40,351	13,817	580,820
Liabilities							
Current, savings and other deposit accounts	400,586	4,287	1,628	965	23,529	–	430,995
Deposits from banks	11,953	86	–	–	4	–	12,043
Trading liabilities	–	–	–	–	–	45,804	45,804
Financial liabilities designated at fair value	–	–	–	967	–	–	967
Derivative financial instruments	–	–	–	–	485	1,307	1,792
Certificates of deposit and other debt securities in issue	225	1,162	798	7,838	–	–	10,023
Other liabilities	–	–	–	–	14,138	–	14,138
Liabilities to customers under investment contracts	–	–	–	–	561	–	561
Liabilities to customers under insurance contracts	–	–	–	–	15,335	–	15,335
Deferred tax and current tax liabilities	–	–	–	–	1,921	–	1,921
Subordinated liabilities	3,511	–	–	–	–	–	3,511
Total liabilities	416,275	5,535	2,426	9,770	55,973	47,111	537,090
Off-balance sheet items	(21,638)	7,189	3,107	11,342			
Net gap position	(30,011)	25,295	20,469	76,893			
Cumulative gap position	(30,011)	(4,716)	15,753	92,646			

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(ii) Interest rate exposure (continued)

Interest rate sensitivity analysis

	Bank						
2005	up to 3 months	More than 3 months and up to 6 months	More than 6 months and up to 12 months	More than 12 Months	Non-interest earning/ bearing	Trading Book	Total
Assets							
Cash and balances with banks and other financial institutions	4,321	–	–	–	4,852	–	9,173
Placings with and advances to banks and other financial institutions	43,573	1,912	1,031	4	–	–	46,520
Trading assets	–	–	–	–	28	9,125	9,153
Financial assets designated at fair value	–	50	–	1,597	–	–	1,647
Derivative financial instruments	–	–	–	–	397	1,226	1,623
Advances to customers	196,409	8,828	4,174	5,408	291	–	215,110
Amounts due from subsidiaries	91,329	–	–	–	1,932	–	93,261
Financial investments	72,090	8,705	11,338	49,935	52	–	142,120
Investments in subsidiaries	–	–	–	–	2,104	–	2,104
Investments in associates	–	–	–	–	1,634	–	1,634
Investment properties	–	–	–	–	2,644	–	2,644
Premises, plant and equipment	–	–	–	–	4,798	–	4,798
Interest in leasehold land held for own use under operating lease	–	–	–	–	594	–	594
Intangible assets	–	–	–	–	71	–	71
Other assets	–	–	–	–	13,836	–	13,836
Total assets	407,722	19,495	16,543	56,944	33,233	10,351	544,288
Liabilities							
Current, savings and other deposit accounts	391,342	4,274	1,622	965	23,315	–	421,518
Deposits from banks	11,953	86	–	–	4	–	12,043
Trading liabilities	–	–	–	–	–	45,804	45,804
Financial liabilities designated at fair value	–	–	–	967	–	–	967
Derivative financial instruments	–	–	–	–	483	1,288	1,771
Certificates of deposit and other debt securities in issue	233	1,162	798	7,867	–	–	10,060
Amounts due to subsidiaries	419	1,014	–	–	–	–	1,433
Other liabilities	–	–	–	–	15,112	–	15,112
Deferred tax and current tax liabilities	–	–	–	–	1,303	–	1,303
Subordinated liabilities	3,511	–	–	–	–	–	3,511
Total liabilities	407,458	6,536	2,420	9,799	40,217	47,092	513,522
Off-balance sheet items	(21,526)	7,470	2,773	11,283			
Net gap position	(21,262)	20,429	16,896	58,428			
Cumulative gap position	(21,262)	(833)	16,063	74,491			

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(ii) Interest rate exposure (continued)

Interest rate sensitivity analysis

	Group						
2004	up to 3 months	More than 3 months and up to 6 months	More than 6 months and up to 12 months	More than 12 Months	Non-interest earning/ bearing	Trading Book	Total
Assets							
Cash and balances with banks and other financial institutions	495	–	–	–	6,753	–	7,248
Placings with and advances to banks and other financial institutions	69,196	3,960	1,919	4	–	–	75,079
Trading assets	–	–	–	–	44	4,188	4,232
Derivative financial instruments	–	–	–	–	–	1,684	1,684
Advances to customers	223,015	14,781	6,182	5,349	2,226	–	251,553
Financial investments	86,028	9,492	19,637	66,619	2,930	–	184,706
Investments in associates	–	–	–	–	2,299	–	2,299
Investment properties	–	–	–	–	3,383	–	3,383
Premises, plant and equipment	–	–	–	–	5,558	–	5,558
Interest in leasehold land held for own use under operating lease	–	–	–	–	609	–	609
Intangible assets	–	–	–	–	1,266	–	1,266
Other assets	–	–	–	–	9,330	–	9,330
Total assets	378,734	28,233	27,738	71,972	34,398	5,872	546,947
Liabilities							
Current, savings and other deposit accounts	407,868	5,320	2,138	2,705	29,429	–	447,460
Deposits from banks	11,406	–	–	–	528	–	11,934
Trading liabilities	–	–	–	–	–	5,840	5,840
Derivative financial instruments	–	–	–	–	–	1,273	1,273
Certificates of deposit and other debt securities in issue	9,902	315	1,104	4,734	–	–	16,055
Other liabilities	–	–	–	–	11,740	–	11,740
Liabilities to customers under investment contracts	–	–	–	–	540	–	540
Liabilities to customers under insurance contracts	–	–	–	–	8,656	–	8,656
Deferred tax and current tax liabilities	–	–	–	–	1,668	–	1,668
Total liabilities	429,176	5,635	3,242	7,439	52,561	7,113	505,166
Off-balance sheet items	(6,493)	494	2,004	3,995			
Net gap position	(56,935)	23,092	26,500	68,528			
Cumulative gap position	(56,935)	(33,843)	(7,343)	61,185			

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(ii) Interest rate exposure (continued)

Interest rate sensitivity analysis

	Bank						
2004	up to 3 months	More than 3 months and up to 6 months	More than 6 months and up to 12 months	More than 12 Months	Non-interest earning/ bearing	Trading Book	Total
Assets							
Cash and balances with banks and other financial institutions	494	–	–	–	6,731	–	7,225
Placings with and advances to banks and other financial institutions	35,550	1,503	114	4	–	–	37,171
Trading assets	–	–	–	–	44	4,103	4,147
Derivative financial instruments	–	–	–	–	–	1,684	1,684
Advances to customers	178,292	11,733	2,043	5,211	1,511	–	198,790
Amounts due from subsidiaries	107,280	–	–	–	2,044	–	109,324
Financial investments	62,467	3,794	15,488	59,974	2	–	141,725
Investments in subsidiaries	–	–	–	–	2,004	–	2,004
Investments in associates	–	–	–	–	1,634	–	1,634
Investment properties	–	–	–	–	2,046	–	2,046
Premises, plant and equipment	–	–	–	–	4,013	–	4,013
Interest in leasehold land held for own use under operating lease	–	–	–	–	609	–	609
Intangible assets	–	–	–	–	17	–	17
Other assets	–	–	–	–	8,140	–	8,140
Total assets	384,083	17,030	17,645	65,189	28,795	5,787	518,529
Liabilities							
Current, savings and other deposit accounts	398,543	5,304	2,132	2,705	29,363	–	438,047
Deposits from banks	11,404	–	–	–	528	–	11,932
Trading liabilities	–	–	–	–	–	5,840	5,840
Derivative financial instruments	–	–	–	–	–	1,272	1,272
Certificates of deposit and other debt securities in issue	9,920	315	1,104	4,771	–	–	16,110
Amounts due to subsidiaries	1,136	–	–	–	–	–	1,136
Other liabilities	–	–	–	–	12,662	–	12,662
Deferred tax and current tax liabilities	–	–	–	–	1,232	–	1,232
Total liabilities	421,003	5,619	3,236	7,476	43,785	7,112	488,231
Off-balance sheet items	(213)	719	802	(1,308)			
Net gap position	(37,133)	12,130	15,211	56,405			
Cumulative gap position	(37,133)	(25,003)	(9,792)	46,613			

50. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

(ii) Interest rate exposure (continued)

The following table indicates the effective interest rates for interest bearing assets and liabilities in 2005 as compared with 2004.

	2005			2004 restated		
	Average balance HK$m	Interest income HK$m	yield %	Average balance HK$m	Interest income HK$m	yield %
Assets						
Balances and placings with and advances to banks	**65,905**	**2,301**	**3.49**	69,548	1,771	2.55
Advances to customers	**255,825**	**10,305**	**4.03**	243,273	6,871	2.82
Financial investments	**183,491**	**6,423**	**3.50**	167,496	4,140	2.47
Total interest-earning assets	**505,221**	**19,029**	**3.77**	480,317	12,782	2.66
Loans impairment allowances	**(983)**	**–**	**–**	–	–	–
Provision for bad & doubtful debts	**–**	**–**	**–**	(1,696)	–	–
Non interest-earning assets and trading assets	**57,535**	**–**	**–**	29,637	–	–
Total assets and interest income	**561,773**	**19,029**	**3.39**	508,258	12,782	2.51

	Average balance HK$m	Interest expense HK$m	Cost %	Average balance HK$m	Interest expense HK$m	Cost %
Liabilities						
Current, savings and other deposit accounts	**400,237**	**6,796**	**1.70**	396,785	2,261	0.57
Deposits from banks	**23,209**	**717**	**3.09**	11,264	203	1.80
Certificates of deposit and debt securities in issue	**11,847**	**412**	**3.48**	9,857	231	2.34
Subordinated liabilities	**913**	**36**	**3.94**	–	–	–
Other interest-bearing liabilities	**15**	**–**	**–**	3,119	82	2.63
Total interest-bearing liabilities	**436,221**	**7,961**	**1.83**	421,025	2,777	0.66
Non interest-bearing current accounts	**25,857**	**–**	**–**	27,690	–	–
Shareholders' funds, non interest-bearing liabilities and trading liabilities	**99,695**	**–**	**–**	59,543	–	–
Total liabilities and interest expenses	**561,773**	**7,961**	**1.42**	508,258	2,777	0.55

(iii) Equities exposure

The Group's equities exposure in 2005 is mainly in long-term equity investments which are reported as "Financial investments" set out in note 21. Equities held for trading purpose are included under "Trading assets" set out in note 18. These are subject to trading limit and risk management control procedures and other market risk regime.

(d) Insurance underwriting risk

Through its insurance subsidiaries, the Group offers a comprehensive insurance products, including life and non life insurance, to both personal and commercial customers. As a result, the Group is exposed to financial risks when the proceeds from the financial assets are not sufficient to fund the obligations arising from insurance and investment contracts. These insurance operating subsidiaries are subject to the supervision of the Insurance Authority in Hong Kong and are required to observe the relevant compliance requirements stipulated by the Insurance Authority.

The Group manages its insurance risks through the application of sound underwriting, reinsurance, risk management and claims procedures. To mitigate the concentration of insurance risk, the Group uses a combination of treaty and facultative reinsurance. Use of reinsurance is confined to a select number of professional companies.

50. FINANCIAL RISK MANAGEMENT (continued)

(e) Operational risk

The Group's established framework for operational risk management includes identification and vigorous assessment of operational risks inherent in processes, activities and products and adequate management information on analysis of operational loss events and data. The Operational Risk Management Committee oversees the implementation of this framework. Operational risk is mitigated by well-established internal control system, adequate insurance cover, back up systems and contingency business resumption plans.

51. USE OF DERIVATIVES

Derivatives are financial contracts whose value and characteristics are derived from underlying assets, exchange and interest rates, and indices. Derivative instruments are subject to both credit risk and market risk. The credit risk relating to a derivative contract is principally the replacement cost of the contract when it has a positive mark-to-market value and the estimated potential future change in value over the residual maturity of the contract. The nominal value of the contracts does not represent the amount of the Group's exposure to credit risk. All activities relating to derivatives are subject to the same credit approval and monitoring procedures used for other credit transactions. Details of the nominal value, fair value and credit risk-weighted amounts of derivatives are set out in note 40.

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 50.

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

Trading derivatives

Most of the Group's trading derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters.

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

Hedging instruments

The Group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the Group to optimise the cost of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

(a) Fair value hedge

The Group's fair value hedge principally consists of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates.

(b) Cash flow hedges

The Group is exposed to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions.

51. USE OF DERIVATIVES (continued)

The table below is a summary of the derivative assets and liabilities held for hedging purposes at 31 December 2005:

	Group		Bank	
	Fair Value hedges	Cash flow hedges	Fair Value hedges	Cash flow hedges
Derivative assets				
– Interest rate contracts	156	298	110	271
Derivative liabilities				
– Interest rate contracts	142	315	141	315

Hedge effectiveness testing

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

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

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

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

52. FAIR VALUES OF FINANCIAL INSTRUMENTS

(a) Determination of fair value

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

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

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

52. FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)

(b) Fair value

All financial instruments are stated at fair value or carried at amounts not materially different from their fair values as at 31 December 2005 and 2004 except as follows:

	Group			
	2005		2004	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	**69,286**	**69,284**	75,079	75,069
Advances to customers	**260,680**	**260,139**	251,553	254,510
Held-to-maturity debt securities	**10,731**	**10,778**	181,000	182,577
Financial Liabilities				
Current, savings and other deposit accounts	**430,995**	**430,944**	447,460	447,429
Deposits from banks	**12,043**	**12,043**	11,934	11,934
Certificates of deposit and other debt securities in issue	**10,023**	**9,825**	16,055	16,142
Subordinated liabilities	**3,511**	**3,547**	–	–

	Bank			
	2005		2004	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	**46,520**	**46,518**	37,171	37,171
Advances to customers	**215,110**	**214,791**	198,790	200,944
Held-to-maturity debt securities	**–**	**–**	141,723	142,708
Financial Liabilities				
Current, savings and other deposit accounts	**421,518**	**421,467**	438,047	438,015
Deposits from banks	**12,043**	**12,043**	11,932	11,932
Certificates of deposit and other debt securities in issue	**10,060**	**9,864**	16,110	16,197
Subordinated liabilities	**3,511**	**3,547**	–	–

53. PARENT AND ULTIMATE HOLDING COMPANIES

The parent and ultimate holding companies of the Bank are The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong) and HSBC Holdings plc (incorporated in England) respectively.

54. APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 6 March 2006.