Notes to the Financial Statements

year ended 31 December 2009
(Figures expressed in millions of Hong Kong dollars unless otherwise indicated)

1. BASIS OF PREPARATION

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

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

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

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

- financial instruments classified as trading, designated at fair value and available-for-sale (see note 4(g));
- investment property (see note 4(r));
- other leasehold land and buildings, for which the fair values cannot be allocated reliably between the land and buildings elements at the inception of the lease and the entire lease is therefore classified as a finance lease (see note 4(s)); 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 4(s)).

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

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

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

Disclosures under HKFRS 4 "Insurance Contract" and HKFRS 7 "Financial Instrument: Disclosure" relating to the nature and extent of risks have been included in note 62 "Financial risk management".

2. NATURE OF BUSINESS

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

3. BASIS OF CONSOLIDATION

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

4. PRINCIPAL ACCOUNTING POLICIES

(a) Interest income and expense

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

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

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

(b) Non-interest income

(i) Fee income

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

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

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

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

(ii) Rental income from operating lease

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

(iii) Dividend income

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(b) Non-interest income (continued)

(iv) Trading income

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

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

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

(c) Segment reporting

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

(d) Cash and cash equivalents

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

(e) Loans and advances to banks and customers

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

(f) Loan impairment

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

(i) Individually assessed loans

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

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

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(f) Loan impairment (continued)

(i) Individually assessed loans (continued)

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

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

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

(ii) Collectively assessed loans

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

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

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of loss has been identified individually, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment allowance. This allowance covers loans that are impaired at the end of the reporting period 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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(f) Loan impairment (continued)

(ii) Collectively assessed loans (continued)

Homogeneous groups of loans

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

(iii) Loan write-offs

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

(iv) Reversals of impairment

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

(v) Repossessed assets

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

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

(vi) Renegotiated loans

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

(g) Financial instruments

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

(i) Trading assets and trading liabilities

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments (continued)

(ii) Financial instruments designated at fair value

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

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

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

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

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

– applies to a group of financial assets, financial liabilities or both that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel. Under this criterion, certain liabilities under investment contracts and financial assets held to meet liabilities under insurance and investment contracts are the main classes of financial instrument so designated. The Group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.

– relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.

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

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

(iii) Available-for-sale financial assets

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(g) Financial instruments (continued)

(iii) Available-for-sale financial assets (continued)

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

(iv) Held-to-maturity investments

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

(h) Derivative financial instruments

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

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

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

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

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

(i) Hedge accounting

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(i) Hedge accounting (continued)

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

(i) Fair value hedge

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

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

(ii) Cash flow hedge

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

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

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

(iii) Hedge effectiveness testing

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

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

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

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

(iv) Derivatives that do not qualify for hedge accounting

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(j) Sale and repurchase agreements

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

(k) Offsetting financial instruments

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

(l) Application of trade date accounting

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

(m) Derecognition of financial assets and liabilities

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

(n) Determination of fair value

The fair value of financial instruments is based on their quoted market prices at the end of the reporting period, without any deduction for estimated future selling costs. Financial assets are priced at current bid prices while financial liabilities are priced at current asking prices.

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

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

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

(o) Subsidiaries

A subsidiary is a corporate entity in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half of the voting power or controls the composition of the board of directors, or a non-corporate entity the Group otherwise controls, directly or indirectly, by way of having the power to govern its financial and operating policies so that the Group obtains benefits from these activities.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(o) Subsidiaries (continued)

A subsidiary is fully consolidated into the consolidated financial statements from the date that control commences until the date that control ceases.

In the Bank's statement of financial position, an investment in subsidiary is stated at cost less impairment allowances.

(p) Associates

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

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

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

In the Bank's statement of financial position, investment in associate is stated at cost less impairment allowances.

(q) Goodwill and intangible assets

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

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

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

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

(r) Investment property

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(r) Investment property (continued)

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

(s) Premises, plant and equipment

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

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

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

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

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 other comprehensive income and are accumulated separately in the "Premises revaluation reserve". Deficits arising on revaluation, are firstly set off against any previous revaluation surpluses included in the "Premises revaluation reserve" in respect of the same property, and are thereafter to the income statement.

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

– freehold land is not depreciated;

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

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

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

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

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

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

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

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(u) Finance and operating leases

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

(i) Finance leases

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

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

(ii) Operating leases

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

(v) Impairment of assets

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

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

(i) Held-to-maturity investments

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

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

(ii) Available-for-sale financial assets

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(v) Impairment of assets (continued)

(ii) Available-for-sale financial assets (continued)

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

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

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

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

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

(iii) Other assets

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

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

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

Calculation of recoverable amount

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(v) Impairment of assets (continued)

(iii) Other assets (continued)

Recognition of impairment losses

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

Reversals of impairment losses

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

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

(w) Income tax

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

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

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

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

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

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

(x) Employee benefits

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(x) 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. Any actuarial gains and losses are fully recognised in shareholders' equity and presented in the statement of changes in equity in the period in which they arise.

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

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

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

(y) Share-based payments

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

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

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

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

(z) Translation of foreign currencies

Foreign currency transactions during the year are translated at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated at the foreign exchange rates ruling at the end of the reporting period. 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.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(z) Translation of foreign currencies (continued)

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

(aa) Provisions

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

(ab) Financial guarantees

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

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

(ac) Insurance contracts

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

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

Insurance contracts are accounted for as follows:

Net earned insurance premiums

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

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

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

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(ac) Insurance contracts (continued)

Claims and reinsurance recoveries

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

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

Deferred acquisition costs

The deferred acquisition costs related to insurance contract, such as initial commission, are amortised over the period in which the related revenues are earned.

Value of long-term insurance business

A value is placed on insurance contracts that are classified as long-term assurance business, and are in force at the end of the reporting period.

The value of the in-force long-term assurance business is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as future mortality, lapse rates, levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. Movements in the value of in-force long-term assurance business are included in other operating income on a pre-tax basis. The value of in-force long-term insurance business is reported under “Intangible assets” in the statement of financial position.

(ad) Investment contracts

Customer liabilities under unit-linked investment contracts are measured at fair value and reported under “Financial liabilities designated at fair value”. The linked financial assets are measured at fair value and the movements in fair value are recognised in the income statement in “Net income from financial instruments designated at fair value”.

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

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

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

(ae) Debt securities in issue and subordinated liabilities

Debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest rate method, and are reported under “Debt securities in issue” or “Subordinated liabilities”, except for those issued for trading or designated at fair value, which are carried at fair value and reported under the “Trading liabilities” and “Financial liabilities designated at fair value” in the statement of financial position.

4. PRINCIPAL ACCOUNTING POLICIES (continued)

(af) Assets held for sale

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

(ag) Related parties

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

(ah) Dividends

Dividends proposed or declared after the end of the reporting period are disclosed as a separate component of shareholders' equity.

5. CHANGES IN ACCOUNTING POLICIES

During the year the Group adopted the following HKFRSs and amendments to HKFRSs:

Amendments to HKFRS 7 "Financial Instruments: Disclosures - Improving Disclosures about Financial Instruments". The amendments introduce a three level fair value hierarchy, which reflects the availability of observable market inputs when estimating fair values and clarifies the quantitative disclosures about the liquidity risk associated with financial instruments. The adoption of the amendment has no effect on the results reported in the consolidated financial statements.

HKFRS 8 "Operating Segments" (HKFRS 8), which replaced HKAS 14 "Segment Reporting". HKFRS 8 requires segment information to be reported using the same measure reported to the chief operating decision maker for the purpose of making decisions about allocating resources to the segment and assessing its performance. The Group's HKFRS 8 operating segments are determined to be customer group segment because the chief operating decision maker uses customer group information in order to make decisions about allocating resources and assessing performance. The five operating segments, or customer groups, are: Personal Financial Services, Commercial Banking, Corporate Banking, Treasury, and "Other". Segment information provided to the chief operating decision maker is on HKFRS basis.

HKAS 1 (Revised 2007) "Presentation of Financial Statements". The revised standard aims to improve users' ability to analyse and compare information given in financial statements. The adoption of the revised standard has no effect on the results reported in the consolidated financial statements. It does, however, result in certain presentational changes in the consolidated financial statements, including:

– the presentation of all items of income and expenditure in two financial statements, the "Consolidated income statement" and the "Consolidated statement of comprehensive income";

– the presentation of the "Consolidated statement of changes in equity" as a financial statement, which replaces the "Reserves" note on the financial statements; and

– the adoption of revised title "Statement of financial position" for the "Balance sheet".

5. CHANGES IN ACCOUNTING POLICIES (continued)

During the year, the Group also adopted a number of HKFRSs or amendments to HKFRSs which had an insignificant effect on the consolidated financial statements. These are:

- Amendments to HKAS 27 "Consolidated and Separate Financial Statements" – "Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate";
- HKAS 23 (Revised 2007) "Borrowing Costs";
- Amendments to HKAS 32 "Financial Instruments: Presentation" and HKAS 1 "Presentation of Financial Statements" – "Puttable Financial Instruments and Obligations Arising on Liquidation";
- Amendments to HKFRS 2 "Share-based Payment" – "Vesting Conditions and Cancellations";
- Improvements to HKFRSs (2008);
- Hong Kong (IFRIC) Interpretation 13 "Customer Loyalty Programmes" ;
- Hong Kong (IFRIC) Interpretation 16 '"Hedges of a Net Investment in a Foreign Operation".

6. ACCOUNTING ESTIMATES AND JUDGEMENTS

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

(a) Key sources of estimation uncertainty

(i) Impairment allowances on loans and advances

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

(ii) Valuation of financial instruments

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

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

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgment may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;
- an appropriate discount rate for the instrument. Management determines this rate based on its assessment of the appropriate spread of the rate for the instrument over the risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative models.

6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

(a) Key sources of estimation uncertainty (continued)

(ii) Valuation of financial instruments (continued)

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

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

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

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

(iii) Insurance contracts

Classification

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

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

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

Insurance liabilities

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

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

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

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

6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

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

(ii) Held-to-maturity investments

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

(iii) Income taxes

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

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2009

The HKICPA has issued a number of amendments to HKFRS and Interpretations which are not yet effective for the year ended 31 December 2009 and which have not been adopted in these financial statements.

A revised HKFRS 3 "Business Combinations" and an amended HKAS 27 "Consolidated and Separate Financial Statements" were issued by the HKICPA in March 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes are that:

– acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;

– equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;

– changes in a parent's ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and

– an option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interests) in the entity either at fair value, or at the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired.

The effect that the changes will have on the consolidated financial statements of the Group will depend on the incident and timing of business combination occurring on or after 1 January 2010.

The HKICPA issued an amendment to HKAS 39 "Financial Instruments: Recognition and Measurement" – "Eligible Hedged Items" in November 2008, which is applicable for annual periods beginning on or after 1 July 2009. The amendment clarifies how the existing principles underlying hedge accounting should be applied. This amendment will have no effect on the consolidated financial statements.

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

Hong Kong (IFRIC) Interpretation 18 "Transfer of Assets from Customers" ("HK (IFRIC)-Int 18") was issued in February 2009 and is effective for annual periods beginning on or after 1 July 2009. HK (IFRIC)-Int 18 clarifies the requirements of HKFRSs for agreements in which an entity receives from a customer an item of property, plant and equipment that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services (such as a supply of electricity, gas or water). The Group does not expect adoption of HK (IFRIC)-Int 18 to have an effect on the consolidated financial statements.

7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2009 (continued)

An amendment to Hong Kong (IFRIC) Interpretation 9 and HKAS 39 – "Embedded Derivatives" was issued by the HKICPA in March 2009 and is effective for annual periods ending on or after 30 June 2009. The amendment clarifies the accounting treatment of embedded derivatives for entities that make use of the amendment to HKAS 39 "Financial Instruments: Recognition and Measurement" and to HKFRS 7 "Financial Instruments: Disclosures" – "Reclassification of Financial Assts" (The "Reclassification Amendment") which was adopted by the Group during 2008. Adoption of the amendment will not have significant effect on the consolidated financial statements.

The HKICPA issued "Improvements to HKFRSs" in May 2009, which comprises a collection of necessary, but not urgent, amendments to HKFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2010, with earlier application permitted. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued Amendments to HKFRS 2 "Share-based Payment" – "Group Cash-settled Share-based Payment Transactions" in July 2009, which is effective for annual periods beginning on or after 1 January 2010. The amendments clarify that an entity that receives goods or services in a share-based payment arrangement must account for those goods or services no matter which entity in the Group settles the transaction, and no matter whether the transaction is settled in shares or cash. It was also clarified that in HKFRS 2 a "Group" includes only a parent and its subsidiaries. The Group does not expect adoption of the amendment to have a significant effect of the consolidated financial statements.

The HKICPA issued HKAS 24 (Revised 2009) "Related Party Disclosures" in November 2009, which is effective for annual periods beginning on or after 1 January 2011. The revised standard simplifies the disclosure requirements for government-related entities and clarifies the definition of a related party. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

HKFRS 9 "Financial Instruments" ("HKFRS 9") was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2013 with earlier application permitted.

Under HKFRS 9, financial assets are classified into two measurement categories: amortised cost or fair value. These two categories replace the four categories under the current HKAS 39 "Financial Instruments: Recognition and Measurement". Under HKFRS 9, financial assets are classified on the basis of both an entity's business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets.

The Group is presently studying the implications of applying HKFRS 9 before the mandatory adoption date. Based on a preliminary, high level analysis, it appears that the majority of financial assets included in "Advances to customers" will continue to be measured at amortised cost less impairment. The impact on other financial assets continues to be evaluated.

The HKICPA issued Hong Kong (IFRIC) Interpretation 19 "Extinguishing Financial Liabilities with Equity Instruments" in December 2009, which is effective for annual periods beginning on or after 1 July 2010. This interpretation provides guidance on how to account for the extinguishment of a financial liability by the issue of equity instruments. The Group does not expect adoption of this amendment to have a significant effect on the consolidated financial statements.

The HKICPA issued an Amendment to Hong Kong (IFRIC) Interpretation 14 "HKAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction" – "Prepayments of a Minimum Funding Requirement" in December 2009, which is effective for annual periods beginning on or after 1 January 2011. The amendment applies in the limited circumstances when an entity is subject to minimum funding requirements and makes an early payment of contributions to cover those requirements. The amendment permits such an entity to treat the benefit of such an early payment as an asset. The Group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

8. INTEREST INCOME/INTEREST EXPENSE

(a) Interest income

	2009	2008
Interest income arising from:		
– financial assets that are not at fair value through profit or loss	15,950	25,599
– trading assets	320	363
– financial assets designated at fair value	120	210
	16,390	26,172
of which:		
– interest income from listed investments	1,801	3,204
– interest income from unlisted investments	3,569	5,701
– interest income from impaired financial assets	46	18

(b) Interest expense

	2009	2008
Interest expense arising from:		
– financial liabilities that are not at fair value through profit or loss	1,799	8,322
– trading liabilities	554	1,574
– financial liabilities designated at fair value	14	44
	2,367	9,940
of which:		
– interest expense from debt securities in issue maturing after five years	–	11
– interest expense from customer accounts maturing after five years	–	1
– interest expense from subordinated liabilities	126	396

9. NET FEE INCOME

	2009	2008
– stockbroking and related services	**1,566**	1,359
– retail investment funds	**604**	1,084
– structured investment products	**28**	341
– insurance	**190**	98
– account services	**291**	282
– private banking service fee	**129**	234
– remittances	**217**	212
– cards	**1,413**	1,304
– credit facilities	**135**	132
– trade services	**379**	409
– other	**238**	249
Fee income	**5,190**	5,704
Fee expense	**(869)**	(735)
	4,321	4,969
of which:		
Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading nor designated at fair value	**1,658**	1,586
– fee income	**2,217**	2,124
– fee expense	**(559)**	(538)
Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers	**383**	620
– fee income	**557**	773
– fee expense	**(174)**	(153)

10. TRADING INCOME

	2009	2008
Foreign exchange	**1,792**	1,384
Gains/(losses) from hedging activities:		
– fair value hedge		
– on hedging instruments	**74**	(515)
– on the hedged items attributable to the hedged risk	**(81)**	496
– cash flow hedge		
– net hedging income	**16**	1
Securities, derivatives and other trading activities	**122**	89
	1,923	1,455

11. NET LOSS FROM FINANCIAL INSTRUMENTS DESIGNATED AT FAIR VALUE

	2009	2008
Net loss on assets designated at fair value which back insurance and investment contracts	**(54)**	(1,045)
Net change in fair value of other financial instruments designated at fair value	**(21)**	14
	(75)	(1,031)
of which dividend income from:		
– listed investments	**1**	35
– unlisted investments	**1**	1
	2	36

12. DIVIDEND INCOME

	2009	2008
Dividend income:		
– listed investments	**3**	66
– unlisted investments	**13**	16
	16	82

13. NET EARNED INSURANCE PREMIUMS

	Non-life insurance	**Life insurance (non-linked)**	**Life insurance (linked)**	**Total**
2009				
Gross written premiums	**422**	**11,237**	**15**	**11,674**
Movement in unearned premiums	**(18)**	**–**	**–**	**(18)**
Gross earned premiums	**404**	**11,237**	**15**	**11,656**
Gross written premiums ceded to reinsurers	**(93)**	**(59)**	**–**	**(152)**
Reinsurers' share of movement in unearned premiums	**15**	**–**	**–**	**15**
Reinsurers' share of gross earned premiums	**(78)**	**(59)**	**–**	**(137)**
Net earned insurance premiums	**326**	**11,178**	**15**	**11,519**
2008				
Gross written premiums	411	12,023	46	12,480
Movement in unearned premiums	(8)	–	–	(8)
Gross earned premiums	403	12,023	46	12,472
Gross written premiums ceded to reinsurers	(80)	(46)	–	(126)
Reinsurers' share of movement in unearned premiums	5	–	–	5
Reinsurers' share of gross earned premiums	(75)	(46)	–	(121)
Net earned insurance premiums	328	11,977	46	12,351

14. OTHER OPERATING INCOME

	2009	2008
Rental income from investment properties	**149**	138
Movement in present value of in-force long-term insurance business	**760**	382
Other	**180**	181
	1,089	701

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

	Non-life insurance	Life insurance (non-linked)	Life insurance (linked)	Total
2009				
Claims, benefits and surrenders paid	**119**	**1,811**	**19**	**1,949**
Movement in provisions	**(16)**	**10,066**	**35**	**10,085**
Gross claims incurred and movement in policyholders' liabilities	**103**	**11,877**	**54**	**12,034**
Reinsurers' share of claims, benefits and surrenders paid	**(10)**	**(18)**	**–**	**(28)**
Reinsurers' share of movement in provisions	**(1)**	**(1)**	**–**	**(2)**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(11)**	**(19)**	**–**	**(30)**
Net insurance claims incurred and movement in policyholders' liabilities	**92**	**11,858**	**54**	**12,004**
2008				
Claims, benefits and surrenders paid	130	646	30	806
Movement in provisions	16	10,745	(41)	10,720
Gross claims incurred and movement in policyholders' liabilities	146	11,391	(11)	11,526
Reinsurers' share of claims, benefits and surrenders paid	(32)	(14)	–	(46)
Reinsurers' share of movement in provisions	(9)	(8)	–	(17)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(41)	(22)	–	(63)
Net insurance claims incurred and movement in policyholders' liabilities	105	11,369	(11)	11,463

16. LOAN IMPAIRMENT CHARGES AND OTHER CREDIT RISK PROVISIONS

	Group		Bank	
	2009	2008	**2009**	2008
Loan impairment charges (note 35(b)):				
– individually assessed	**(310)**	(925)	**(285)**	(808)
– collectively assessed	**(502)**	(476)	**(503)**	(378)
	(812)	(1,401)	**(788)**	(1,186)
of which:				
– new and additional	**(1,104)**	(1,505)	**(1,028)**	(1,272)
– releases	**230**	48	**194**	43
– recoveries	**62**	56	**46**	43
	(812)	(1,401)	**(788)**	(1,186)
Other credit risk provisions	**–**	(1,375)	**–**	(846)
	(812)	(2,776)	**(788)**	(2,032)

There was no impairment charge provided for available-for-sale debt securities by the Group and the Bank (2008: HK$1,375 million and HK$846 million). No impairment loss was made in relation to held-to-maturity investments in 2009 (2008: Nil).

17. OPERATING EXPENSES

	2009	2008
Employee compensation and benefits:		
– salaries and other costs	**2,714**	2,817
– performance-related pay*	**377**	462
– retirement benefit costs		
– defined benefit scheme (note 59(a))	**213**	104
– defined contribution scheme (note 59(b))	**74**	69
	3,378	3,452
General and administrative expenses:		
– rental expenses	**430**	409
– amortisation of prepaid operating lease payment (note 41)	**15**	14
– other premises and equipment	**900**	926
– marketing and advertising expenses	**382**	516
– other operating expenses	**1,021**	986
	2,748	2,851
Depreciation of business premises and equipment (note 40(a))	**466**	432
Amortisation of intangible assets (note 42(c))	**84**	60
	6,676	6,795
* of which:		
share based payments (note 60(e))	**101**	109
Cost efficiency ratio	**32.1%**	29.2%

Included in operating expenses are minimum lease payments under operating leases of HK$461 million (2008: HK$437 million).

18. THE EMOLUMENTS OF THE FIVE HIGHEST PAID INDIVIDUALS

(a) The aggregate emoluments

	2009	2008
Salaries, allowances and benefits in kind	**17**	22
Retirement scheme contributions	**2**	3
Discretionary bonuses	**10**	18
Share-based payments	**6**	8
	35	51

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

	2009 Number of Individuals	2008 Number of Individuals
HK$		
5,000,001 – 5,500,000	**1**	–
5,500,001 – 6,000,000	**1**	–
6,000,001 – 6,500,000	**1**	–
6,500,001 – 7,000,000	**1**	1
7,500,001 – 8,000,000	**–**	2
9,000,001 – 9,500,000	**–**	1
10,500,001 – 11,000,000	**1**	–
19,500,001 – 20,000,000	**–**	1
	5	5

The emoluments of the five highest paid individuals set out above include the emoluments of three (2008: three) Executive Directors and one non-executive director (2008: Nil). Their respective directors' emoluments are included in note 19.

19. DIRECTORS' EMOLUMENTS

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

	Fees '000	Salaries, allowances and benefits in kind '000	Pension and Pension contribution[6] '000	Discretionary Bonuses '000	Share-based payments[7] '000	Total 2009 '000	Total 2008 '000
Executive Directors							
Ms Margaret Leung [1]							
(Appointed on 6 May 09)	27	4,234	573	–	–	4,834	–
Mr William W C Leung [3]							
(Appointed on 7 Aug 09)	–	1,359	156	–	359	1,874	–
Mr Raymond C F Or [2]							
(Resigned on 6 May 09)	–	3,447	406	3,195	3,652	10,700	19,646
Mr Joseph C Y Poon [3]							
(Resigned on 30 Sep 09)	–	3,002	308	2,728	–	6,038	9,085
Mr Patrick K W Chan [3]							
(Resigned on 6 May 09)	–	1,261	104	1,476	–	2,841	6,987
Non-Executive Directors							
Mr Raymond K F Ch'ien [5]	360	–	–	–	–	360	360
Mr Edgar David Ancona [4]							
(Resigned on 31 Aug 09)	187	–	–	–	–	187	280
Mr Iain James MACKAY [4]							
(Appointed on 1 Sep 09)	93	–	–	–	–	93	–
Ms Dorothy K Y P Sit [3]							
(Appointed on 7 Aug 09)	–	1,556	155	–	380	2,091	–
Mr Alexander A Flockhart [4]	280	–	–	–	–	280	280
Mr John C C Chan [5]	340	–	–	–	–	340	340
Dr Y T Cheng [5]							
(Resigned on 6 May 09)	117	–	–	–	–	117	280
Dr Marvin K T Cheung [5]	360	–	–	–	–	360	360
Mr Jenkin Hui [5]	320	–	–	–	–	320	320
Mr Peter T C Lee [5]							
(Deceased on 17 Oct 09)	267	–	–	–	–	267	320
Dr Eric K C Li [5]	400	–	–	–	–	400	400
Dr Vincent H S Lo	280	–	–	–	–	280	280
Dr David W K Sin [5]							
(Resigned on 6 May 09)	117	–	–	–	–	117	280
Mr Richard Y S Tang [5]	473	–	–	–	–	473	473
Mr Peter T S Wong [4]	280	–	–	–	–	280	280
Past Directors	–	–	2,169	–	–	2,169	2,169
	3,901	14,859	3,871	7,399	4,391	34,421	42,140
2008	4,253	15,131	3,848	13,037	5,871		

Notes :

(1) Fee received by Mrs Margaret Leung as Non-Executive Director of the Bank for the period from 1 April 2009 to 6 May 2009 in the sum of HK$27,616 was surrendered to The Hongkong and Shanghai Banking Corporation Limited in accordance with the HSBC Group's internal policy. No Director's fee was payable to Mrs Leung in her capacity as Executive Director of the Bank. The sums paid by the Bank to Mrs Leung as an executive of the Bank include sums paid by the Bank in respect of the period from 20 April 2009 to 5 May 2009 when Mrs Leung worked full-time at the Bank to facilitate a smooth handover before she formally took up the position of Chief Executive of the Bank on 6 May 2009.

(2) In line with the HSBC Group's remuneration policy, no Director's fee was paid to Mr Raymond Or during the period from 1 January 2009 to 6 May 2009. The sum paid by the Bank to Mr Raymond Or during the year include sum paid by the Bank in respect of the period from 6 May to 31 May 2009 when Mr Raymond Or, having retired from the Board and ceased to be the Bank's Chief Executive, still worked full-time at the Bank to facilitate a smooth handover to the Bank's new Chief Executive.

(3) Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2009.

(4) 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.

(5) Independent Non-Executive Director.

(6) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.2 million in 2009. The Bank made contributions during 2009 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.

(7) These represent the estimated fair value of share option granted to certain directors under the HSBC Group share option plan and the purchase cost of restricted share and performance share under the HSBC Group share plan, which is measured according to the Group's accounting policies for share-based payment as set out in note 4(y). The details of these benefits in kind are also set out in note 60.

20. AUDITORS' REMUNERATION

	Group		Bank	
	2009	2008	**2009**	2008
Statutory audit services	**13**	13	**9**	8
Non-statutory audit services and others	**6**	7	**5**	5
	19	20	**14**	13

21. GAINS LESS LOSSES FROM FINANCIAL INVESTMENTS AND FIXED ASSETS

	2009	2008
Net gains from disposal of available-for-sale equity securities:		
– reclassified from reserve	**165**	2,199
– net losses arising in the year	**(4)**	(1,553)
	161	646
Net losses from disposal of available-for-sale debt securities	**(152)**	(83)
Impairment of available-for-sale equity securities	**(4)**	(284)
Gains less losses on disposal of assets held for sale	**187**	–
Gains less losses on disposal of fixed assets	**(6)**	(12)
	186	267

There was no impairment losses or gains less losses on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost for 2009 and 2008.

22. NET SURPLUS ON PROPERTY REVALUATION

	2009	2008
Surplus of revaluation on investment properties (note 39(a))	**250**	8
(Revaluation deficit)/reversal of revaluation deficit on premises (note 40(a))	**(31)**	71
	219	79

23. TAX EXPENSE

(a) Taxation in the consolidated income statement represents:

	2009	2008
Current tax-provision for Hong Kong profits tax		
Tax for the year	**1,844**	2,167
Adjustment in respect of prior year	**(3)**	(350)
	1,841	1,817
Current tax-taxation outside Hong Kong		
Tax for the year	**50**	(21)
Deferred tax (note 50(b))		
Origination and reversal of temporary differences	**365**	31
Effect of decrease in tax rate on deferred tax balances at 1 January	**–**	(48)
	365	(17)
Total tax expense	**2,256**	1,779

23. TAX EXPENSE (continued)

(a) Taxation in the consolidated income statement represents: (continued)

The current tax provision is based on the estimated assessable profit for 2009, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2008: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

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

	2009	2008
Profit before tax	**15,477**	15,878
Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2008: 16.5%)	**2,554**	2,620
Tax effect of:		
– different tax rates in other countries/areas	**(139)**	(122)
– non-taxable income and non-deductible expenses	**(108)**	(68)
– share of results of associates	**(288)**	(298)
– reduction in tax rate on deferred tax opening balance	**–**	(48)
– others	**237**	(305)
Actual charge for taxation	**2,256**	1,779

24. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to shareholders, HK$10,341 million (2008: HK$10,598 million) has been dealt with in the financial statements of the Bank.

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

	2009	2008
Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements	**10,341**	10,598
Dividends declared during the year by subsidiaries from retained profits	**5**	232
The Bank's profit for the year	**10,346**	10,830

25. EARNINGS PER SHARE

The calculation of earnings per share for 2009 is based on earnings of HK$13,221 million (HK$14,099 million in 2008) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2008).

26. DIVIDENDS PER SHARE

(a) Dividends attributable to the year:

	2009		2008	
	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**	3.00	5,736
	5.20	**9,942**	6.30	12,045

The fourth interim dividend proposed after the end of the reporting period has not been recognised as a liability at the end of the reporting period.

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

	2009	2008
Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK$3.00 per share (2008: HK$3.00 per share)	**5,736**	5,736

27. SEGMENTAL ANALYSIS

The Group's business comprises five customer groups. On first-time adoption of HKFRS 8 "Operating segments" and in a manner consistent with the way in which information is reported internally for the purposes of resource allocation and performance assessment, the Group has identified the following five reportable segments.

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

(a) Segment result

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

27. SEGMENTAL ANALYSIS (continued)

(a) Segment result (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Total reportable segments	Inter-segment elimination	Total
2009								
Net interest income	8,195	2,011	1,158	2,162	497	14,023	–	14,023
Net fee income/(expense)	3,000	1,114	145	(35)	97	4,321	–	4,321
Trading income/(loss)	662	245	8	1,054	(46)	1,923	–	1,923
Net (loss)/income from financial instruments designated at fair value	(54)	–	–	5	(26)	(75)	–	(75)
Dividend income	2	6	–	–	8	16	–	16
Net earned insurance premiums	11,293	225	1	–	–	11,519	–	11,519
Other operating income	898	29	1	–	632	1,560	(471)	1,089
Total operating income	23,996	3,630	1,313	3,186	1,162	33,287	(471)	32,816
Net insurance claims incurred and movement in policyholders' liabilities	(11,868)	(134)	(2)	–	–	(12,004)	–	(12,004)
Net operating income before loan impairment charges and other credit risk provisions	12,128	3,496	1,311	3,186	1,162	21,283	(471)	20,812
Loan impairment charges and other credit risk provisions	(454)	(278)	(78)	(2)	–	(812)	–	(812)
Net operating income	11,674	3,218	1,233	3,184	1,162	20,471	(471)	20,000
Total operating expenses*	(4,671)	(1,507)	(332)	(268)	(369)	(7,147)	471	(6,676)
Operating profit	7,003	1,711	901	2,916	793	13,324	–	13,324
Gains less losses from financial investments and fixed assets	96	53	14	(152)	175	186	–	186
Net surplus on property revaluation	–	–	–	–	219	219	–	219
Share of profits from associates	159	873	–	629	87	1,748	–	1,748
Profit before tax	7,258	2,637	915	3,393	1,274	15,477	–	15,477
Share of profit before tax	46.9%	17.0%	5.9%	21.9%	8.3%	100.0%	–	100.0%
Operating profit excluding loan impairment charges and other credit risk provisions	7,457	1,989	979	2,918	793	14,136	–	14,136
** Depreciation/amortisation included in total operating expenses*	(173)	(31)	(7)	(4)	(335)	(550)	–	(550)
Total assets	234,723	96,490	88,135	377,561	29,059	825,968	–	825,968
Total liabilities	554,357	123,996	37,477	21,503	30,411	767,744	–	767,744
Investments in associates	847	4,284	–	2,707	2,388	10,226	–	10,226
Capital expenditure incurred	181	34	5	–	92	312	–	312

27. SEGMENTAL ANALYSIS (continued)

(a) Segment result (continued)

	Personal Financial Services	Commercial Banking	Corporate Banking	Treasury	Other	Total reportable segments	Inter-segment elimination	Total
2008								
Net interest income	8,700	2,411	988	2,682	1,451	16,232	–	16,232
Net fee income/(expense)	3,696	1,066	127	(33)	113	4,969	–	4,969
Trading income/(loss)	743	245	18	641	(192)	1,455	–	1,455
Net (loss)/income from financial instruments designated at fair value	(1,043)	(2)	–	(10)	24	(1,031)	–	(1,031)
Dividend income	25	10	–	–	47	82	–	82
Net earned insurance premiums	12,135	213	3	–	–	12,351	–	12,351
Other operating income	439	54	2	4	671	1,170	(469)	701
Total operating income	24,695	3,997	1,138	3,284	2,114	35,228	(469)	34,759
Net insurance claims incurred and movement in policyholders' liabilities	(11,349)	(113)	(1)	–	–	(11,463)	–	(11,463)
Net operating income before loan impairment charges and other credit risk provisions	13,346	3,884	1,137	3,284	2,114	23,765	(469)	23,296
Loan impairment charges and other credit risk provisions	(347)	(853)	(201)	(1,375)	–	(2,776)	–	(2,776)
Net operating income	12,999	3,031	936	1,909	2,114	20,989	(469)	20,520
Total operating expenses*	(4,879)	(1,530)	(322)	(247)	(286)	(7,264)	469	(6,795)
Operating profit	8,120	1,501	614	1.662	1,828	13,725	–	13,725
Gains less losses from financial investments and fixed assets	156	85	31	(84)	79	267	–	267
Net surplus on property revaluation	–	–	–	–	79	79	–	79
Share of profits from associates	134	884	–	701	88	1,807	–	1,807
Profit before tax	8,410	2,470	645	2,279	2,074	15,878	–	15,878
Share of profit before tax	52.9%	15.6%	4.1%	14.4%	13.0%	100.0%	–	100.0%
Operating profit excluding loan impairment charges and other credit risk provisions	8,467	2,354	815	3,037	1,828	16,501	–	16,501
* *Depreciation/amortisation included in total operating expenses*	(140)	(24)	(7)	(3)	(318)	(492)	–	(492)
Total assets	211,092	85,791	93,570	345,920	25,795	762,168	–	762,168
Total liabilities	508,596	96,905	41,981	34,575	28,485	710,542	–	710,542
Investments in associates	501	3,194	–	2,784	2,391	8,870	–	8,870
Capital expenditure incurred	374	52	14	3	223	666	–	666

27. SEGMENTAL ANALYSIS (continued)

(b) Geographic Information

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

	2009	**%**	2008	%
Total operating income				
– Hong Kong	**30,923**	**94**	31,381	90
– Americas	**885**	**3**	2,378	7
– Mainland and other	**1,008**	**3**	1,000	3
	32,816	**100**	34,759	100
Profit before tax				
– Hong Kong	**12,902**	**83**	12,834	81
– Americas	**799**	**5**	1,771	11
– Mainland and other	**1,776**	**12**	1,273	8
	15,477	**100**	15,878	100
Total assets				
– Hong Kong	**705,467**	**85**	656,411	86
– Americas	**63,808**	**8**	55,365	7
– Mainland and other	**56,693**	**7**	50,392	7
	825,968	**100**	762,168	100
Total liabilities				
– Hong Kong	**733,842**	**96**	680,296	96
– Americas	**1,109**	**–**	1,238	–
– Mainland and other	**32,793**	**4**	29,008	4
	767,744	**100**	710,542	100
Interest in associates				
– Hong Kong	**916**	**9**	883	10
– Americas	**–**	**–**	–	–
– Mainland and other	**9,310**	**91**	7,987	90
	10,226	**100**	8,870	100
Non-current assets*				
– Hong Kong	**13,947**	**98**	12,722	97
– Americas	**–**	**–**	–	–
– Mainland and other	**317**	**2**	346	3
	14,264	**100**	13,068	100
Contingent liabilities and commitments				
– Hong Kong	**198,996**	**92**	196,778	94
– Americas	**–**	**–**	–	–
– Mainland and other	**18,038**	**8**	13,464	6
	217,034	**100**	210,242	100

* Non-current assets consist of properties, plant and equipment, goodwill and other intangible assets.

28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY

The maturity analysis is based on the remaining period at the end of the reporting period to the contractual maturity date, with the exception of the trading portfolio that may be sold before maturity and is accordingly recorded as "Trading".

	Group								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2009									
Assets									
Cash and balances with banks and other financial institutions	22,086	–	–	–	–	–	–	–	22,086
Placings with and advances to banks and other financial institutions	4,352	72,226	25,557	2,416	–	–	–	–	104,551
Trading assets	–	–	–	–	–	–	66,597	–	66,597
Financial assets designated at fair value	–	–	20	646	4,201	58	–	525	5,450
Derivative financial instruments	–	7	34	232	118	–	4,659	–	5,050
Advances to customers	9,254	22,927	25,005	51,673	121,394	114,368	–	–	344,621
Financial investments:									
– available-for-sale investments	–	18,050	16,426	48,560	108,360	628	–	809	192,833
– held-to-maturity debt securities	–	31	282	1,395	21,538	25,423	–	–	48,669
Investments in associates	–	–	–	–	–	–	–	10,226	10,226
Investment properties	–	–	–	–	–	–	–	2,872	2,872
Premises, plant and equipment	–	–	–	–	–	–	–	7,178	7,178
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	–	536	536
Intangible assets	–	–	–	–	–	–	–	4,214	4,214
Other assets	4,558	2,682	1,838	1,511	126	14	–	340	11,069
Deferred tax assets	–	–	–	–	–	–	–	16	16
	40,250	115,923	69,162	106,433	255,737	140,491	71,256	26,716	825,968
Liabilities									
Current, savings and other deposit accounts	494,026	81,129	38,108	22,427	679	–	–	–	636,369
Deposits from banks	2,964	1,737	28	25	116	–	–	–	4,870
Trading liabilities	–	–	–	–	–	–	38,391	–	38,391
Financial liabilities designated at fair value	3	–	–	1,000	–	–	–	453	1,456
Derivative financial instruments	–	–	6	21	630	13	3,581	–	4,251
Certificates of deposit and other debt securities in issue:									
– certificates of deposit in issue	–	159	171	1,177	319	–	–	–	1,826
Other liabilities	6,044	3,158	1,955	1,452	150	116	–	2,410	15,285
Liabilities to customers under insurance contracts	–	–	–	–	–	–	–	54,240	54,240
Current tax liabilities	–	–	–	52	–	–	–	–	52
Deferred tax liabilities	–	–	–	–	–	–	–	1,684	1,684
Subordinated liabilities	–	–	–	3,516	5,804	–	–	–	9,320
	503,037	86,183	40,268	29,670	7,698	129	41,972	58,787	767,744
of which:									
Certificates of deposit included in:									
– trading assets	–	–	–	–	–	–	–	–	–
– financial assets designated at fair value	–	–	–	130	–	–	–	(1)	129
– available-for-sale investments	–	–	1,493	2,061	2,026	116	–	38	5,734
– held-to-maturity debt securities	–	–	23	161	941	806	–	–	1,931
	–	–	1,516	2,352	2,967	922	–	37	7,794
Debt securities included in:									
– trading assets	–	–	–	–	–	–	66,590	–	66,590
– financial assets designated at fair value	–	–	20	516	4,201	58	–	3	4,798
– available-for-sale investments	–	18,050	14,933	46,499	106,334	512	–	424	186,752
– held-to-maturity debt securities	–	31	259	1,234	20,597	24,617	–	–	46,738
	–	18,081	15,212	48,249	131,132	25,187	66,590	427	304,878
Certificates of deposit in issue included in:									
– trading liabilities	–	–	–	–	–	–	478	–	478
– financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– issue at amortised cost	–	159	171	1,177	319	–	–	–	1,826
	–	159	171	1,177	319	–	478	–	2,304

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

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

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

	Bank								
	Repayable on demand	One month or less but not on demand	Over one month but within three months	Over three months but within one year	Over one year but within five years	Over five years	Trading	No contractual maturity	Total
2009									
Assets									
Cash and balances with banks and other financial institutions	18,461	–	–	–	–	–	–	–	18,461
Placings with and advances to banks and other financial institutions	1,326	45,657	17,809	832	–	–	–	–	65,624
Trading assets	–	–	–	–	–	–	65,288	–	65,288
Financial assets designated at fair value	–	–	–	20	144	–	–	10	174
Derivative financial instruments	–	7	24	227	101	–	4,557	–	4,916
Advances to customers	9,248	20,461	20,035	42,646	105,426	101,363	–	–	299,179
Amounts due from subsidiaries	61,771	1,783	18,373	3,449	1,984	–	–	–	87,360
Financial investments:									
– available-for-sale investments	–	15,619	11,365	39,353	89,143	629	–	606	156,715
Investments in subsidiaries	–	–	–	–	–	–	–	11,584	11,584
Investments in associates	–	–	–	–	–	–	–	2,546	2,546
Investment properties	–	–	–	–	–	–	–	1,883	1,883
Premises, plant and equipment	–	–	–	–	–	–	–	4,198	4,198
Interest in leasehold land held for own use under operating lease	–	–	–	–	–	–	–	536	536
Intangible assets	–	–	–	–	–	–	–	399	399
Other assets	4,464	2,210	1,013	389	74	–	–	86	8,236
Deferred tax assets	–	–	–	–	–	–	–	2	2
	95,270	85,737	68,619	86,916	196,872	101,992	69,845	21,850	727,101
Liabilities									
Current, savings and other deposit accounts	485,929	78,600	33,958	13,177	350	–	–	–	612,014
Deposits from banks	2,963	1,337	28	25	116	–	–	–	4,469
Trading liabilities	–	–	–	–	–	–	35,071	–	35,071
Financial liabilities designated at fair value	–	–	–	1,000	–	–	–	3	1,003
Derivative financial instruments	–	–	6	21	568	13	3,572	–	4,180
Certificates of deposit and other debt securities in issue:									
– certificates of deposit in issue	–	159	171	1,177	319	–	–	–	1,826
Amounts due to subsidiaries	4,749	4,974	237	–	–	–	–	–	9,960
Other liabilities	5,834	3,046	1,431	708	82	17	–	3,215	14,333
Current tax liabilities	–	–	–	10	–	–	–	–	10
Deferred tax liabilities	–	–	–	–	–	–	–	569	569
Subordinated liabilities	–	–	–	3,516	5,804	–	–	–	9,320
	499,475	88,116	35,831	19,634	7,239	30	38,643	3,787	692,755
of which:									
Certificates of deposit included in:									
– trading assets	–	–	–	–	–	–	–	–	–
– financial assets designated at fair value	–	–	–	–	–	–	–	–	–
– available-for-sale investments	–	–	621	1,194	1,158	116	–	37	3,126
– held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	–	621	1,194	1,158	116	–	37	3,126
Debt securities included in:									
– trading assets	–	–	–	–	–	–	65,281	–	65,281
– financial assets designated at fair value	–	–	–	20	144	–	–	10	174
– available-for-sale investments	–	15,619	10,744	38,159	87,985	513	–	422	153,442
– held-to-maturity debt securities	–	–	–	–	–	–	–	–	–
	–	15,619	10,744	38,179	88,129	513	65,281	432	218,897
Certificates of deposit in issue included in:									
– trading liabilities	–	–	–	–	–	–	478	–	478
– financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–
– issue at amortised cost	–	159	171	1,177	319	–	–	–	1,826
	–	159	171	1,177	319	–	478	–	2,304

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

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

29. ACCOUNTING CLASSIFICATIONS

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

	Group						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2009							
Cash and balances with banks and other financial institutions	–	–	–	–	–	22,086	22,086
Placings with and advances to banks and other financial institutions	–	–	–	–	104,551	–	104,551
Derivative financial instruments	4,641	18	391	–	–	–	5,050
Advances to customers	–	–	–	–	344,621	–	344,621
Investment securities	66,596	5,450	192,833	48,669	–	–	313,548
Acceptances and endorsements	–	–	–	–	–	3,584	3,584
Other financial assets	1	–	–	–	–	7,142	7,143
Total financial assets	71,238	5,468	193,224	48,669	449,172	32,812	800,583
Non-financial assets							25,385
Total assets							825,968
Current, savings and other deposit accounts	22,212	–	–	–	–	636,369	658,581
Deposits from banks	–	–	–	–	–	4,870	4,870
Derivative financial instruments	3,568	13	670	–	–	–	4,251
Certificates of deposit and other debt securities in issue	3,247	–	–	–	–	1,826	5,073
Other financial liabilities	12,932	–	–	–	–	8,221	21,153
Subordinated liabilities	–	1,003	–	–	–	9,320	10,323
Liabilities to customers under investment contracts	–	453	–	–	–	–	453
Acceptances and endorsements	–	–	–	–	–	3,584	3,584
Total financial liabilities	41,959	1,469	670	–	–	664,190	708,288
Non-financial liabilities							59,456
Total liabilities							767,744

29. ACCOUNTING CLASSIFICATIONS (continued)

	Group						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2008							
Cash and balances with banks and other financial institutions	–	–	–	–	–	24,822	24,822
Placings with and advances to banks and other financial institutions	–	–	–	–	69,579	–	69,579
Derivative financial instruments	5,663	31	1,410	–	–	–	7,104
Advances to customers	–	–	–	–	329,121	–	329,121
Investment securities	108,371	7,798	144,954	36,205	–	–	297,328
Acceptances and endorsements	–	–	–	–	–	3,090	3,090
Other financial assets	18	–	–	–	–	8,033	8,051
Total financial assets	114,052	7,829	146,364	36,205	398,700	35,945	739,095
Non-financial assets							23,073
Total assets							762,168
Current, savings and other deposit accounts	29,785	–	–	–	–	562,183	591,968
Deposits from banks	–	–	–	–	–	11,556	11,556
Derivative financial instruments	14,346	30	569	–	–	–	14,945
Certificates of deposit and other debt securities in issue	9,716	–	–	–	–	2,772	12,488
Other financial liabilities	8,781	–	–	–	–	6,997	15,778
Subordinated liabilities	–	994	–	–	–	9,309	10,303
Liabilities to customers under investment contracts	–	413	–	–	–	–	413
Acceptances and endorsements	–	–	–	–	–	3,090	3,090
Total financial liabilities	62,628	1,437	569	–	–	595,907	660,541
Non-financial liabilities							50,001
Total liabilities							710,542

29. ACCOUNTING CLASSIFICATIONS (continued)

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2009							
Cash and balances with banks and other financial institutions	–	–	–	–	–	18,461	18,461
Placings with and advances to banks and other financial institutions	–	–	–	–	65,624	–	65,624
Derivative financial instruments	4,540	17	359	–	–	–	4,916
Advances to customers	–	–	–	–	299,179	–	299,179
Investment securities	65,287	174	156,715	–	–	–	222,176
Amounts due from subsidiaries	–	–	–	–	–	87,360	87,360
Acceptances and endorsements	–	–	–	–	–	2,435	2,435
Other financial assets	1	–	–	–	–	5,605	5,606
Total financial assets	69,828	191	157,074	–	364,803	113,861	705,757
Non-financial assets							21,344
Total assets							727,101
Current, savings and other deposit accounts	18,892	–	–	–	–	612,014	630,906
Deposits from banks	–	–	–	–	–	4,469	4,469
Derivative financial instruments	3,559	13	608	–	–	–	4,180
Certificates of deposit and other debt securities in issue	3,247	–	–	–	–	1,826	5,073
Amounts due to subsidiaries	–	–	–	–	–	9,960	9,960
Other financial liabilities	12,932	–	–	–	–	8,677	21,609
Subordinated liabilities	–	1,003	–	–	–	9,320	10,323
Acceptances and endorsements	–	–	–	–	–	2,435	2,435
Total financial liabilities	38,630	1,016	608	–	–	648,701	688,955
Non-financial liabilities							3,800
Total liabilities							692,755

29. ACCOUNTING CLASSIFICATIONS (continued)

	Bank						
	Trading	Designated at fair value	Available-for-sale/ hedging	Held-to-maturity	Loans and receivables	Other amortised cost	Total
2008							
Cash and balances with banks and other financial institutions	–	–	–	–	–	22,071	22,071
Placings with and advances to banks and other financial institutions	–	–	–	–	38,097	–	38,097
Derivative financial instruments	5,669	31	1,210	–	–	–	6,910
Advances to customers	–	–	–	–	280,255	–	280,255
Investment securities	107,757	830	112,000	–	–	–	220,587
Amounts due from subsidiaries	–	–	–	–	–	84,907	84,907
Acceptances and endorsements	–	–	–	–	–	2,255	2,255
Other financial assets	18	–	–	–	–	6,372	6,390
Total financial assets	113,444	861	113,210	–	318,352	115,605	661,472
Non-financial assets							21,160
Total assets							682,632
Current, savings and other deposit accounts	24,970	–	–	–	–	547,385	572,355
Deposits from banks	–	–	–	–	–	8,263	8,263
Derivative financial instruments	14,346	30	562	–	–	–	14,938
Certificates of deposit and other debt securities in issue	9,716	–	–	–	–	2,772	12,488
Amounts due to subsidiaries	–	–	–	–	–	8,575	8,575
Other financial liabilities	8,781	–	–	–	–	7,438	16,219
Subordinated liabilities	–	994	–	–	–	9,309	10,303
Acceptances and endorsements	–	–	–	–	–	2,255	2,255
Total financial liabilities	57,813	1,024	562	–	–	585,997	645,396
Non-financial liabilities							5,183
Total liabilities							650,579

30. CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	Group		Bank	
	2009	2008	**2009**	2008
Cash in hand	**4,299**	3,696	**4,079**	3,488
Balances with central banks	**3,397**	2,426	**924**	896
Balances with banks and other financial institutions	**14,390**	18,700	**13,458**	17,687
	22,086	24,822	**18,461**	22,071

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

	Group		Bank	
	2009	2008	**2009**	2008
Placings with and advances to banks and other financial institutions maturing within one month	**76,579**	47,025	**46,984**	23,776
Placings with and advances to banks and other financial institutions maturing after one month but less than one year	**27,972**	22,554	**18,640**	14,321
Placings with and advances to banks and other financial institutions maturing after one year	**–**	–	**–**	–
	104,551	69,579	**65,624**	38,097

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2009 by the Group and the Bank. (2008: Nil).

32. TRADING ASSETS

	Group		Bank	
	2009	2008	**2009**	2008
Treasury bills	**62,028**	103,621	**62,028**	103,463
Certificates of deposit	**–**	–	**–**	–
Other debt securities	**4,562**	4,750	**3,253**	4,294
Debt securities	**66,590**	108,371	**65,281**	107,757
Equity shares	**6**	–	**6**	–
Total trading securities	**66,596**	108,371	**65,287**	107,757
Other*	**1**	18	**1**	18
Total trading assets	**66,597**	108,389	**65,288**	107,775
Debt securities:				
– listed in Hong Kong	**2,712**	3,631	**2,712**	3,631
– listed outside Hong Kong	**157**	269	**157**	269
	2,869	3,900	**2,869**	3,900
– unlisted	**63,721**	104,471	**62,412**	103,857
	66,590	108,371	**65,281**	107,757
Equity shares:				
– listed in Hong Kong	**6**	–	**6**	–
– unlisted	**–**	–	**–**	–
	6	–	**6**	–
Total trading securities	**66,596**	108,371	**65,287**	107,757
Debt securities				
Issued by public bodies:				
– central governments and central banks	**65,817**	107,428	**64,508**	106,814
– other public sector entities	**369**	378	**369**	378
	66,186	107,806	**64,877**	107,192
Issued by other bodies:				
– banks and other financial institutions	**292**	306	**292**	306
– corporate entities	**112**	259	**112**	259
	404	565	**404**	565
	66,590	108,371	**65,281**	107,757
Equity shares				
Issued by corporate entities	**6**	–	**6**	–
Total trading securities	**66,596**	108,371	**65,287**	107,757

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

33. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

	Group		Bank	
	2009	2008	**2009**	2008
Certificates of deposit	**129**	163	**–**	–
Other debt securities	**4,798**	7,273	**174**	830
Debt securities	**4,927**	7,436	**174**	830
Equity shares	**523**	362	**–**	–
	5,450	7,798	**174**	830
Debt securities:				
– listed in Hong Kong	**3**	834	**–**	449
– listed outside Hong Kong	**194**	1,004	**154**	276
	197	1,838	**154**	725
– unlisted	**4,730**	5,598	**20**	105
	4,927	7,436	**174**	830
Equity shares:				
– listed in Hong Kong	**21**	26	**–**	–
– listed outside Hong Kong	**69**	57	**–**	–
	90	83	**–**	–
– unlisted	**433**	279	**–**	–
	523	362	**–**	–
	5,450	7,798	**174**	830
Debt securities				
Issued by public bodies:				
– central governments and central banks	**154**	924	**154**	517
– other public sector entities	**168**	564	**–**	226
	322	1,488	**154**	743
Issued by other bodies:				
– banks and other financial institutions	**4,464**	5,317	**–**	65
– corporate entities	**141**	631	**20**	22
	4,605	5,948	**20**	87
	4,927	7,436	**174**	830
Equity shares				
Issued by corporate entities	**523**	362	**–**	–
	5,450	7,798	**174**	830

34. DERIVATIVE FINANCIAL INSTRUMENTS

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

The Group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge its own risks. For accounting purposes, derivative financial instruments are held for trading, or financial instruments designated at fair value, or designated as either fair value hedge or cash flow hedge. The Group primarily traded over-the-counter derivatives and also participated in exchange traded derivatives.

Trading derivatives

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

Trading derivatives also include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Hedging instruments

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

(a) Fair value hedge

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

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(b) Cash flow hedge

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

Gains and losses are initially recognised in equity, in the cash flow hedge reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2009, the amount of cash flow hedge reserve transferred to the income statement comprised HK$848 million (2008: HK$376 million) included in net interest income and HK$16 million (2008: HK$1 million) included in net trading income.

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2009 and 2008. During the year of 2009, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur (2008: Nil). A gain of HK$16 million for 2009 (2008: Nil) was recognised due to termination of such forecast transactions.

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

		Group	
	Three months or less	Over three months but within one year	Over one year but within five years
At 31 December 2009			
Cash inflows from assets	**45,526**	**39,564**	**20,587**
Cash outflows from liabilities	**–**	**–**	**–**
Net cash inflows	**45,526**	**39,564**	**20,587**
At 31 December 2008			
Cash inflows from assets	73,395	52,855	12,844
Cash outflows from liabilities	–	–	–
Net cash inflows	73,395	52,855	12,844

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

	Group					
	2009			2008		
	Contract amounts	**Derivative assets**	**Derivative liabilities**	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Exchange rate contracts:						
– spot and forward foreign exchange	**382,260**	**2,289**	**608**	570,950	2,676	5,144
– currency swaps	**20,837**	**261**	**132**	18,356	337	229
– currency options purchased	**30,561**	**83**	**–**	32,729	287	–
– currency options written	**40,105**	**–**	**197**	33,601	–	340
– other exchange rate contracts	**226**	**3**	**1**	141	–	4
	473,989	**2,636**	**938**	655,777	3,300	5,717
Interest rate contracts:						
– interest rate swaps	**162,662**	**1,552**	**1,622**	161,018	2,120	2,249
– interest rate options purchased	**143**	**–**	**–**	142	–	–
– interest rate options written	**142**	**–**	**–**	142	–	–
– other interest rate contracts	**407**	**–**	**1**	217	1	–
	163,354	**1,552**	**1,623**	161,519	2,121	2,249
Equity and other contracts:						
– equity swaps	**5,706**	**29**	**994**	13,025	1	6,271
– equity options purchased	**1,705**	**91**	**–**	2,680	113	–
– equity options written	**1,317**	**–**	**13**	2,770	–	100
– other equity contracts	**6**	**–**	**–**	8	–	–
– spot and forward contracts and other	**2,651**	**333**	**–**	2,685	128	9
	11,385	**453**	**1,007**	21,168	242	6,380
Total derivatives held for trading	**648,728**	**4,641**	**3,568**	838,464	5,663	14,346
Derivatives embedded in financial assets designated at fair value						
Exchange rate contracts:						
– spot and forward foreign exchange	**89**	**1**	**–**	–	–	–
Interest rate contracts:						
– interest rate swaps	**1,160**	**17**	**13**	1,797	31	30
	1,249	**18**	**13**	1,797	31	30
Cash flow hedge derivatives						
Interest rate contracts:						
– interest rate swaps	**45,526**	**366**	**13**	73,394	1,410	14
Fair value hedge derivatives						
Interest rate contracts:						
– interest rate swaps	**21,028**	**25**	**657**	12,548	–	555
Total derivatives	**716,531**	**5,050**	**4,251**	926,203	7,104	14,945

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

	Bank					
	2009			2008		
	Contract amounts	**Derivative assets**	**Derivative liabilities**	Contract amounts	Derivative assets	Derivative liabilities
Derivatives held for trading						
Exchange rate contracts:						
– spot and forward foreign exchange	**381,799**	**2,275**	**602**	567,613	2,621	5,145
– currency swaps	**20,837**	**260**	**132**	18,356	337	229
– currency options purchased	**30,606**	**83**	**–**	32,735	287	–
– currency options written	**40,105**	**–**	**199**	33,601	–	356
– other exchange rate contracts	**226**	**3**	**1**	141	–	4
	473,573	**2,621**	**934**	652,446	3,245	5,734
Interest rate contracts:						
– interest rate swaps	**166,030**	**1,543**	**1,612**	160,254	2,119	2,232
– interest rate options purchased	**143**	**–**	**–**	142	–	–
– interest rate options written	**142**	**–**	**–**	142	–	–
– other interest rate contracts	**407**	**–**	**1**	217	1	–
	166,722	**1,543**	**1,613**	160,755	2,120	2,232
Equity and other contracts:						
– equity swaps	**7,366**	**29**	**998**	14,097	62	6,271
– equity options purchased	**1,296**	**13**	**–**	2,680	114	–
– equity options written	**1,317**	**–**	**13**	2,770	–	100
– other equity contracts	**6**	**–**	**–**	8	–	–
– spot and forward contracts and other	**2,808**	**334**	**1**	2,685	128	9
	12,793	**376**	**1,012**	22,240	304	6,380
Total derivatives held for trading	**653,088**	**4,540**	**3,559**	835,441	5,669	14,346
Derivatives embedded in financial assets designated at fair value						
Interest rate contracts:						
– interest rate swaps	**1,160**	**17**	**13**	1,797	31	30
Cash flow hedge derivatives						
Interest rate contracts:						
– interest rate swaps	**43,898**	**351**	**13**	68,165	1,210	14
Fair value hedge derivatives						
Interest rate contracts:						
– interest rate swaps	**16,634**	**8**	**595**	12,428	–	548
Total derivatives	**714,780**	**4,916**	**4,180**	917,831	6,910	14,938

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

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

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

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

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

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

With the Capital Rules effective from 1 January 2007, the Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2009 were calculated based on the advanced internal ratings-based approach and the risk-weighted assets for 2008 were calculated based on the foundation internal ratings-based approach.

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2009						
Exchange rate contracts:						
– spot and forward foreign exchange	334,133	5,573	689	332,869	5,546	649
– currency swaps	20,837	1,090	250	20,837	1,090	250
– currency options purchased	30,561	548	239	30,591	549	239
– other exchange rate contracts	226	6	–	226	6	–
	385,757	7,217	1,178	384,523	7,191	1,138
Interest rate contracts:						
– interest rate swaps	230,376	2,640	413	221,751	2,575	396
– interest rate options purchased	143	–	–	143	–	–
– other interest rate contracts	–	–	–	–	–	–
	230,519	2,640	413	221,894	2,575	396
Equity and other contracts:						
– equity swaps	5,706	383	31	5,706	383	31
– equity options purchased	1,296	91	61	1,296	91	61
– other equity contracts	–	–	–	–	–	–
	7,002	474	92	7,002	474	92

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

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

35. ADVANCES TO CUSTOMERS

(a) Advances to customers

	Group		Bank	
	2009	2008	**2009**	2008
Gross advances to customers	**346,586**	331,164	**300,842**	281,996
Less: loan impairment allowances				
– individually assessed	**(1,151)**	(1,241)	**(957)**	(1,046)
– collectively assessed	**(814)**	(802)	**(706)**	(695)
	344,621	329,121	**299,179**	280,255
Included in advances to customers are:				
Trade bills	**2,802**	2,899	**2,504**	2,806
Less: loan impairment allowances	**(42)**	(30)	**(42)**	(30)
	2,760	2,869	**2,462**	2,776

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

	Group		Bank	
	2009	2008	**2009**	2008
	%	%	**%**	%
Loan impairment allowances:				
– individually assessed	**0.33**	0.37	**0.32**	0.37
– collectively assessed	**0.23**	0.24	**0.23**	0.25
Total loan impairment allowances	**0.56**	0.61	**0.55**	0.62

35. ADVANCES TO CUSTOMERS (continued)

(b) Loan impairment allowances against advances to customers

	Group Individually assessed	Group Collectively assessed	Group Total
2009			
At 1 January	**1,241**	**802**	**2,043**
Amounts written off	**(394)**	**(526)**	**(920)**
Recoveries of advances written off in previous years	**24**	**38**	**62**
New impairment allowances charged to income statement (note 16)	**564**	**540**	**1,104**
Impairment allowances released to income statement (note 16)	**(254)**	**(38)**	**(292)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(30)**	**(2)**	**(32)**
At 31 December	**1,151**	**814**	**1,965**
2008			
At 1 January	417	636	1,053
Amounts written off	(110)	(346)	(456)
Recoveries of advances written off in previous years	20	36	56
New impairment allowances charged to income statement (note 16)	993	512	1,505
Impairment allowances released to income statement (note 16)	(68)	(36)	(104)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(11)	–	(11)
At 31 December	1,241	802	2,043

	Bank Individually assessed	Bank Collectively assessed	Bank Total
2009			
At 1 January	**1,046**	**695**	**1,741**
Amounts written off	**(349)**	**(526)**	**(875)**
Recoveries of advances written off in previous years	**9**	**37**	**46**
New impairment allowances charged to income statement (note 16)	**488**	**540**	**1,028**
Impairment allowances released to income statement (note 16)	**(203)**	**(37)**	**(240)**
Other movement	**(16)**	**–**	**(16)**
Unwinding of discount of loan impairment allowances recognised as "interest income"	**(18)**	**(3)**	**(21)**
At 31 December	**957**	**706**	**1,663**
2008			
At 1 January	330	627	957
Amounts written off	(91)	(346)	(437)
Recoveries of advances written off in previous years	7	36	43
New impairment allowances charged to income statement (note 16)	858	414	1,272
Impairment allowances released to income statement (note 16)	(50)	(36)	(86)
Unwinding of discount of loan impairment allowances recognised as "interest income"	(8)	–	(8)
At 31 December	1,046	695	1,741

35. ADVANCES TO CUSTOMERS (continued)

(c) Impaired advances and allowances

	Group		Bank	
	2009	2008	**2009**	2008
Gross impaired advances	**2,508**	3,404	**1,761**	2,032
Individually assessed allowances	**(1,151)**	(1,241)	**(957)**	(1,046)
Net impaired advances	**1,357**	2,163	**804**	986
Individually assessed allowances as a percentage of gross impaired advances	**45.9%**	36.5%	**54.3%**	51.5%
Gross impaired advances as a percentage of gross advances to customers	**0.7%**	1.0%	**0.6%**	0.7%

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

	Group		Bank	
	2009	2008	**2009**	2008
Gross individually assessed impaired advances	**2,434**	3,297	**1,687**	1,925
Individually assessed allowances	**(1,151)**	(1,241)	**(957)**	(1,046)
	1,283	2,056	**730**	879
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.7%**	1.0%	**0.6%**	0.7%
Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**1,024**	1,502	**569**	1,102

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

35. ADVANCES TO CUSTOMERS (continued)

(d) Overdue advances

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

	Group	%	Bank	%
2009				
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– more than three months but not more than six months	**241**	**0.1**	**204**	**0.1**
– more than six months but not more than one year	**353**	**0.1**	**333**	**0.1**
– more than one year	**864**	**0.2**	**539**	**0.2**
	1,458	**0.4**	**1,076**	**0.4**
of which:				
– individually impaired allowances	**(984)**		**(879)**	
– covered portion of overdue loans and advances	**553**		**231**	
– uncovered portion of overdue loans and advances	**905**		**845**	
– current market value held against the covered portion of overdue loans and advances	**1,095**		**580**	
2008				
Gross advances to customers which have been overdue with respect to either principal or interest for periods of:				
– more than three months but not more than six months	340	0.1	183	0.1
– more than six months but not more than one year	419	0.1	380	0.1
– more than one year	311	0.1	95	–
	1,070	0.3	658	0.2
of which:				
– individually impaired allowances	(554)		(501)	
– covered portion of overdue loans and advances	574		373	
– uncovered portion of overdue loans and advances	496		285	
– current market value held against the covered portion of overdue loans and advances	697		549	

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

35. ADVANCES TO CUSTOMERS (continued)

(e) Rescheduled advances

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

	Group		Bank	
		%		%
2009	**703**	**0.2**	**423**	**0.1**
2008	281	0.1	169	0.1

Rescheduled advances are those that have been rescheduled or renegotiated for reasons related to the borrower's financial difficulties. This will normally involve the granting of concessionary terms and resetting the overdue account to non-overdue status.

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

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

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area that is different from that of the counterparty. At 31 December 2009, about 90 per cent (about 90 per cent at 31 December 2008) of the Group's advances to customers, including related impaired advances and overdue advances, were classified under Hong Kong. There was no geographical segment other than Hong Kong to which the Bank's advances to customers is not less than 10 per cent of the total loans and advances.

35. ADVANCES TO CUSTOMERS (continued)

(g) Gross advances to customers by industry sector

The analysis of gross advances to customers by industry sector based on categories and definitions used by the HKMA is as follows:

	Group			
	2009		2008	
		% of gross advances covered by collateral		% of gross advances covered by collateral
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	**23,618**	**36.1**	25,314	32.7
– property investment	**75,264**	**82.3**	66,179	87.4
– financial concerns	**2,720**	**33.9**	3,146	60.7
– stockbrokers	**480**	**42.9**	526	39.2
– wholesale and retail trade	**7,812**	**49.5**	6,183	54.3
– manufacturing	**12,080**	**30.4**	12,828	27.0
– transport and transport equipment	**6,503**	**83.3**	8,400	78.3
– recreational activities	**37**	**41.4**	26	64.6
– information technology	**1,247**	**2.4**	1,075	4.6
– other	**24,405**	**43.9**	21,553	41.7
	154,166	**61.8**	145,230	62.4
Individuals				
– advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**14,647**	**99.9**	16,739	99.9
– advances for the purchase of other residential properties	**96,651**	**99.7**	89,669	99.4
– credit card advances	**13,818**	**–**	12,841	–
– other	**11,961**	**45.3**	11,892	33.0
	137,077	**84.9**	131,141	83.7
Total gross advances for use in Hong Kong	**291,243**	**72.7**	276,371	72.5
Trade finance	**19,215**	**35.6**	19,039	41.5
Gross advances for use outside Hong Kong	**36,128**	**55.4**	35,754	59.4
Gross advances to customers	**346,586**	**68.8**	331,164	69.3

35. ADVANCES TO CUSTOMERS (continued)

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

	Bank			
	2009		2008	
		% of gross advances covered by collateral		% of gross advances covered by collateral
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial sectors				
– property development	**23,618**	**36.1**	25,004	31.9
– property investment	**74,128**	**82.8**	64,869	88.0
– financial concerns	**2,720**	**33.9**	3,146	60.7
– stockbrokers	**480**	**42.9**	526	39.2
– wholesale and retail trade	**7,812**	**49.5**	6,181	54.3
– manufacturing	**12,079**	**30.4**	12,826	27.0
– transport and transport equipment	**4,841**	**77.6**	5,620	67.5
– recreational activities	**37**	**41.4**	26	64.6
– information technology	**1,247**	**2.4**	1,075	4.6
– other	**24,335**	**44.1**	21,524	41.6
	151,297	**61.5**	140,797	61.6
Individuals				
– advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**3,446**	**99.6**	3,318	99.5
– advances for the purchase of other residential properties	**93,028**	**99.7**	84,971	99.4
– credit card advances	**13,818**	**–**	12,841	–
– other	**11,954**	**45.3**	11,880	32.9
	122,246	**83.1**	113,010	81.1
Total gross advances for use in Hong Kong	**273,543**	**71.2**	253,807	70.3
Trade finance	**19,215**	**35.6**	19,039	41.5
Gross advances for use outside Hong Kong	**8,084**	**17.2**	9,150	26.9
Gross advances to customers	**300,842**	**67.4**	281,996	67.0

35. ADVANCES TO CUSTOMERS (continued)

(h) Net investments in finance leases

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

	Group		Bank	
	2009	2008	**2009**	2008
Finance leases	**24**	51	**24**	51
Hire purchase contracts	**5,630**	7,329	**3,963**	4,515
	5,654	7,380	**3,987**	4,566

	Group		
	Present value of minimum lease payments receivable	**Interest income relating to future periods**	**Total minimum lease payments receivable**
2009			
Amounts receivable:			
– within one year	**371**	**93**	**464**
– after one year but within five years	**1,486**	**312**	**1,798**
– after five years	**3,813**	**614**	**4,427**
	5,670	**1,019**	**6,689**
Loans impairment allowances	**(16)**		
Net investments in finance leases and hire purchase contracts	**5,654**		
2008			
Amounts receivable:			
– within one year	598	148	746
– after one year but within five years	1,981	485	2,466
– after five years	4,825	865	5,690
	7,404	1,498	8,902
Loans impairment allowances	(24)		
Net investments in finance leases and hire purchase contracts	7,380		

35. ADVANCES TO CUSTOMERS (continued)
(h) Net investments in finance leases (continued)

	Bank		
	Present value of minimum lease payments receivable	**Interest income relating to future periods**	**Total minimum lease payments receivable**
2009			
Amounts receivable:			
– within one year	**250**	**57**	**307**
– after one year but within five years	**1,053**	**196**	**1,249**
– after five years	**2,696**	**462**	**3,158**
	3,999	**715**	**4,714**
Loans impairment allowances	**(12)**		
Net investments in finance leases and hire purchase contracts	**3,987**		
2008			
Amounts receivable:			
– within one year	395	88	483
– after one year but within five years	1,315	288	1,603
– after five years	2,875	580	3,455
	4,585	956	5,541
Loans impairment allowances	(19)		
Net investments in finance leases and hire purchase contracts	4,566		

36. FINANCIAL INVESTMENTS

	Group		Bank	
	2009	2008	**2009**	2008
Financial investments:				
– which may be repledged or resold by counterparties	**141**	1,260	**141**	219
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**241,361**	179,899	**156,574**	111,781
	241,502	181,159	**156,715**	112,000
Held-to-maturity debt securities at amortised cost	**48,669**	36,205	**–**	–
Available-for-sale at fair value:				
– debt securities	**192,486**	144,520	**156,568**	111,726
– equity shares	**347**	434	**147**	274
	241,502	181,159	**156,715**	112,000
Treasury bills	**53,973**	9,927	**49,277**	4,304
Certificates of deposit	**7,665**	12,871	**3,126**	7,963
Other debt securities	**179,517**	157,927	**104,165**	99,459
Debt securities	**241,155**	180,725	**156,568**	111,726
Equity shares	**347**	434	**147**	274
	241,502	181,159	**156,715**	112,000

There was no overdue debt securities in 2009 (2008: HK$5 million).

(a) Held-to-maturity debt securities

	Group		Bank	
	2009	2008	**2009**	2008
Listed in Hong Kong	**634**	1,227	**–**	–
Listed outside Hong Kong	**5,627**	3,301	**–**	–
	6,261	4,528	**–**	–
Unlisted	**42,408**	31,677	**–**	–
	48,669	36,205	**–**	–
Issued by public bodies:				
– central governments and central banks	**244**	240	**–**	–
– other public sector entities	**7,235**	2,343	**–**	–
	7,479	2,583	**–**	–
Issued by other bodies:				
– banks and other financial institutions	**32,145**	29,604	**–**	–
– corporate entities	**9,045**	4,018	**–**	–
	41,190	33,622	**–**	–
	48,669	36,205	**–**	–
Fair value of held-to-maturity debt securities:				
– listed	**6,384**	4,849	**–**	–
– unlisted	**43,421**	34,466	**–**	–
	49,805	39,315	**–**	–

There were no held-to-maturity debt securities determined to be impaired at 31 December 2009 for the Group and the Bank (2008: Nil).

36. FINANCIAL INVESTMENTS (continued)

(b) Available-for-sale debt securities

	Group		Bank	
	2009	2008	**2009**	2008
Listed in Hong Kong	**6,973**	4,377	**6,960**	4,369
Listed outside Hong Kong	**60,991**	63,717	**45,769**	50,273
	67,964	68,094	**52,729**	54,642
Unlisted	**124,522**	76,426	**103,839**	57,084
	192,486	144,520	**156,568**	111,726
Issued by public bodies:				
– central governments and central banks	**64,532**	16,403	**58,372**	10,238
– other public sector entities	**17,830**	2,010	**14,974**	2,010
	82,362	18,413	**73,346**	12,248
Issued by other bodies:				
– banks and other financial institutions	**101,167**	114,563	**77,782**	91,096
– corporate entities	**8,957**	11,544	**5,440**	8,382
	110,124	126,107	**83,222**	99,478
	192,486	144,520	**156,568**	111,726

As at 31 December 2009, there was no available-for-sale debt securities individually determined to be impaired for the Group and the Bank. As at 31 December 2008, the Group's and the Bank's available-for-sale debt securities were individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in note 4(v)(ii).

(c) Available-for-sale equity shares

	Group		Bank	
	2009	2008	**2009**	2008
Listed in Hong Kong	**60**	37	**5**	3
Listed outside Hong Kong	**85**	68	**85**	68
	145	105	**90**	71
Unlisted	**202**	329	**57**	203
	347	434	**147**	274
Issued by corporate entities	**347**	434	**147**	274

During the year of 2009 and 2008, certain Group's and the Bank's available-for-sale equity securities were individually determined to be impaired. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in note 4(v)(ii).

37. INVESTMENTS IN SUBSIDIARIES

	Bank 2009	Bank 2008
Unlisted shares, at cost	**11,584**	11,284

The principal subsidiaries of the Bank are:

Name of company	Place of incorporation	Principal activities	Issued equity capital
Hang Seng Bank (China) Limited	People's Republic of China	Banking	RMB4,500,000,000
Hang Seng Finance Limited	Hong Kong SAR	Lending	HK$1,000,000,000
Hang Seng Credit Limited	Hong Kong SAR	Lending	HK$200,000,000
Hang Seng Bank (Bahamas) Limited	Bahamas	Banking	US$1,000,000
Hang Seng Finance (Bahamas) Limited	Bahamas	Finance	US$5,000
Hang Seng Bank (Trustee) Limited	Hong Kong SAR	Trustee service	HK$3,000,000
Hang Seng (Nominee) Limited	Hong Kong SAR	Nominee service	HK$100,000
Hang Seng Life Limited	Hong Kong SAR	Retirement benefits and life assurance	HK$970,000,000
Hang Seng Insurance Company Limited	Hong Kong SAR	Retirement benefits and life assurance	HK$4,626,184,570
Hang Seng General Insurance (Hong Kong) Company Limited	Hong Kong SAR	General insurance	HK$620,000,000
Hang Seng Asset Management Pte Ltd	Singapore	Fund management	SG$2,000,000
Hang Seng Investment Management Limited	Hong Kong SAR	Fund management	HK$10,000,000
Haseba Investment Company Limited	Hong Kong SAR	Investment holding	HK$6,000
Hang Seng Securities Limited	Hong Kong SAR	Stockbroking	HK$26,000,000
Yan Nin Development Company Limited	Hong Kong SAR	Investment holding	HK$100,000
Hang Seng Indexes Company Limited	Hong Kong SAR	Compilation and dissemination of the Hang Seng share index	HK$10,000
Hang Seng Real Estate Management Limited	Hong Kong SAR	Property management	HK$10,000

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

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

38. INVESTMENTS IN ASSOCIATES

	Group		Bank	
	2009	2008	**2009**	2008
Unlisted investments, at cost	**–**	–	**912**	909
Listed investments, at cost	**–**	–	**1,634**	1,634
Share of net assets	**9,691**	8,314	**–**	–
Intangible asset	**106**	157	**–**	–
Goodwill	**429**	399	**–**	–
	10,226	8,870	**2,546**	2,543

The associates are:

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

Investment in associates included listed investment of HK$8,406 million (2008: HK$7,078 million). At the end of the reporting period, the fair value of these investments, based on quoted market prices was HK$29,261 million (2008: HK$10,599 million).

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

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

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

For the year ended 31 December 2009, the financial results of Industrial Bank Co., Ltd. and Yantai Bank were included in the financial statements based on financial statements drawn up to 30 September 2009, but taking into account any changes in the subsequent period from 1 October 2009 to 31 December 2009 that would materially affect the results. The Group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 "Investments in Associates" whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

38. INVESTMENTS IN ASSOCIATES (continued)

In February 2007, IB issued 1,001 million new shares in an Initial Public Offer for a total consideration of RMB15,996 million. The Bank did not subscribe for any additional shares and, thus, its interest in the equity of IB decreased from 15.98 per cent to 12.78 per cent. The decrease of the Bank's interest in the equity of Industrial Bank Co., Ltd. does not affect the Bank's influence over this associate, as there has been no change in the composition of major shareholders in IB or in the Bank's representation on its Board of Directors or Executive Committee. The Bank will continue to have the power to participate in the financial and operating policy decisions of IB, and will continue to account for its results using the equity method.

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

	Assets	Liabilities	Equity	Revenue	Expenses	Profit
2009						
100 per cent	**1,473,189**	**1,402,699**	**70,490**	**34,418**	**21,038**	**13,380**
Group's effective interest	**191,044**	**181,353**	**9,691**	**4,496**	**2,748**	**1,748**
2008						
100 per cent	1,087,222	1,027,344	59,878	32,594	18,783	13,811
Group's effective interest	141,824	133,510	8,314	4,216	2,409	1,807

There is no impairment loss of our investments in associates for the years ended 31 December 2009 and 2008.

39. INVESTMENT PROPERTIES

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2009, and were updated for any material changes in the valuation as at 31 December 2009. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

(a) Movement of investment properties

	Group		Bank	
	2009	2008	**2009**	2008
At 1 January	**2,593**	2,581	**1,714**	1,708
Surplus on revaluation credited to income statement (note 22)	**250**	8	**153**	1
Transfer from assets held for sale	**16**	–	**16**	–
Transfer from premises (note 40(a))	**13**	4	**–**	5
At 31 December	**2,872**	2,593	**1,883**	1,714

(b) Terms of lease

	Group		Bank	
	2009	2008	**2009**	2008
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,272**	1,137	**506**	467
– medium leases (10 to 50 years unexpired)	**1,600**	1,456	**1,377**	1,247
Held outside Hong Kong:				
– medium leases (10 to 50 years unexpired)	**–**	–	**–**	–
	2,872	2,593	**1,883**	1,714

39. INVESTMENT PROPERTIES (continued)

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

The direct operating expenses arising from investment properties were HK$21 million in 2009 (2008: HK$18 million). Of this amount, HK$20 million (2008: HK$17 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	
	2009	2008	**2009**	2008
Less than one year	**107**	117	**67**	77
Over one year but within five years	**54**	72	**35**	57
	161	189	**102**	134

40. PREMISES, PLANT AND EQUIPMENT

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2009, and were updated for any material changes in the valuation as at 31 December 2009. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use.

(a) Movement of premises, plant and equipment

	Group		
	Premises	**Plant and equipment**	**Total**
2009			
Cost or valuation:			
At 1 January	**6,161**	**3,421**	**9,582**
Additions	**–**	**160**	**160**
Disposals	**–**	**(192)**	**(192)**
Elimination of accumulated depreciation on revalued premises	**(162)**	**–**	**(162)**
Surplus on revaluation:			
– credited to premises revaluation reserve	**700**	**–**	**700**
– debited to income statement (note 22)	**(31)**	**–**	**(31)**
Transfer to assets held for sale	**(253)**	**–**	**(253)**
Transfer to investment property (note 39(a))	**(13)**	**–**	**(13)**
Other	**–**	**(2)**	**(2)**
At 31 December	**6,402**	**3,387**	**9,789**
Accumulated depreciation:			
At 1 January	**–**	**(2,492)**	**(2,492)**
Charge for the year (note 17)	**(162)**	**(304)**	**(466)**
Written off on disposal	**–**	**185**	**185**
Elimination of accumulated depreciation on revalued premises	**162**	**–**	**162**
At 31 December	**–**	**(2,611)**	**(2,611)**
Net book value at 31 December	**6,402**	**776**	**7,178**

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

	Group		
	Premises	Plant and equipment	Total
2008			
Cost or valuation:			
At 1 January	6,082	3,186	9,268
Exchange adjustments	6	16	22
Additions	–	491	491
Disposals	–	(272)	(272)
Elimination of accumulated depreciation on revalued premises	(165)	–	(165)
Surplus on revaluation:			
– credited to premises revaluation reserve	171	–	171
– debited to income statement (note 22)	71	–	71
Transfer to investment property (note 39(a))	(4)	–	(4)
At 31 December	6,161	3,421	9,582
Accumulated depreciation:			
At 1 January	–	(2,474)	(2,474)
Exchange adjustments	–	(6)	(6)
Charge for the year (note 17)	(165)	(267)	(432)
Written off on disposal	–	254	254
Elimination of accumulated depreciation on revalued premises	165	–	165
Other	–	1	1
At 31 December	–	(2,492)	(2,492)
Net book value at 31 December	6,161	929	7,090

40. PREMISES, PLANT AND EQUIPMENT (continued)

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

	Premises	Bank Plant and equipment	Total
2009			
Cost or valuation:			
At 1 January	**3,591**	**3,050**	**6,641**
Additions	**–**	**142**	**142**
Disposals	**–**	**(186)**	**(186)**
Elimination of accumulated depreciation on revalued premises	**(100)**	**–**	**(100)**
Surplus on revaluation:			
– credited to premises revaluation reserve	**395**	**–**	**395**
– debited to income statement	**(31)**	**–**	**(31)**
Transfer to assets held for sale	**(254)**	**–**	**(254)**
At 31 December	**3,601**	**3,006**	**6,607**
Accumulated depreciation:			
At 1 January	**–**	**(2,347)**	**(2,347)**
Charge for the year	**(100)**	**(243)**	**(343)**
Written off on disposal	**–**	**181**	**181**
Elimination of accumulated depreciation on revalued premises	**100**	**–**	**100**
At 31 December	**–**	**(2,409)**	**(2,409)**
Net book value at 31 December	**3,601**	**597**	**4,198**
2008			
Cost or valuation:			
At 1 January	3,578	2,927	6,505
Additions	–	378	378
Disposals	–	(255)	(255)
Elimination of accumulated depreciation on revalued premises	(102)	–	(102)
Surplus on revaluation:			
– credited to premises revaluation reserve	49	–	49
– credited to income statement	71	–	71
Transfer to investment property (note 39(a))	(5)	–	(5)
At 31 December	3,591	3,050	6,641
Accumulated depreciation:			
At 1 January	–	(2,378)	(2,378)
Charge for the year	(102)	(210)	(312)
Written off on disposal	–	241	241
Elimination of accumulated depreciation on revalued premises	102	–	102
At 31 December	–	(2,347)	(2,347)
Net book value at 31 December	3,591	703	4,294

40. PREMISES, PLANT AND EQUIPMENT (continued)

(b) Terms of lease

The net book value of premises comprises:

	Group		Bank	
	2009	2008	**2009**	2008
Leaseholds				
Held in Hong Kong:				
– long leases (over 50 years unexpired)	**1,583**	1,448	**796**	717
– medium leases (10 to 50 years unexpired)	**4,670**	4,601	**2,773**	2,874
– short leases (under 10 years unexpired)	**31**	–	**31**	–
Held outside Hong Kong:				
– long leases (over 50 years unexpired)	**7**	6	**–**	–
– medium leases (10 to 50 years unexpired)	**111**	106	**1**	–
	6,402	6,161	**3,601**	3,591

(c) The carrying amount of all premises which have been stated in the statement of financial position would have been as follows had they been stated at cost less accumulated depreciation:

	Group		Bank	
	2009	2008	**2009**	2008
Cost less accumulated depreciation at 31 December	**1,822**	1,879	**701**	725

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

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

	Group		Bank	
	2009	2008	**2009**	2008
At 1 January	**551**	565	**551**	565
Amortisation of prepaid operating lease payment (note 17)	**(15)**	(14)	**(15)**	(14)
At 31 December	**536**	551	**536**	551

42. INTANGIBLE ASSETS

	Group		Bank	
	2009	2008	**2009**	2008
Present value of in-force long-term insurance business	**3,466**	2,707	**–**	–
Internally developed software	**385**	321	**384**	321
Acquired software	**34**	28	**15**	21
Goodwill	**329**	329	**–**	–
	4,214	3,385	**399**	342

42. INTANGIBLE ASSETS (continued)

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

	Group	
	2009	2008
At 1 January	**2,707**	2,324
Addition from current year new business	**747**	838
Movement from in-force business	**12**	(455)
At 31 December	**3,466**	2,707

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

	2009	2008
Risk discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Average lapse rate:		
– 1st year	**3.4%**	2.9%
– 2nd year onwards	**1.4%**	1.6%

The sensitivity of PVIF valuation to changes in individual assumptions at the end of the reporting periods is shown in note 62(d).

(b) Goodwill

	Group		Bank	
	2009	2008	**2009**	2008
At 1 January and at 31 December	**329**	329	**–**	–

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

During 2009, there was no impairment of goodwill (2008: Nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating unit based on appraisal value with the carrying amount of its net assets, including attributable goodwill.

The appraisal value comprises HSIC's net assets (other than value of business acquired and goodwill) as at 31 December 2009, the present value of in-force long-term insurance business and the expected value of future business. The present value of the in-force long-term insurance business is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 42(a) and 62(d).

42. INTANGIBLE ASSETS (continued)

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

	Group		Bank	
	2009	2008	**2009**	2008
Cost:				
At 1 January	**532**	366	**522**	364
Additions	**152**	175	**138**	166
Disposals	**(20)**	(9)	**(19)**	(8)
Other	**2**	–	**–**	–
At 31 December	**666**	532	**641**	522
Accumulated amortisation:				
At 1 January	**(183)**	(130)	**(180)**	(130)
Charge for the year (note 17)	**(84)**	(60)	**(81)**	(58)
Written off on disposals	**20**	8	**19**	8
Other	**–**	(1)	**–**	–
At 31 December	**(247)**	(183)	**(242)**	(180)
Net book value at 31 December	**419**	349	**399**	342

During 2009, there was no impairment on internally developed application software and acquired software (2008: Nil).

43. OTHER ASSETS

	Group		Bank	
	2009	2008	**2009**	2008
Items in the course of collection from other banks	**4,343**	4,028	**4,343**	4,017
Prepayments and accrued income	**1,835**	2,711	**804**	1,616
Assets held for sale*				
– repossessed assets	**47**	136	**30**	104
– other assets held for sale	**–**	16	**–**	16
Acceptances and endorsements	**3,584**	3,090	**2,435**	2,255
Retirement benefit assets	**86**	30	**86**	30
Other accounts	**1,174**	1,495	**538**	834
	11,069	11,506	**8,236**	8,872

* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2009 and 2008.

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

44. CURRENT, SAVINGS AND OTHER DEPOSIT ACCOUNTS

	Group		Bank	
	2009	2008	**2009**	2008
Current, savings and other deposit accounts:				
– as stated in statement of financial position	**636,369**	562,183	**612,014**	547,385
– structured deposits reported as rading liabilities (note 45)	**22,212**	29,785	**18,892**	24,970
	658,581	591,968	**630,906**	572,355
By type:				
– demand and current accounts	**53,450**	36,321	**53,409**	37,616
– savings accounts	**437,440**	294,556	**429,062**	289,296
– time and other deposits	**167,691**	261,091	**148,435**	245,443
	658,581	591,968	**630,906**	572,355

45. TRADING LIABILITIES

	Group		Bank	
	2009	2008	**2009**	2008
Structured certificates of deposit in issue (note 47)	**478**	3,861	**478**	3,861
Other debt securities in issue (note 47)	**2,769**	5,855	**2,769**	5,855
Structured deposits (note 44)	**22,212**	29,785	**18,892**	24,970
Short positions in securities and other	**12,932**	8,781	**12,932**	8,781
	38,391	48,282	**35,071**	43,467

46. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

	Group		Bank	
	2009	2008	**2009**	2008
4.125% callable fixed rate subordinated notes (note 51)	**1,003**	994	**1,003**	994
Liabilities to customers under investment contracts	**453**	413	**–**	–
	1,456	1,407	**1,003**	994

At 31 December 2009, the difference between the carrying amount and the contractual amount of subordinated notes payable at maturity for the Group and the Bank amounted to HK$3 million (2008: HK$6 million). The accumulated amount of the change in fair value attributable to change in credit risk for the Group and the Bank was HK$46 million (2008: HK$54 million) and the change for the year ended 31 December 2009 was HK$8 million (2008: HK$42 million) for the Group and the Bank.

47. CERTIFICATES OF DEPOSIT AND OTHER DEBT SECURITIES IN ISSUE

	Group		Bank	
	2009	2008	**2009**	2008
Certificates of deposit and other debt securities in issue:				
– as stated in statement of financial position	**1,826**	2,772	**1,826**	2,772
– structured certificates of deposit in issue reported as trading liabilities (note 45)	**478**	3,861	**478**	3,861
– other structured debt securities in issue reported as trading liabilities (note 45)	**2,769**	5,855	**2,769**	5,855
	5,073	12,488	**5,073**	12,488
By type:				
– certificates of deposit in issue	**2,304**	6,633	**2,304**	6,633
– other debt securities in issue	**2,769**	5,855	**2,769**	5,855
	5,073	12,488	**5,073**	12,488

48. OTHER LIABILITIES

	Group		Bank	
	2009	2008	**2009**	2008
Items in the course of transmission to other banks	**6,304**	4,583	**6,303**	4,575
Accruals	**2,039**	2,924	**1,668**	2,471
Acceptances and endorsements	**3,584**	3,090	**2,435**	2,255
Retirement benefit liabilities	**1,712**	3,532	**1,712**	3,532
Other	**1,646**	1,319	**2,215**	1,977
	15,285	15,448	**14,333**	14,810

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS

	Group					
	2009			2008		
	Gross	**Reinsurance**	**Net**	Gross	Reinsurance	Net
Non-life insurance						
Unearned premiums	**192**	**(52)**	**140**	199	(42)	157
Notified claims	**146**	**(19)**	**127**	162	(22)	140
Claims incurred but not reported	**43**	**(8)**	**35**	43	(8)	35
Other	**47**	**(1)**	**46**	26	(3)	23
	428	**(80)**	**348**	430	(75)	355
Policyholders' liabilities						
Life (non-linked)	**53,588**	**(19)**	**53,569**	43,211	(18)	43,193
Life (linked)	**224**	**–**	**224**	194	–	194
	53,812	**(19)**	**53,793**	43,405	(18)	43,387
	54,240	**(99)**	**54,141**	43,835	(93)	43,742

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

Amounts recoverable from reinsurance of liabilities under insurance contracts issued are included in the consolidated statement of financial position in "Other assets".

The movement of liabilities under insurance contracts was as follows:

(a) Non-life insurance

		Group	
	Gross	Reinsurance	Net
2009			
Unearned premiums			
At 1 January	199	(42)	157
Gross written premiums	422	(93)	329
Gross earned premiums	(404)	78	(326)
Exchange and other movements	(25)	5	(20)
At 31 December	192	(52)	140
Notified and incurred but not reported claims			
At 1 January			
– notified claims	162	(22)	140
– claims incurred but not reported	43	(8)	35
	205	(30)	175
Claims paid	(119)	10	(109)
Claims incurred	103	(11)	92
	(16)	(1)	(17)
Exchange and other movements	–	4	4
At 31 December			
– notified claims	146	(19)	127
– claims incurred but not reported	43	(8)	35
	189	(27)	162
Other	47	(1)	46
	428	(80)	348

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(a) Non-life insurance (continued)

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

(b) Policyholders' liabilities

	Group		
	Gross	**Reinsurance**	**Net**
2009			
Life (non-linked)			
At 1 January	**43,211**	**(18)**	**43,193**
Benefits paid	**(1,811)**	**18**	**(1,793)**
Claims incurred and movement in policyholders' liabilities	**11,877**	**(19)**	**11,858**
Exchange and other movements	**311**	**–**	**311**
At 31 December	**53,588**	**(19)**	**53,569**
Life (linked)			
At 1 January	**194**	**–**	**194**
Benefits paid	**(19)**	**–**	**(19)**
Claims incurred and movement in policyholders' liabilities	**54**	**–**	**54**
Exchange and other movements	**(5)**	**–**	**(5)**
At 31 December	**224**	**–**	**224**
	53,812	**(19)**	**53,793**

49. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

(b) Policyholders' liabilities (continued)

	Group		
	Gross	Reinsurance	Net
2008			
Life (non-linked)			
At 1 January	32,444	(10)	32,434
Benefits paid	(646)	14	(632)
Claims incurred and movement in policyholders' liabilities	11,391	(22)	11,369
Exchange and other movements	22	–	22
At 31 December	43,211	(18)	43,193
Life (linked)			
At 1 January	235	–	235
Benefits paid	(30)	–	(30)
Claims incurred and movement in policyholders' liabilities	(11)	–	(11)
At 31 December	194	–	194
	43,405	(18)	43,387

50. CURRENT TAX AND DEFERRED TAX

(a) Current tax and deferred tax assets and liabilities are represented in the statement of financial position:

	Group		Bank	
	2009	2008	**2009**	2008
Current taxation recoverable (included in "Other assets")	**5**	25	**–**	–
Deferred tax assets	**16**	201	**2**	187
	21	226	**2**	187
Current tax liabilities:				
Provision for Hong Kong profits tax	**41**	91	**2**	65
Provision for taxation outside Hong Kong	**11**	3	**8**	1
	52	94	**10**	66
Deferred tax liabilities	**1,684**	711	**569**	–
	1,736	805	**579**	66

50. CURRENT TAX AND DEFERRED TAX (continued)

(b) Deferred tax assets and liabilities recognised

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

	Group						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available-for-sale financial assets	Cash flow hedge	Other	Total
2009							
At 1 January	**124**	**1,098**	**(99)**	**(476)**	**104**	**(241)**	**510**
(Credited)/charged to income statement (note 23(a))	**(5)**	**18**	**–**	**–**	**–**	**352**	**365**
Charged/(credited) to reserves	**–**	**72**	**–**	**481**	**(69)**	**309**	**793**
At 31 December	**119**	**1,188**	**(99)**	**5**	**35**	**420**	**1,668**
2008							
At 1 January	98	1,149	(97)	(69)	29	254	1,364
Charged/(credited) to income statement (note 23(a))	26	(32)	(2)	–	–	(9)	(17)
(Credited)/charged to reserves	–	(19)	–	(407)	75	(486)	(837)
At 31 December	124	1,098	(99)	(476)	104	(241)	510

	Bank						
	Depreciation allowances in excess of related depreciation	Revaluation of properties	Loan impairment allowances	Fair value adjustments for available-for-sale financial assets	Cash flow hedge	Other	Total
2009							
At 1 January	**126**	**771**	**(98)**	**(480)**	**104**	**(610)**	**(187)**
(Credited)/charged to income statement	**(8)**	**8**	**–**	**–**	**–**	**7**	**7**
Charged/(credited) to reserves	**–**	**23**	**–**	**484**	**(69)**	**309**	**747**
At 31 December	**118**	**802**	**(98)**	**4**	**35**	**(294)**	**567**
2008							
At 1 January	105	820	(96)	(100)	29	(109)	649
Charged/(credited) to income statement	21	(22)	(2)	–	–	(16)	(19)
(Credited)/charged to reserves	–	(27)	–	(380)	75	(485)	(817)
At 31 December	126	771	(98)	(480)	104	(610)	(187)

(c) Deferred tax assets not recognised

At the end of the reporting period, the Group has not recognised deferred tax assets in respect of tax losses of subsidiaries amounting to HK$25 million (2008: HK$29 million) which are considered unlikely to be utilised. There is no expiry provisions for tax losses.

(d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised in 2009 (2008: Nil).

51. SUBORDINATED LIABILITIES

Nominal value	Description	Group 2009	Group 2008	Bank 2009	Bank 2008
Amount owed to third parties					
HK$1,500 million	Callable floating rate subordinated notes due June 2015 (1)	**1,499**	1,498	**1,499**	1,498
HK$1,000 million	4.125% callable fixed rate subordinated notes due June 2015 (2)	**1,003**	994	**1,003**	994
US$450 million	Callable floating rate subordinated notes due July 2016 (3)	**3,483**	3,478	**3,483**	3,478
US$300 million	Callable floating rate subordinated notes due July 2017 (4)	**2,321**	2,318	**2,321**	2,318
Amount owed to HSBC Group undertakings					
US$260 million	Callable floating rate subordinated loan debt due December 2015 (5)	**2,017**	2,015	**2,017**	2,015
		10,323	10,303	**10,323**	10,303
Representing:					
– measured at amortised cost		**9,320**	9,309	**9,320**	9,309
– designated at fair value (note 46)		**1,003**	994	**1,003**	994
		10,323	10,303	**10,323**	10,303

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

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

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

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

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

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

52. SHARE CAPITAL

Authorised:
The authorised share capital of the Bank is HK$11,000 million (2008: HK$11,000 million) divided into 2,200 million shares (2008: 2,200 million shares) of HK$5 each.

	2009	2008
Issued and fully paid: 1,911,842,736 shares (2008: 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 (2008: Nil).

53. RESERVES

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity. Details of the changes in the Bank's individual components of equity between the beginning and the end of the year are set out below:

	Bank	
	2009	2008
Retained profits (including proposed dividends)	**21,494**	21,299
Premises revaluation reserve	**2,556**	2,503
Cash flow hedge reserve	**180**	528
Available-for-sale investment reserve:		
– on debt securities	**(51)**	(2,532)
– on equity securities	**50**	177
Capital redemption reserve	**99**	99
Other reserves	**459**	420
Total reserves (including proposed dividends)	**24,787**	22,494
Retained profits (including proposed dividends)		
At beginning of the year	**21,299**	24,947
Dividends to shareholders		
– dividends approved in respect of the previous year	**(5,736)**	(5,736)
– dividends declared in respect of the current year	**(6,309)**	(6,309)
Transfer	**319**	95
Total comprehensive income for the year	**11,921**	8,302
	21,494	21,299
Premises revaluation reserve		
At beginning of the year	**2,503**	2,522
Transfer	**(319)**	(95)
Total comprehensive income for the year	**372**	76
	2,556	2,503
Available-for-sale investment reserve		
At beginning of the year	**(2,355)**	(95)
Total comprehensive income for the year	**2,354**	(2,260)
	(1)	(2,355)
Cash flow hedge reserve		
At beginning of the year	**528**	137
Total comprehensive income for the year	**(348)**	391
	180	528
Capital redemption reserve		
At beginning of the year	**99**	99
Total comprehensive income for the year	**–**	–
	99	99
Other reserve		
At beginning of the year	**420**	298
Costs of share-based payment arrangements	**35**	127
Total comprehensive income for the year	**4**	(5)
	459	420
Total reserves (including proposed dividends)	**24,787**	22,494

53. RESERVES (continued)

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

Regulatory reserve

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2009, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group to shareholders by HK$920 million (2008: HK$854 million).

Retained profits

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

Premises revaluation reserve

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

The premises revaluation reserve included nil amount in relation to properties classified as assets held for sale, included in "Other assets" in the consolidated statement of financial position at 31 December 2009 (31 December 2008: Nil).

Cash flow hedge reserve

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

Available-for-sale investment reserve

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

Capital redemption reserve

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

Other reserves

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

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

54. RECONCILIATION OF CASH FLOW STATEMENT

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

	2009	2008
Operating profit	13,324	13,725
Net interest income	(14,023)	(16,232)
Dividend income	(16)	(82)
Loan impairment charges and other credit risk provisions	812	2,776
Impairment of available-for-sale equity securities	4	284
Depreciation	466	432
Amortisation of intangible assets	84	60
Amortisation of available-for-sale investments	76	(398)
Amortisation of held-to-maturity debt securities	1	1
Advances written off net of recoveries	(858)	(400)
Interest received	11,126	16,232
Interest paid	(1,478)	(9,249)
Operating profit before changes in working capital	9,518	7,149
Change in treasury bills and certificates of deposit with original maturity more than three months	(41,353)	14,016
Change in placings with and advances to banks maturing after one month	(5,418)	(2,895)
Change in trading assets	77,386	(100,363)
Change in financial assets designated at fair value	(2,549)	(276)
Change in derivative financial instruments	(8,640)	7,848
Change in advances to customers	(15,454)	(21,766)
Change in other assets	(1,070)	(3,474)
Change in financial liabilities designated at fair value	8	5
Change in current, savings and other deposit accounts	74,186	15,530
Change in deposits from banks	(6,566)	(8,300)
Change in trading liabilities	(9,891)	131
Change in certificates of deposit and other debt securities in issue	(946)	(2,913)
Change in other liabilities	4,048	7,150
Elimination of exchange differences and other non-cash items	(5,523)	4,542
Cash generated from/(used in) operating activities	67,736	(83,616)
Taxation paid	(1,921)	(3,214)
Net cash inflow/(outflow) from operating activities	65,815	(86,830)

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

	2009	2008
Cash and balances with banks and other financial institutions	22,086	24,822
Placings with and advances to banks and other financial institutions maturing within one month	74,459	44,572
Treasury bills	40,214	6,722
	136,759	76,116

The balances of cash and cash equivalents included cash balances with central banks and financial institutions that are subject to exchange control and regulatory restrictions, amounting to HK$8,410 million at 31 December 2009 (2008: HK$5,085 million).

55. CONTINGENT LIABILITIES AND COMMITMENTS

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

For the purposes of these financial statements, acceptances and endorsements are recognised on the statements of financial position in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK$3,584 million (2008: HK$3,090 million) and HK$2,435 million (2008: HK$2,255 million) respectively.

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

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

With the Capital Rules effective from 1 January 2007, the Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2009 were calculated based on the "advanced internal ratings-based approach" and the risk-weighted assets for 2008 were calculated based on the "foundation internal ratings-based approach".

	Group			Bank		
	Contract amounts	Credit equivalent amounts	Risk-weighted amounts	Contract amounts	Credit equivalent amounts	Risk-weighted amounts
2009						
Direct credit substitutes	**3,121**	**2,987**	**1,785**	**3,121**	**2,987**	**1,785**
Transaction-related contingencies	**550**	**289**	**155**	**328**	**244**	**101**
Trade-related contingencies	**9,451**	**2,465**	**1,466**	**8,144**	**2,096**	**1,172**
Forward asset purchases	**36**	**36**	**36**	**36**	**36**	**36**
Undrawn formal standby facilities, credit lines and other commitments to lend:						
– not unconditionally cancellable*	**29,069**	**16,447**	**7,720**	**26,796**	**14,330**	**5,957**
– unconditionally cancellable	**158,817**	**53,514**	**15,036**	**147,079**	**50,369**	**12,603**
	201,044	**75,738**	**26,198**	**185,504**	**70,062**	**21,654**

55. CONTINGENT LIABILITIES AND COMMITMENTS (continued)

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

* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of "not more than one year" and "more than one year" as at 31 December 2009 were HK$13,371 million and HK$15,698 million respectively (2008: HK$10,444 million and HK$13,264 million).

56. ASSETS PLEDGED AS SECURITY FOR LIABILITIES

At 31 December 2009, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements for the Group and the Bank amounted to HK$12,929 million (Group and Bank in 2008: HK$9,807 million and HK$8,766 million respectively). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK$13,153 million (Group and Bank in 2008: HK$10,110 million and HK$9,069 million respectively) and mainly comprised items included in "Trading assets" and "Financial investments".

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

57. CAPITAL COMMITMENTS

	Group		**Bank**	
	2009	2008	**2009**	2008
Expenditure authorised and contracted for	**73**	141	**65**	138
Expenditure authorised but not contracted for	**–**	–	**–**	–

58. LEASE COMMITMENTS

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

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

	Group		**Bank**	
	2009	2008	**2009**	2008
Within one year	**414**	398	**296**	284
Between one and five years	**360**	497	**256**	361
Over five years	**–**	2	**–**	–
	774	897	**552**	645

59. EMPLOYEE RETIREMENT BENEFITS

(a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 50 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The 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 2009 were performed by E Chiu, fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Ltd, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the statement of financial position 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 statements of financial position are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2009			
Present value of funded obligations (note 59(a)(iii))	**(5,557)**	**(170)**	**(2)**
Fair value of scheme assets (note 59(a)(iv))	**3,845**	**225**	**33**
Net (liabilities)/assets recognised in the statement of financial position (note 59(a)(v))	**(1,712)**	**55**	**31**
Reported as "Assets"	**–**	**55**	**31**
Reported as "Liabilities"	**(1,712)**	**–**	**–**
	(1,712)	**55**	**31**
Obligations covered by scheme assets (%)	**69**	**132**	**1,650**
2008			
Present value of funded obligations (note 59(a)(iii))	(6,961)	(219)	(3)
Fair value of scheme assets (note 59(a)(iv))	3,430	218	33
Net (liabilities)/assets recognised in the statement of financial position (note 59(a)(v))	(3,531)	(1)	30
Reported as "Assets"	–	–	30
Reported as "Liabilities"	(3,531)	(1)	–
	(3,531)	(1)	30
Obligations covered by scheme assets (%)	49	100	1,100

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

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

On an on-going basis, the actuarial value of the principal scheme assets of HSBDBS represented 100 per cent (2008: 89 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK$14 million (deficit in 2008: HK$453 million). On a wind-up basis, the actuarial value of the scheme assets represented 100 per cent (2008: 90 per cent) of the members' vested benefits, based on salaries at that date, and the resulting surplus amounted to HK$19 million (deficit in 2008: HK$379 million).

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

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2009			
Equity	**945**	**28**	**–**
Bonds	**2,724**	**171**	**–**
Certificates of deposit issued by the Bank	**–**	**–**	**–**
Ordinary shares issued by ultimate holding company	**48**	**–**	**–**
Other	**128**	**26**	**33**
	3,845	**225**	**33**
2008			
Equity	787	15	–
Bonds	2,055	162	–
Certificates of deposit issued by the Bank	–	–	–
Ordinary shares issued by ultimate holding company	44	–	–
Other	544	41	33
	3,430	218	33

(iii) Change in the present value of scheme obligations

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2009			
At 1 January	**6,961**	**219**	**3**
Current service cost	**349**	**–**	**–**
Interest cost	**82**	**3**	**–**
Actuarial gains	**(1,491)**	**(37)**	**(1)**
Benefits paid	**(344)**	**(15)**	**–**
At 31 December	**5,557**	**170**	**2**
2008			
At 1 January	5,722	188	3
Current service cost	296	–	–
Interest cost	195	6	–
Actuarial losses	987	40	–
Benefits paid	(239)	(15)	–
At 31 December	6,961	219	3

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(iv) Change in the fair value of scheme assets

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2009			
At 1 January	**3,430**	**218**	**33**
Contributions by the Bank	**212**	**–**	**–**
Expected return on scheme assets	**211**	**9**	**1**
Experience gains/(losses)	**336**	**13**	**(1)**
Benefits paid	**(344)**	**(15)**	**–**
At 31 December	**3,845**	**225**	**33**
2008			
At 1 January	5,089	267	32
Contributions by the Bank	143	–	–
Expected return on scheme assets	382	10	1
Experience losses	(1,945)	(44)	–
Benefits paid	(239)	(15)	–
At 31 December	3,430	218	33

The Group and the Bank expect to make HK$188 million of contributions to defined benefit schemes during the following year (2008: HK$400 million).

(v) Movements in the net (liabilities)/assets recognised in the statements of financial position are as follows:

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2009			
At 1 January	**(3,531)**	**(1)**	**30**
Contributions by the Bank	**212**	**–**	**–**
Net (expense)/income recognised in the income statement (note 59(a)(vi))	**(220)**	**6**	**1**
Net actuarial gains	**1,827**	**50**	**–**
At 31 December	**(1,712)**	**55**	**31**
Experience gains on scheme liabilities	**288**	**5**	**–**
Experience gains/(losses) on scheme assets	**336**	**13**	**(1)**
Gains from change in actuarial assumptions	**1,203**	**32**	**1**
Net actuarial gains	**1,827**	**50**	**–**
2008			
At 1 January	(633)	79	29
Contributions by the Bank	143	–	–
Net (expense)/income recognised in the income statement (note 59(a)(vi))	(109)	4	1
Net actuarial losses	(2,932)	(84)	–
At 31 December	(3,531)	(1)	30
Experience gains on scheme liabilities	258	2	–
Experience losses on scheme assets	(1,945)	(44)	–
Losses from change in actuarial assumptions	(1,245)	(42)	–
Net actuarial losses	(2,932)	(84)	–

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

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

	Group		
	HSBDBS	HSBPS	HSBNTBS
2009			
Current service cost	**(349)**	**–**	**–**
Interest cost	**(82)**	**(3)**	**–**
Expected return on scheme assets	**211**	**9**	**1**
Net (expense)/income for the year (note 17)	**(220)**	**6**	**1**
Actual return on scheme assets	**547**	**22**	**–**
2008			
Current service cost	(296)	–	–
Interest cost	(195)	(6)	–
Expected return on scheme assets	382	10	1
Net (expense)/income for the year (note 17)	(109)	4	1
Actual return on scheme assets	(1,563)	(33)	–

The net actuarial gains recognised in the Group's retained profit during 2009 in respect of defined benefit schemes were HK$1,568 million (net actuarial losses of HK$2,529 million during 2008). The total cumulative amount of actuarial losses recognised in the retained profit was HK$1,911 million (2008: the cumulative amount of actuarial losses was HK$3,479 million). The total effect of the limit on schemes surpluses in 2009 and 2008 in respect of defined benefit schemes was HK$ nil.

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

	Group and Bank		
	HSBDBS	HSBPS	HSBNTBS
2009	**%**	**%**	**%**
Discount rate	**2.6**	**2.6**	**2.6**
Expected rate of return on scheme assets	**5.5**	**4.0**	**3.0**
Expected rate of salary increases	**5.0**	**5.0**	**5.0**
Expected rate of pension increases	**–**	**1.0**	**–**
2008	%	%	%
Discount rate	1.2	1.2	1.2
Expected rate of return on scheme assets	6.0	4.0	3.0
Expected rate of salary increases	5.0	5.0	5.0
Expected rate of pension increases	–	1.5	–

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

59. EMPLOYEE RETIREMENT BENEFITS (continued)

(a) Defined benefit schemes (continued)

(viii) Amounts for the current and previous years

	Group and Bank				
	2009	2008	2007	2006	2005
Defined benefit obligations	**5,729**	7,183	5,913	3,905	3,742
Plan assets	**4,103**	3,681	5,388	4,728	4,199
Net (deficits)/surpluses	**(1,626)**	(3,502)	(525)	823	457
Experience gains/(losses) on scheme liabilities	**293**	260	(212)	(36)	19
Experience gains/(losses) on scheme assets	**348**	(1,989)	416	413	68
Gains/(losses) from change in actuarial assumptions	**1,236**	(1,287)	(1,711)	(113)	104

(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:

	2009	2008
Amounts charged to the income statement (note 17)	**74**	69

Under the Schemes, the Group's contributions are reduced by contributions forfeited by those employees who leave the Schemes prior to the contributions vesting fully. There was no forfeited contributions utilised during the year or available at the year-end to reduce future contributions (2008: Nil).

60. SHARE-BASED PAYMENTS

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

(a) Savings-Related Share Option Plan

The Savings-Related Share Option Plan, invites eligible employees to enter into savings contracts to save Hong Kong dollar equivalent of up to £250 per month, with the option to use the savings to acquire shares. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contract depending on conditions set at grant. There is generally one Savings-Related Share Option Plan grant each year (in April or May). The exercise price is at a 20 per cent (2008: 20 per cent) discount to the market value at the date of grant.

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

60. SHARE-BASED PAYMENTS (continued)

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

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

(i) Option scheme with exercise price set in pounds sterling

	2009		2008	
	Weighted average exercise price £	Number ('000)	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	6.55	543	6.43	1,922
Exercised in the year	5.64	(171)	6.36	(1,235)
Lapsed in the year	6.55	(387)	6.43	(144)
Adjustment for rights issue	5.69	44	–	–
Outstanding at 31 December	5.82	29	6.55	543
Exercisable at 31 December	–	–	6.68	2

The weighted average share price at the date of exercise for share options exercised during the year was £6.56 (2008: £8.44).

The options outstanding at the year end had an exercise price of £5.82 (2008: £6.47 to £6.68), and a weighted average remaining contractual life of 1.08 years (2008: 1.45 years).

(ii) Option scheme with exercise price set in Hong Kong dollars

	2009		2008	
	Weighted average exercise price HK$	Number ('000)	Weighted average exercise price HK$	Number ('000)
Outstanding at 1 January	106.14	2,296	106.73	3,363
Granted in the year	37.88	12,292	106.25	2,034
Exercised in the year	90.14	(11)	108.45	(584)
Lapsed in the year	102.99	(2,526)	106.73	(2,517)
Adjustment for rights issue	92.30	142	–	–
Outstanding at 31 December	38.30	12,193	106.14	2,296
Exercisable at 31 December	–	–	–	–

The weighted average share price at the date of exercise for share options exercised during the year was HK$83.33 (2008: HK$124.65).

The options outstanding at the year end had an exercise price in the range of HK$37.88 to HK$94.51 (2008: HK$103.44 to HK$108.45), and a weighted average remaining contractual life of 3.50 years (2008: 2.17 years).

The weighted average fair value of options granted during the year was HK$15.74 (2008: HK$29.42).

60. SHARE-BASED PAYMENTS (continued)

(b) Executive/Group Share Option Plan

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

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

	2009		2008	
	Weighted average exercise price £	**Number ('000)**	Weighted average exercise price £	Number ('000)
Outstanding at 1 January	**7.93**	**2,747**	7.89	2,976
Exercised in the year	**7.55**	**(60)**	7.03	(158)
Lapsed in the year	**7.93**	**(441)**	7.89	(71)
Adjustment for rights issue	**6.99**	**406**	–	–
Outstanding at 31 December	**7.04**	**2,652**	7.93	2,747
Exercisable at 31 December	**7.04**	**2,652**	7.93	2,747

The weighted average share price at the date of exercise for share options exercised during the year was £5.86 (2008: £7.99).

The options outstanding at the year end had an exercise price in the range of £6.02 to £7.59 (2008: £6.38 to £8.71), and a weighted average remaining contractual life of 2.89 years (2008: 3.56 years).

(c) Calculation of fair value

The recognition of compensation cost of share option is based on the fair value of the options on grant date. The calculation of the fair value of HSBC share option is centrally managed by HSBC Holdings plc. Fair values of share options, measured at the date of grant of the options are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. Expected dividends are incorporated into the valuation model for share options and awards where applicable. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

60. SHARE-BASED PAYMENTS (continued)

(c) Calculation of fair value (continued)

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

	1-year Savings-Related Share Option Plan	3-year Savings-Related Share Option Plan	5-year Savings-Related Share Option Plan
2009			
Risk-free interest rate (%)	**0.7**	**2.1**	**2.4**
Expected life (years)	**1**	**3**	**5**
Expected volatility (%)	**50**	**35**	**30**
Share price at grant date (HK$)	**53.34**	**53.34**	**53.34**
2008			
Risk-free interest rate (%)	4.5	4.5	4.5
Expected life (years)	1	3	5
Expected volatility (%)	25	25	25
Share price at grant date (HK$)	136.23	136.23	136.23

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

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

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

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

	2009 Number ('000)	2008 Number ('000)
Outstanding at 1 January	**917**	500
Additions during the year	**181**	462
Released in the year	**(141)**	(45)
Outstanding at 31 December	**957**	917

The closing price of the HSBC Holdings plc share at 31 December 2009 was £7.09 (2008: £6.62).

The weighted average remaining vesting period as at 31 December 2009 was 1.33 years (2008: 1.86 years).

60. SHARE-BASED PAYMENTS (continued)

(e) Employee expenses

During 2009, HK$101 million was charged to the income statement in respect of share-based payment transactions settled in equity (2008: HK$109 million). This expense, which was computed from the fair values of the share-based payment transactions when granted, arose under employee share awards made in accordance with the Group's reward structures.

61. MATERIAL RELATED-PARTY TRANSACTIONS

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

In 2009, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The Group used the IT service of, and shared an automated teller machine network with, its immediate holding company. The Group also shared certain IT projects with and used certain processing services of fellow subsidiaries on a cost recovery basis. The Group maintained a staff retirement benefit scheme for which a fellow subsidiary company acts as insurer and administrator. A fellow subsidiary company was appointed as fund manager to manage the Group's investment portfolios. The Bank acted as agent for the marketing of Mandatory Provident Fund products and the distribution of retail investment funds for two fellow subsidiary companies.

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

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

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

	Group					
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Associates	
	2009	2008	**2009**	2008	**2009**	2008
Interest income	**245**	315	**–**	57	**2**	1
Interest expense	**(43)**	(314)	**(3)**	(12)	**(3)**	(13)
Other operating income/(expense)	**17**	(52)	**1**	12	**2**	2
Operating expenses*	**(736)**	(696)	**(415)**	(388)	**(12)**	(13)
Amounts due from:						
Cash and balances with banks and other financial institutions	**1,495**	6,765	**758**	267	**13**	245
Placings with and advances to banks and other financial institutions	**10,841**	10,899	**–**	–	**–**	–
Derivative financial instruments	**373**	602	**10**	33	**–**	–
Financial assets designated at fair value	**3,346**	3,545	**–**	–	**–**	–
Advances to customers	**–**	–	**–**	–	**233**	233
Financial investments	**412**	692	**–**	–	**–**	–
Other assets	**55**	108	**10**	118	**3**	3
	16,522	22,611	**778**	418	**249**	481
Amounts due to:						
Current, savings and other deposit accounts	**1,527**	36	**126**	141	**63**	51
Deposits from banks	**1,309**	5,478	**4**	–	**116**	441
Derivative financial instruments	**1,238**	7,390	**76**	35	**–**	–
Subordinated liabilities	**2,017**	2,015	**–**	–	**–**	–
Other liabilities	**246**	194	**84**	80	**–**	–
	6,337	15,113	**290**	256	**179**	492
Derivative contracts:						
Contract amount	**46,180**	136,269	**18,280**	8,593	**–**	–
Guarantees:						
Guarantees issued	**–**	4	**–**	–	**116**	–

* 2009 Operating expenses included payment of HK$107 million (2008: HK$127 million) of software costs which were capitalised as intangible assets in the statement of financial position of the Group.

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

	Bank							
	Immediate holding company and its subsidiaries		Fellow subsidiaries		Subsidiaries		Associates	
	2009	2008	**2009**	2008	**2009**	2008	**2009**	2008
Amounts due from:								
Cash and balances with banks and other financial institutions	**1,397**	6,724	**701**	261	**–**	–	**–**	–
Placings with and advances to banks and other financial institutions	**5,196**	6,192	**–**	–	**–**	–	**–**	–
Derivative financial instruments	**280**	592	**10**	33	**1**	62	**–**	–
Financial assets designated at fair value	**–**	–	**–**	–	**–**	–	**–**	–
Advances to customers	**–**	–	**–**	–	**–**	–	**–**	–
Amounts due from subsidiaries	**–**	–	**–**	–	**87,360**	84,907	**–**	–
Financial investments	**–**	–	**–**	–	**–**	–	**–**	–
Other assets	**17**	59	**5**	94	**–**	–	**3**	3
	6,890	13,567	**716**	388	**87,361**	84,969	**3**	3
Amounts due to:								
Current, savings and other deposit accounts	**1,527**	36	**126**	141	**–**	–	**63**	51
Deposits from banks	**1,309**	4,958	**4**	–	**–**	–	**116**	–
Derivative financial instruments	**1,230**	7,379	**75**	35	**18**	74	**–**	–
Subordinated liabilities	**2,017**	2,015	**–**	–	**–**	–	**–**	–
Amounts due to subsidiaries	**–**	–	**–**	–	**9,960**	8,575	**–**	–
Other liabilities	**194**	162	**82**	75	**–**	–	**–**	–
	6,277	14,550	**287**	251	**9,978**	8,649	**179**	51
Derivative contracts:								
Contract amount	**40,975**	135,420	**18,280**	8,593	**12,220**	3,636	**–**	–
Guarantees:								
Guarantees issued	**–**	4	**–**	–	**543**	564	**116**	–
Guarantees received	**–**	–	**–**	–	**142**	10	**–**	–

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(b) Key management personnel remuneration

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

	Group		Bank	
	2009	2008	**2009**	2008
Employee benefits	**39**	51	**39**	51
Post-employment benefits	**5**	5	**5**	5
Share-based payments	**6**	8	**6**	8
	50	64	**50**	64

(c) Material transactions with key management personnel

During the year, the Group provided credit facilities to and accepted deposits from key management personnel of the Bank and its holding companies, their close family members and companies controlled or significantly influenced by them. The credit facilities extended and deposit taken were provided in the ordinary course of business and on substantially the same terms as for comparable transactions with persons of a similar standing or, where applicable, with other employees.

Material transactions conducted with key management personnel of the Bank and its holding companies and parties related to them are as follows:

	Group		Bank	
	2009	2008	**2009**	2008
Interest received	**232**	444	**230**	432
Interest paid	**5**	137	**5**	137
Fees and exchange income received	**16**	20	**16**	20
Loans and advances	**9,834**	17,749	**9,254**	16,385
Deposits	**2,096**	5,348	**2,085**	5,348
Undrawn commitments	**3,206**	4,182	**3,167**	4,182
Maximum aggregate amount of loans and advances during the year	**21,401**	21,020	**19,836**	19,424

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

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

61. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

(d) Loans to officers

Loans to officers of the Bank disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	Group		Bank	
	2009	2008	**2009**	2008
Aggregate amount of relevant transactions outstanding at 31 December	**73**	50	**69**	45
Maximum aggregate amount of relevant transactions during the year	**132**	174	**127**	168

(e) Associates

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

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2009 was HK$233 million (2008: HK$233 million).

The Bank has been assisting Industrial Bank Co., Ltd. in managing and growing the credit card business, and providing support in the issuance of dual-logo credit cards.

The Bank has entered into Technical Support Agreement with Yantai Bank Co., Ltd. ("Yantai Bank") to provide technical support and assistance in relation to various banking operations and businesses of Yantai Bank.

(f) Ultimate holding company

The Group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the Group. As disclosed in note 60, the Group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under "Other reserves". The balance of this reserve as at 31 December 2009 amounted to HK$446 million comprising HK$445 million relating to share option schemes and HK$1 million relating to share award schemes (2008: HK$411 million comprising HK$371 million relating to share option schemes and HK$40 million relating to share award schemes).

(g) Employee retirement benefits

At 31 December 2009, defined benefit scheme assets amounted to HK$1,341 million (2008: HK$1,387 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK$10 million (2008: HK$4 million).

62. FINANCIAL RISK MANAGEMENT

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

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

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

(a) Credit risk

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

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

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

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

– undertaking an independent review and objective assessment of credit risk for all commercial non-bank credit facilities in excess of designated amount prior to the facilities being committed to customers;

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

– maintaining and developing credit risk rating/facility grading process to categorise exposures and facilitate focused management;

– reporting to senior executives and various committees on aspects of the Group loan portfolio;

– managing and directing credit-related systems initiatives; and

– providing advice and guidance to business units on various credit-related issues.

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

Impairment loan management and recovery

The Group undertakes ongoing credit analysis and monitoring at several levels. Special attention is paid to problem loans. Loans impairment allowances are made promptly where necessary and need to be consistent with established guidelines. Recovery units are established by the Group to provide the customers with intensive support in order to maximise recoveries of doubtful debts. Management regularly performs an assessment of the adequacy of the established impairment provisions by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics against historical trends and undertaking an assessment of current economic conditions.

Risk rating framework

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

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

Collateral and other credit enhancements

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

– in the personal sector, charges over the properties, securities, investment funds and deposits;

– in the commercial and industrial sector, charges over business assets such as properties, stock, debtors, investment funds, deposits and machinery;

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

Repossessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the statement of financial position within "Other assets" at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The Group does not generally occupy repossessed properties for its business use.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured with the exception of asset backed securities and similar instruments, which are secured by pools of financial assets.

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

Settlement risk

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

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

Concentration of credit risk

Concentration of credit risk exists when changes in geographic, economic or industry factors similarly affect groups of counterparties whose aggregate credit exposure is material in relation to the Group's total exposures. The Group's portfolio of financial instrument is diversified along geographic, industry and product sectors. Analysis of geographical concentration of the Group's assets is disclosed in note 27 to the financial statements and credit risk concentration of respective financial assets is disclosed in notes 32, 33, 35 and 36.

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

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

	Group		Bank	
	2009	2008	**2009**	2008
Cash and balances with banks and other financial institutions	**22,086**	24,822	**18,461**	22,071
Placings with and advances to banks and other financial institutions	**104,551**	69,579	**65,624**	38,097
Trading assets	**66,597**	108,389	**65,288**	107,775
Financial assets designated at fair value	**5,450**	7,798	**174**	830
Derivative financial instruments	**5,050**	7,104	**4,916**	6,910
Advances to customers	**344,621**	329,121	**299,179**	280,255
Financial investments	**241,502**	181,159	**156,715**	112,000
Amounts due from subsidiaries	**–**	–	**87,360**	84,907
Other assets	**10,726**	11,123	**8,040**	8,627
Financial guarantees and other credit related contingent liabilities	**9,137**	8,744	**9,294**	8,682
Loan commitments and other credit related commitments	**295,084**	285,507	**280,093**	273,210
	1,104,804	1,033,346	**995,144**	943,364

(ii) Credit quality

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

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

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

Quality classification definitions:

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

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

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

- Impaired: Exposures have been assessed, individually or collectively, as impaired. The Group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ("Expected loss") grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

The Group's policy in respect of impairment on loans and advances and debt securities is set out in note 4 on the financial statements. Analysis of impairment allowances as at 31 December 2009 and the movement of such allowances during the year are disclosed in note 35.

Granular risk rating scales:

The CRR ("Customer Risk Rating") 10-grade scale maps to a more granular underlying 22-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Distribution of financial instruments by credit quality

	Group						
	Neither past due nor impaired						
	Strong	Medium*	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2009							
Items in the course of collection from other banks	4,343	–	–	–	–	–	4,343
Trading assets:							
– treasury and eligible bills	62,028	–	–	–	–	–	62,028
– debt securities	4,562	–	–	–	–	–	4,562
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	1	–	–	–	–	1
	66,590	1	–	–	–	–	66,591
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	4,841	86	–	–	–	–	4,927
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	4,841	86	–	–	–	–	4,927
Derivatives	4,050	983	17	–	–	–	5,050
Loans and advances held at amortised cost:							
– loans and advances to banks	115,838	6,500	–	–	–	–	122,338
– loans and advances to customers	196,834	138,333	4,797	4,114	2,508	(1,965)	344,621
	312,672	144,833	4,797	4,114	2,508	(1,965)	466,959
Financial investments:							
– treasury and similar bills	53,973	–	–	–	–	–	53,973
– debt securities	177,926	9,256	–	–	–	–	187,182
	231,899	9,256	–	–	–	–	241,155
Other assets:							
– acceptances and endorsements	877	2,576	131	–	–	–	3,584
– other	1,792	968	34	5	–	–	2,799
	2,669	3,544	165	5	–	–	6,383

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

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

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

	Bank						
	Neither past due nor impaired			Past due			
	Strong	Medium*	Sub-standard	not impaired	Impaired	Impairment allowances	Total
2009							
Items in the course of collection from other banks	4,343	–	–	–	–	–	4,343
Trading assets:							
– treasury and eligible bills	62,028	–	–	–	–	–	62,028
– debt securities	3,253	–	–	–	–	–	3,253
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	1	–	–	–	–	1
	65,281	1	–	–	–	–	65,282
Financial assets designated at fair value:							
– treasury and eligible bills	–	–	–	–	–	–	–
– debt securities	174	–	–	–	–	–	174
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–	–
	174	–	–	–	–	–	174
Derivatives	3,930	971	15	–	–	–	4,916
Loans and advances held at amortised cost:							
– loans and advances to banks	76,150	3,856	–	–	–	–	80,006
– loans and advances to customers	170,878	122,500	2,779	2,924	1,761	(1,663)	299,179
	247,028	126,356	2,779	2,924	1,761	(1,663)	379,185
Financial investments:							
– treasury and similar bills	49,277	–	–	–	–	–	49,277
– debt securities	101,905	5,386	–	–	–	–	107,291
	151,182	5,386	–	–	–	–	156,568
Other assets:							
– acceptances and endorsements	763	1,641	31	–	–	–	2,435
– other	974	282	2	4	–	–	1,262
	1,737	1,923	33	4	–	–	3,697

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

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

* Includes HK$3,006 million (2008: HK$7,917 million) and HK$1,557 million (2008: HK$6,296 million) of debt securities that have been classified as BBB– to BBB+ for the Group and the Bank respectively in 2009, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

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

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

	Group					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2009						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	3,432	588	83	11	–	4,114
	3,432	588	83	11	–	4,114
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	4	1	–	–	–	5
	4	1	–	–	–	5

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

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

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

	Bank					
	Up to 29 days	30-59 days	60-89 days	90-180 days	Over 180 days	Total
2009						
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Financial assets designated at fair value:						
– treasury and eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost:						
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers#	2,540	331	52	1	–	2,924
	2,540	331	52	1	–	2,924
Financial investments:						
– treasury and similar bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
	–	–	–	–	–	–
Other assets:						
– acceptances and endorsements	–	–	–	–	–	–
– other	3	1	–	–	–	4
	3	1	–	–	–	4

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

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

Impaired loans and advances

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

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

Analyses of impairment allowances at 31 December 2009 and the movement of such allowances during the year are disclosed in note 35.

62. FINANCIAL RISK MANAGEMENT (continued)

(a) Credit risk (continued)

(ii) Credit quality (continued)

Renegotiated loans that would otherwise be past due or impaired

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

	Group		Bank	
	2009	2008	**2009**	2008
Renegotiated loans that would otherwise be past due or impaired	**1,110**	296	**801**	228

(iii) Collateral and other credit enhancements obtained

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

	Group		Bank	
	2009	2008	**2009**	2008
Nature of assets:				
Residential properties	**19**	115	**12**	103
Commercial and industrial properties	**–**	14	**–**	14
Other	**–**	1	**–**	1
	19	130	**12**	118

(b) Liquidity risk

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

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (continued)

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

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

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

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

	Group	
	2009	2008
The Bank and its subsidiaries designated by the HKMA	**48.1%**	46.4%

62. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (continued)

The following tables give the undiscounted cash-flow projection of the Group's financial liabilities including interest payable and undrawn commitments at the end of the reporting period based on the dates of their contractual payment obligations. Interest payable in respect of term financial liabilities are reported based on contractual interest payment date. Financial liabilities repayable on demand (such as savings and current deposits) including interest accrued up to the end of the reporting period are reported under the column "repayable on demand".

	Group					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2009						
Current, savings and other deposit accounts	**494,372**	**119,462**	**22,508**	**753**	**–**	**637,095**
Deposits from banks	**2,964**	**1,771**	**25**	**117**	**–**	**4,877**
Financial liabilities designated at fair value	**3**	**10**	**1,010**	**–**	**451**	**1,474**
Trading liabilities	**38,391**	**–**	**–**	**–**	**–**	**38,391**
Derivative financial instruments	**3,581**	**75**	**365**	**242**	**(8)**	**4,255**
Certificates of deposit and other debt securities in issue	**–**	**344**	**1,214**	**328**	**–**	**1,886**
Other financial liabilities	**5,881**	**4,935**	**1,103**	**114**	**116**	**12,149**
Subordinated liabilities	**–**	**12**	**3,547**	**5,846**	**–**	**9,405**
	545,192	**126,609**	**29,772**	**7,400**	**559**	**709,532**
Commitments	**7,410**	**31,823**	**13,493**	**157,443**	**11**	**210,180**
Financial guarantee contracts	**599**	**741**	**755**	**260**	**372**	**2,727**
	8,009	**32,564**	**14,248**	**157,703**	**383**	**212,907**
At 31 December 2008						
Current, savings and other deposit accounts	359,235	188,640	14,338	817	348	563,378
Deposits from banks	5,712	5,578	299	–	–	11,589
Financial liabilities designated at fair value	3	10	31	1,021	410	1,475
Trading liabilities	48,282	–	–	–	–	48,282
Derivative financial instruments	14,376	37	(46)	248	52	14,667
Certificates of deposit and other debt securities in issue	–	337	1,154	1,443	–	2,934
Other financial liabilities	4,254	2,616	2,796	58	117	9,841
Subordinated liabilities	–	91	272	9,960	–	10,323
	431,862	197,309	18,844	13,547	927	662,489
Commitments	3,282	32,087	12,206	154,778	10	202,363
Financial guarantee contracts	358	752	1,377	914	374	3,775
	3,640	32,839	13,583	155,692	384	206,138

62. FINANCIAL RISK MANAGEMENT (continued)

(b) Liquidity risk (continued)

	Bank					
	Repayable on demand	Three months or less but not on demand	Over three months but within one year	Over one year but within five years	Over five years	Total
At 31 December 2009						
Current, savings and other deposit accounts	**486,023**	**112,668**	**13,207**	**403**	**–**	**612,301**
Deposits from banks	**2,963**	**1,365**	**25**	**117**	**–**	**4,470**
Financial liabilities designated at fair value	**–**	**10**	**1,010**	**–**	**–**	**1,020**
Trading liabilities	**35,071**	**–**	**–**	**–**	**–**	**35,071**
Derivative financial instruments	**3,572**	**71**	**324**	**217**	**(8)**	**4,176**
Certificates of deposit and other debt securities in issue	**–**	**344**	**1,214**	**328**	**–**	**1,886**
Amounts due to subsidiaries	**4,749**	**4,973**	**238**	**–**	**–**	**9,960**
Other financial liabilities	**5,794**	**4,053**	**646**	**50**	**909**	**11,452**
Subordinated liabilities	**–**	**12**	**3,547**	**5,846**	**–**	**9,405**
	538,172	**123,496**	**20,211**	**6,961**	**901**	**689,741**
Commitments	**219**	**30,506**	**9,778**	**155,290**	**11**	**195,804**
Financial guarantee contracts	**599**	**741**	**754**	**255**	**372**	**2,721**
	818	**31,247**	**10,532**	**155,545**	**383**	**198,525**
At 31 December 2008						
Current, savings and other deposit accounts	354,343	182,448	11,096	123	348	548,358
Deposits from banks	5,711	2,560	–	–	–	8,271
Financial liabilities designated at fair value	–	10	31	1,021	–	1,062
Trading liabilities	43,467	–	–	–	–	43,467
Derivative financial instruments	14,376	38	(48)	245	52	14,663
Certificates of deposit and other debt securities in issue	–	337	1,154	1,443	–	2,934
Amounts due to subsidiaries	3,532	5,044	–	–	–	8,576
Other financial liabilities	4,159	2,071	2,398	2	910	9,540
Subordinated liabilities	–	91	272	9,960	–	10,323
	425,588	192,599	14,903	12,794	1,310	647,194
Commitments	265	30,702	7,753	153,847	10	192,577
Financial guarantee contracts	358	753	1,377	912	374	3,774
	623	31,455	9,130	154,759	384	196,351

(c) Market risk

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

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

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

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

Value at risk ("VAR")

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

VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence. Historical simulation uses scenarios derived from historical market rates and takes account of the relationships between different markets and rates, for example, interest rates and foreign exchange rates. Movements in market prices are calculated by reference to market data from the last two years. The assumed holding period is a 1-day period with a 99 per cent level of confidence, reflecting the way the risk positions are managed.

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

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

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

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

The Group's VAR, both trading and non-trading, for all interest rate risk and foreign exchange risk positions and on individual risk portfolios during 2009 and 2008 are shown in the table below.

62. FINANCIAL RISK MANAGEMENT (continued)

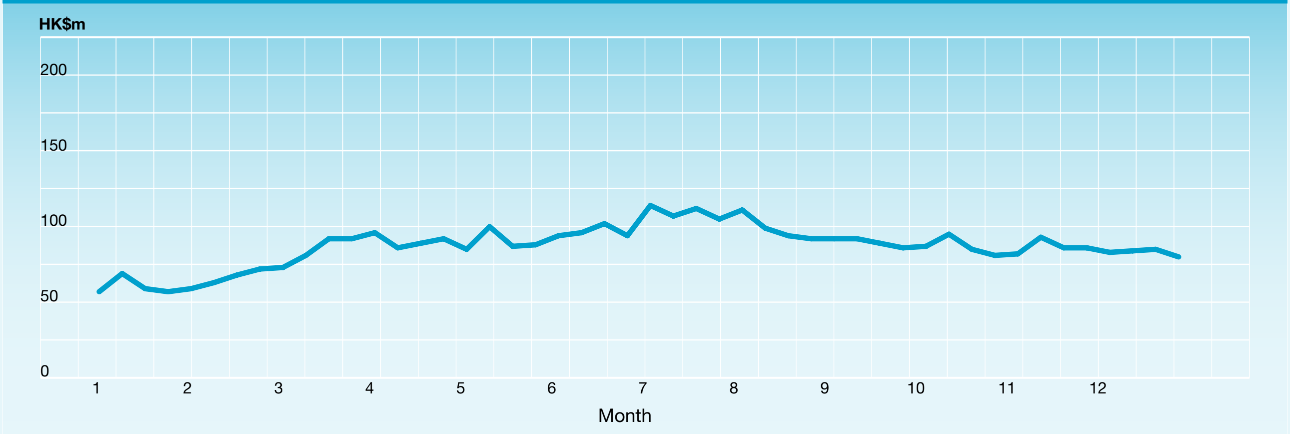
(c) Market risk (continued)

Value at risk ("VAR") (continued)

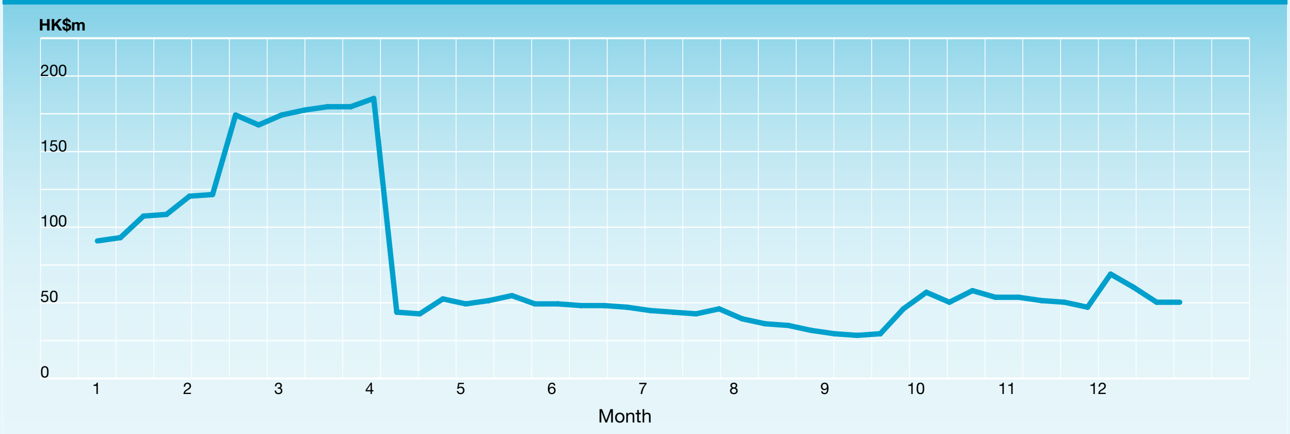
	At 31 December 2009	**Minimum during the year**	**Maximum during the year**	**Average for the year**
VAR for all interest rate risk and foreign exchange risk	**76**	**46**	**130**	**86**
VAR for foreign exchange risk (trading)	**2**	**1**	**24**	**7**
VAR for interest rate risk:				
– trading	**7**	**5**	**13**	**8**
– non-trading	**73**	**47**	**115**	**83**

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

Value at Risk for 2009



Value at Risk for 2008



Notes to the Financial Statements

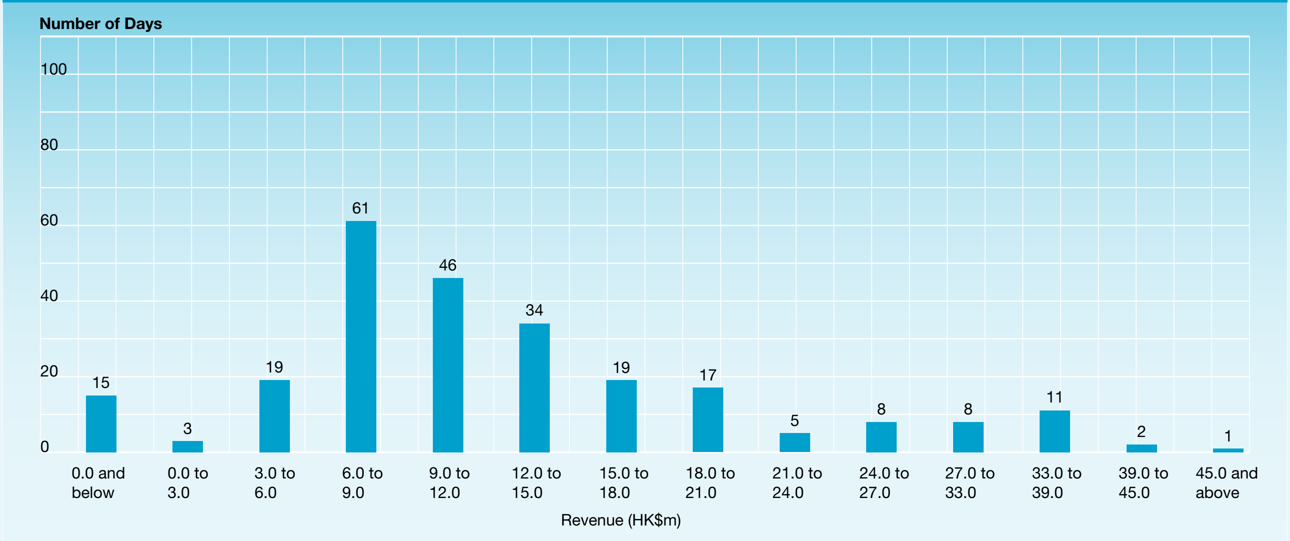
62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

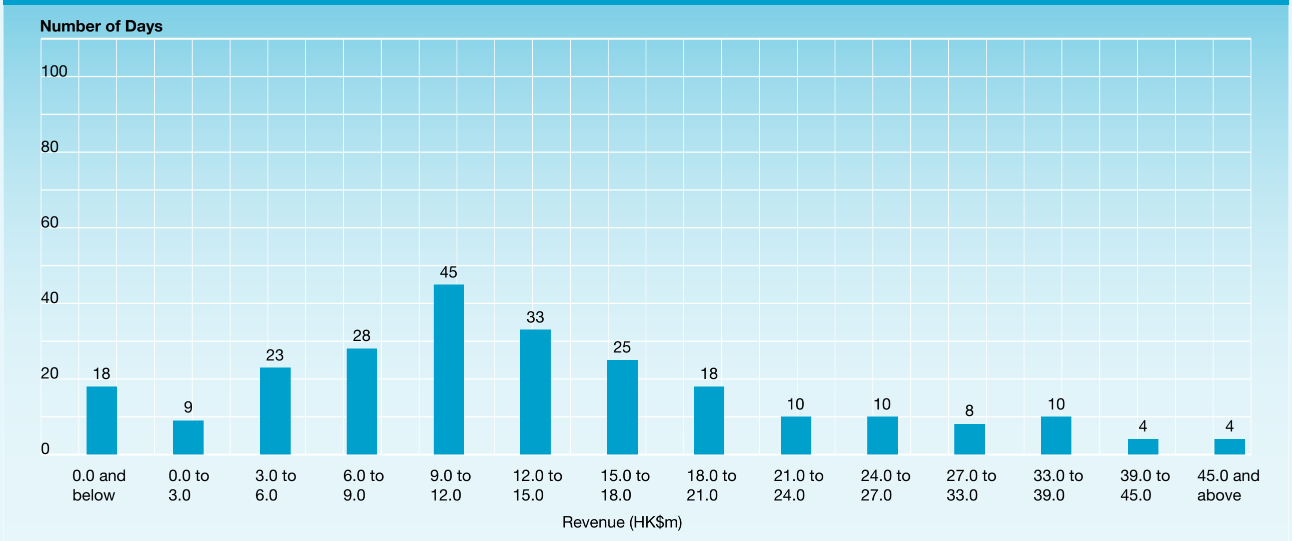
The average daily revenue earned from market risk-related treasury activities in 2009, including non-trading book net interest income and funding related to trading positions, was HK$12 million (2008: HK$14 million). The standard deviation of these daily revenues was HK$10 million, compared with HK$11 million for 2008.

An analysis of the frequency distribution of daily revenue shows that out of 249 trading days in 2009, losses were recorded on 15 days (2008: 18 days) and the maximum daily loss was HK$24 million (2008: HK$25 million). The most frequent result was a daily revenue of between HK$3 million and HK$15 million, with 160 occurrences (2008: 129 occurrences). The highest daily revenue was HK$62 million (2008: HK$52 million).

Daily Distribution of Market Risk Revenues for 2009



Daily Distribution of Market Risk Revenues for 2008



62. FINANCIAL RISK MANAGEMENT (continued)

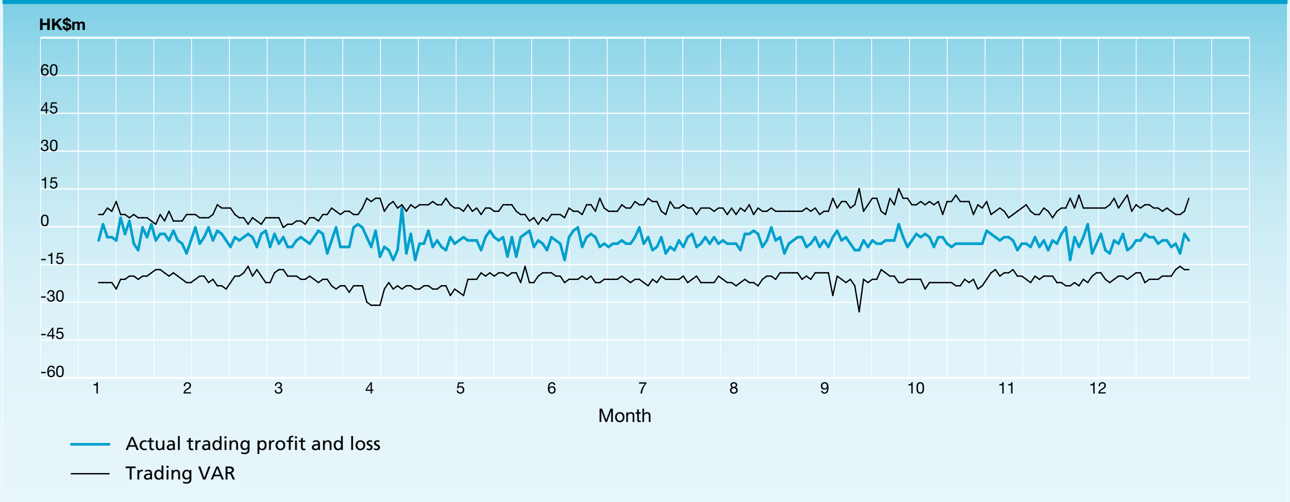
(c) Market risk (continued)

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

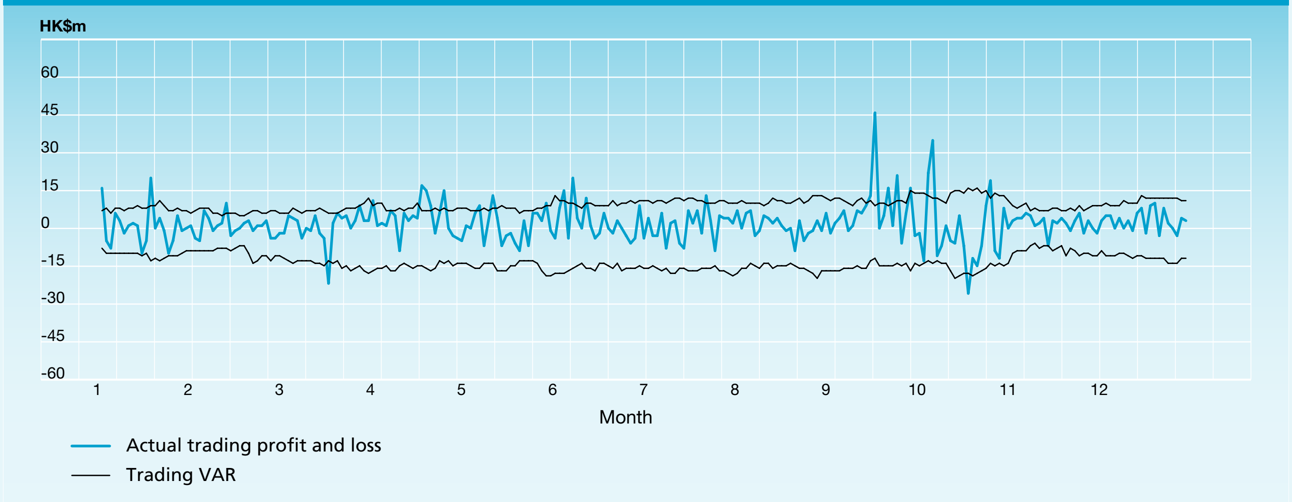
The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2009 and 2008 are shown in the table below. The exceptions of the back-testing mainly resulted from unanticipated market movement.

A Comparison of Trading VAR with Actual Trading Profit and Loss for 2009



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



62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Interest rate exposure

Interest rate risks comprise those originating from treasury activities, both trading and non-trading portfolios which include structural interest rate exposures. Treasury manages interest rate risks within the limits approved by the Risk Management Committee and under the monitoring of both ALCO and Risk Management Committee.

Trading

The Group's control of market risk is based on restricting individual operations to trading within VAR and underlying sensitivity limits including foreign exchange position limits, present value of a basis point ("PVBP") limits and option trading limits, and a list of permissible instruments authorised by the Risk Management Committee, and enforcing rigorous new product approval procedures. In particular, trading in the derivative products is supported by robust control systems whereas more complicated derivatives are mainly traded on back-to-back basis. Analysis of VAR for trading portfolio is disclosed in "Value at Risk" section.

Non-trading

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Structural interest rate risk arises from the differing repricing characteristics of commercial banking assets and liabilities, including non-interest bearing liabilities, such as shareholders' funds and some current accounts.

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

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

Net interest income

A principal part of the Group's management of interest rate risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

The table below sets out the impact on future net interest income of a 100 basis points parallel fall or rise in all-in yield curves at the beginning of year from 1 January 2010 and 25 basis points parallel fall or rise in all-in yield curves at the beginning of each quarter during the 12 month period from 1 January 2010.

Assuming no management actions, such a series of incremental parallel rises in all-in yield curves would increase planned net interest income for the year to 31 December 2010 by HK$2,186 million for 100 basis points case and by HK$1,188 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK$2,160 million for 100 basis points case and by HK$1,254 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and takes into account the change in pricing of retail products relative to change in market interest rates.

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Projected Net Interest Income

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

	100bp parallel increase	100bp parallel decrease	25bp increase at the beginning of each quarter	25bp decrease at the beginning of each quarter
Change in 2010 projected net interest income				
– HKD	**1,737**	**(1,949)**	**993**	**(1,426)**
– USD	**214**	**(95)**	**72**	**143**
– other	**235**	**(116)**	**123**	**29**
Total	**2,186**	**(2,160)**	**1,188**	**(1,254)**
Change in 2009 projected net interest income				
– HKD	147	(1,012)	2	(677)
– USD	276	(58)	138	39
– other	110	(111)	30	(30)
Total	533	(1,181)	170	(668)

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. The figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Group's current interest rate risk profile. This effect, however, does not incorporate actions that would be taken by Treasury or in the business units to mitigate the impact of this interest rate risk. In reality, Treasury seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections also make other simplifying assumptions, including that all positions run to maturity.

It can be seen from the above that projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. In a rising rate environment, the most critical exposures are those managed within Treasury.

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Sensitivity of reserves

The Group monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all-in yield curves. The table below describes the sensitivity to these movements at the end of the reporting period indicated below and the maximum and minimum month figures during the year then ended:

	At 31 December 2009	**Maximum impact**	**Minimum impact**
+ 100 basis points parallel move in all-in yield curves	**(975)**	**(996)**	**(729)**
As a percentage of shareholders' funds at 31 December 2009 (%)	**(1.7)**	**(1.7)**	**(1.3)**
– 100 basis points parallel move in all-in yield curves	**975**	**996**	**729**
As a percentage of shareholders' funds at 31 December 2009 (%)	**1.7**	**1.7**	**1.3**

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Foreign exchange exposure

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

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

	Group			
	USD	RMB	Other foreign currencies	Total foreign currencies
2009				
Non-structural position				
Spot assets	**214,379**	**41,638**	**143,592**	**399,609**
Spot liabilities	**(164,511)**	**(41,564)**	**(110,044)**	**(316,119)**
Forward purchases	**169,349**	**29,483**	**42,340**	**241,172**
Forward sales	**(219,453)**	**(29,603)**	**(76,020)**	**(325,076)**
Net options position	**(4)**	**–**	**7**	**3**
Net short non-structural position	**(240)**	**(46)**	**(125)**	**(411)**
Structural position	**285**	**14,550**	**287**	**15,122**
2008				
Non-structural position				
Spot assets	240,624	37,665	154,872	433,161
Spot liabilities	(200,971)	(37,568)	(89,134)	(327,673)
Forward purchases	269,935	26,549	44,434	340,918
Forward sales	(303,047)	(27,082)	(110,258)	(440,387)
Net options position	(1)	–	2	1
Net long/(short) non-structural position	6,540	(436)	(84)	6,020
Structural position	285	13,343	202	13,830

62. FINANCIAL RISK MANAGEMENT (continued)

(c) Market risk (continued)

Foreign exchange exposure (continued)

	Bank			
	USD	RMB	Other foreign currencies	Total foreign currencies
2009				
Non-structural position				
Spot assets	**178,264**	**13,820**	**105,554**	**297,638**
Spot liabilities	**(130,310)**	**(12,730)**	**(71,643)**	**(214,683)**
Forward purchases	**165,452**	**27,274**	**41,750**	**234,476**
Forward sales	**(215,240)**	**(27,146)**	**(75,789)**	**(318,175)**
Net options position	**(4)**	**–**	**7**	**3**
Net (short)/long non-structural position	**(1,838)**	**1,218**	**(121)**	**(741)**
Structural position	**285**	**14,550**	**287**	**15,122**
2008				
Non-structural position				
Spot assets	202,503	13,718	125,155	341,376
Spot liabilities	(164,750)	(12,320)	(59,144)	(236,214)
Forward purchases	266,721	23,991	43,605	334,317
Forward sales	(300,209)	(23,931)	(109,700)	(433,840)
Net options position	(1)	–	2	1
Net long/(short) non-structural position	4,264	1,458	(82)	5,640
Structural position	285	13,343	202	13,830

Equities exposure

The Group's equities exposures in 2009 and 2008 are mainly in long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk

Risk management objectives and policies for management of insurance risk

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

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

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

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

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

Asset/liability management

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

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Statement of financial position of insurance subsidiaries by type of contract

	Life linked contracts[1]	Life non-linked contracts[2]	Non-life insurance[3]	Other assets[4]	Total
2009					
Financial assets:					
– financial assets designated at fair value	**217**	**4,441**	**–**	**616**	**5,274**
– derivatives	**–**	**78**	**–**	**–**	**78**
– financial investments	**–**	**46,791**	**–**	**2,329**	**49,120**
– other financial assets	**130**	**2,340**	**474**	**777**	**3,721**
Total financial assets	**347**	**53,650**	**474**	**3,722**	**58,193**
Reinsurance assets	**–**	**17**	**81**	**23**	**121**
PVIF[5]	**–**	**–**	**–**	**3,466**	**3,466**
Other assets	**–**	**607**	**7**	**713**	**1,327**
Total assets	**347**	**54,274**	**562**	**7,924**	**63,107**
Liabilities under investment contracts designated at fair value	**121**	**332**	**–**	**–**	**453**
Liabilities under insurance contracts	**224**	**53,588**	**428**	**–**	**54,240**
Deferred tax	**–**	**–**	**–**	**533**	**533**
Other liabilities	**–**	**–**	**–**	**225**	**225**
Total liabilities	**345**	**53,920**	**428**	**758**	**55,451**
Shareholders' equity	**–**	**–**	**–**	**7,656**	**7,656**
Total liabilities and shareholders' equity	**345**	**53,920**	**428**	**8,414**	**63,107**
2008					
Financial assets:					
– financial assets designated at fair value	144	6,064	–	757	6,965
– derivatives	–	–	–	–	–
– financial investments	–	34,646	–	1,829	36,475
– other financial assets	136	2,448	491	734	3,809
Total financial assets	280	43,158	491	3,320	47,249
Reinsurance assets	–	16	49	22	87
PVIF[5]	–	–	–	2,707	2,707
Other assets	–	468	8	404	880
Total assets	280	43,642	548	6,453	50,923
Liabilities under investment contracts designated at fair value	85	328	–	–	413
Liabilities under insurance contracts	191	43,214	430	–	43,835
Deferred tax	–	–	–	375	375
Other liabilities	–	–	–	313	313
Total liabilities	276	43,542	430	688	44,936
Shareholders' equity	–	–	–	5,987	5,987
Total liabilities and shareholders' equity	276	43,542	430	6,675	50,923

1 Comprises life linked insurance contracts and linked investment contracts
2 Comprises life non-linked insurance contracts and non-linked investment contracts
3 Comprises non-life insurance contracts
4 Comprises shareholder assets
5 Present value of in-force long-term insurance contracts

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Underwriting strategy

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

Reinsurance strategy

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

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

Nature of risks covered

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

(i) Insurance contracts – non-linked products

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

(ii) Insurance contracts – unit-linked products

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

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

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

(iv) Investment contracts – unit-linked products

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

(v) Non-life insurance contracts

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Concentration of insurance risks

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

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

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

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

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

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

	2009	2008
Accident and health	**108**	115
Fire and other damage	**110**	117
Motor	**23**	27
Liability	**58**	43
Marine, aviation and transport	**19**	24
Other (non-life)	**11**	5
	329	331

Financial risks

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Concentration of insurance risks (continued)

The following table analyses the assets held in the Group's insurance underwriting subsidiaries at 31 December 2009 by type of liability, and provides a view of the exposure to financial risk:

Financial assets held by insurance operations

	Group				
	Life linked contracts	Life non-linked contracts	Non-life insurance	Other assets	Total
2009					
Financial assets designated at fair value:					
– debt securities	**–**	**4,136**	**–**	**616**	**4,752**
– equity securities	**217**	**305**	**–**	**–**	**522**
	217	**4,441**	**–**	**616**	**5,274**
Financial investments					
Held-to-maturity:					
– debt securities	**–**	**46,791**	**–**	**1,878**	**48,669**
	–	**46,791**	**–**	**1,878**	**48,669**
Available-for-sale:					
– debt securities	**–**	**–**	**–**	**445**	**445**
– equity securities	**–**	**–**	**–**	**6**	**6**
	–	**–**	**–**	**451**	**451**
Derivatives	**–**	**78**	**–**	**–**	**78**
Other financial assets	**130**	**2,340**	**474**	**777**	**3,721**
	347	**53,650**	**474**	**3,722**	**58,193**
2008					
Financial assets designated at fair value:					
– debt securities	–	5,847	–	757	6,604
– equity securities	144	217	–	–	361
	144	6,064	–	757	6,965
Financial investments					
Held-to-maturity:					
– debt securities	–	34,646	–	1,559	36,205
	–	34,646	–	1,559	36,205
Available-for-sale:					
– debt securities	–	–	–	266	266
– equity securities	–	–	–	4	4
	–	–	–	270	270
Derivatives	–	–	–	–	–
Other financial assets	136	2,448	491	734	3,809
	280	43,158	491	3,320	47,249

The table demonstrates that for linked contracts, the Group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 0.6% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2009 (2008: 0.6%). The table also shows that approximately 92.6% of financial assets was invested in debt securities at 31 December 2009 (2008: 91.2%) with 0.9% (2008: 0.8%) invested in equity securities.

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Concentration of insurance risks (continued)

Market risk

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

Interest rate risk

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

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

An immediate and permanent movement in interest yield curves as at 31 December 2009 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	2009		2008	
	Impact on profit for the year	**Impact on net assets**	Impact on profit for the year	Impact on net assets
+ 100 basis points shift in yield curves	**205**	**197**	210	208
– 100 basis points shift in yield curves	**(128)**	**(120)**	(139)	(136)

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

Equity risk

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

	2009		2008	
	Impact on profit for the year	**Impact on net assets**	Impact on profit for the year	Impact on net assets
10 per cent increase in equity prices	**26**	**26**	18	18
10 per cent decrease in equity prices	**(26)**	**(26)**	(18)	(18)

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

Foreign currency risk

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

Credit risk

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2009							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	4,051	85	–	–	–	–	4,136
	4,051	85	–	–	–	–	4,136
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	46,239	552	–	–	–	–	46,791
	46,239	552	–	–	–	–	46,791
Supporting shareholders funds							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	616	–	–	–	–	–	616
	616	–	–	–	–	–	616
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	2,323	–	–	–	–	–	2,323
	2,323	–	–	–	–	–	2,323
Total							
Financial assets designated at fair value:							
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	4,667	85	–	–	–	–	4,752
	4,667	85	–	–	–	–	4,752
Financial investments:							
– treasury and other similar bills	–	–	–	–	–	–	–
– debt securities	48,562	552	–	–	–	–	49,114
	48,562	552	–	–	–	–	49,114

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

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

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong	Medium	Sub-standard	Past due not impaired	Impaired	Impairment allowances	Total
2009							
Linked insurance contracts	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Non-linked insurance contracts	**82**	**16**	**–**	**–**	**–**	**–**	**98**
Total	**82**	**16**	**–**	**–**	**–**	**–**	**98**
Reinsurance Debtors	**7**	**2**	**–**	**13**	**–**	**–**	**22**
2008							
Linked insurance contracts	–	–	–	–	–	–	–
Non-linked insurance contracts	63	2	–	–	–	–	65
Total	63	2	–	–	–	–	65
Reinsurance Debtors	8	1	–	12	–	–	21

Liquidity risk

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

The following table shows the expected maturity of insurance contract liabilities at 31 December 2009 and 31 December 2008:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year	Over 1 year but within 5 years	Over 5 years but within 15 years	Over 15 years	Total
2009					
Non-life insurance	**249**	**160**	**33**	**–**	**442**
Life insurance (non-linked)	**3,985**	**26,231**	**56,760**	**32,549**	**119,525**
Life insurance (linked)	**28**	**183**	**158**	**973**	**1,342**
	4,262	**26,574**	**56,951**	**33,522**	**121,309**
2008					
Non-life insurance	258	147	25	–	430
Life insurance (non-linked)	3,352	21,382	52,519	26,818	104,071
Life insurance (linked)	27	234	332	1,059	1,652
	3,637	21,763	52,876	27,877	106,153

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			
	Linked investment contracts	Non-linked investment contracts	Investment contracts with DPF	Total
2009				
Remaining contractual maturity:				
– due within 1 year	**2**	**–**	**–**	**2**
– due over 1 year but within 5 years	**–**	**–**	**–**	**–**
– due over 5 years but within 10 years	**–**	**–**	**–**	**–**
– due over 10 years	**–**	**–**	**–**	**–**
– undated	**119**	**332**	**–**	**451**
	121	**332**	**–**	**453**
2008				
Remaining contractual maturity:				
– due within 1 year	2	1	–	3
– due over 1 year but within 5 years	–	–	–	–
– due over 5 years but within 10 years	–	–	–	–
– due over 10 years	83	327	–	410
– undated	–	–	–	–
	85	328	–	413

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

The Group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2009 was HK$3,466 million (2008: HK$2,707 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2009 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF as at 31 December 2009 of reasonably possible changes in the main economic and business assumptions:

	2009	2008
+ 100 basis points shift in risk-free rate	**548**	504
– 100 basis points shift in risk-free rate	**(375)**	(331)
+ 100 basis points shift in risk discount rate	**(181)**	(153)
– 100 basis points shift in risk discount rate	**204**	172
+ 100 basis points shift in expenses inflation	**(15)**	(12)
– 100 basis points shift in expenses inflation	**13**	11
+ 100 basis points shift in lapse rate	**853**	793
– 100 basis points shift in lapse rate	**(817)**	(771)

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

62. FINANCIAL RISK MANAGEMENT (continued)

(d) Insurance risk (continued)

Non-economic assumptions

The sensitivity of profit for the year and net assets to reasonably possible changes in assumptions used in respect of insurance businesses at 31 December 2009 is as follows:

	Impact on 2009 results		Impact on 2008 results	
	Profit for the year	**Net assets**	Profit for the year	Net assets
20 per cent increase in claims costs	**(24)**	**(24)**	(26)	(26)
20 per cent decrease in claims costs	**24**	**24**	26	26
10 per cent increase in mortality and/or morbidity rates	**(22)**	**(22)**	(25)	(25)
10 per cent decrease in mortality and/or morbidity rates	**21**	**21**	26	26
50 per cent increase in lapse rates	**535**	**535**	505	505
50 per cent decrease in lapse rates	**(549)**	**(549)**	(516)	(516)
10 per cent increase in expense rates	**(36)**	**(36)**	(33)	(33)
10 per cent decrease in expense rates	**36**	**36**	33	33

(e) Operational risk

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

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

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

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

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

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

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

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

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

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(f) Capital management

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

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

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

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

Externally imposed capital requirements:

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

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

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

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

62. FINANCIAL RISK MANAGEMENT (continued)

(f) Capital management (continued)

For credit risk, with the HKMA approval, the Group has adopted the advanced internal ratings-based approach for the majority of its business with effect from 1 January 2009, with the remainder on standardised approach.

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

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

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

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

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

63. FAIR VALUE OF FINANCIAL INSTRUMENTS

(a) Determination of fair value

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

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

Control framework

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

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

Determination of fair value of financial instruments carried at fair value

Fair value are determined according to the following hierarchy:

(i) Level 1: Quoted market price
Financial instruments with quoted prices for identical instruments in active markets.

(ii) Level 2: Valuation technique using observable inputs
Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(iii) Level 3: Valuation technique with significant non-observable inputs
Financial instruments valued using models where one or more significant inputs are not observable.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

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

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

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

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

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

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

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

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

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

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

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

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

– Debt securities, Treasury and eligible bills, and Equities

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

– Derivatives

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

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

– Private equity

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

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

Analysis of fair value determination

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

	Group					
	Valuation techniques					
	quoted market price	using observable inputs	with significant non-observable inputs	Third party total	Amounts with HSBC entities	Total
2009						
Assets						
Trading assets	**64,476**	**2,121**	**–**	**66,597**	**–**	**66,597**
Financial assets designated at fair value	**216**	**1,192**	**696**	**2,104**	**3,346**	**5,450**
Derivative financial instruments	**511**	**4,156**	**–**	**4,667**	**383**	**5,050**
Available-for-sale financial investments	**59,809**	**132,490**	**448**	**192,747**	**86**	**192,833**
Liabilities						
Trading liabilities	**12,932**	**24,703**	**756**	**38,391**	**–**	**38,391**
Financial liabilities designated at fair value	**–**	**1,456**	**–**	**1,456**	**–**	**1,456**
Derivative financial instruments	**92**	**2,845**	**–**	**2,937**	**1,314**	**4,251**
2008						
Assets						
Trading assets	3,369	105,020	–	108,389	–	108,389
Financial assets designated at fair value	782	3,254	217	4,253	3,545	7,798
Derivative financial instruments	449	6,020	–	6,469	635	7,104
Available-for-sale financial investments	2,796	141,953	137	144,886	68	144,954
Liabilities						
Trading liabilities	3,563	42,381	2,338	48,282	–	48,282
Financial liabilities designated at fair value	–	1,407	–	1,407	–	1,407
Derivative financial instruments	35	7,485	–	7,520	7,425	14,945

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

	Bank					
	Valuation techniques					
	quoted market price	using observable inputs	with significant non-observable inputs	Third party total	Amounts with HSBC entities	Total
2009						
Assets						
Trading assets	**64,476**	**812**	**–**	**65,288**	**–**	**65,288**
Financial assets designated at fair value	**–**	**174**	**–**	**174**	**–**	**174**
Derivative financial instruments	**510**	**4,115**	**–**	**4,625**	**291**	**4,916**
Available-for-sale financial investments	**55,360**	**101,236**	**33**	**156,629**	**86**	**156,715**
Liabilities						
Trading liabilities	**12,932**	**21,537**	**602**	**35,071**	**–**	**35,071**
Financial liabilities designated at fair value	**–**	**1,003**	**–**	**1,003**	**–**	**1,003**
Derivative financial instruments	**92**	**2,765**	**–**	**2,857**	**1,323**	**4,180**
2008						
Assets						
Trading assets	3,369	104,406	–	107,775	–	107,775
Financial assets designated at fair value	306	524	–	830	–	830
Derivative financial instruments	447	5,776	–	6,223	687	6,910
Available-for-sale financial investments	2,762	109,136	34	111,932	68	112,000
Liabilities						
Trading liabilities	3,563	37,566	2,338	43,467	–	43,467
Financial liabilities designated at fair value	–	994	–	994	–	994
Derivative financial instruments	33	7,417	–	7,450	7,488	14,938

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	Group						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2009	**137**	**–**	**217**	**–**	**2,338**	**–**	**–**
Total gains or losses recognised in profit and loss	**(3)**	**–**	**14**	**–**	**310**	**–**	**–**
Total gains or losses recognised in other comprehensive income	**1**	**–**	**–**	**–**	**–**	**–**	**–**
Purchases	**1**	**–**	**56**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**951**	**–**	**–**
Sales	**(5)**	**–**	**(9)**	**–**	**–**	**–**	**–**
Settlements	**–**	**–**	**–**	**–**	**(1,629)**	**–**	**–**
Transfers out	**–**	**–**	**–**	**–**	**(1,211)**	**–**	**–**
Transfers in	**317**	**–**	**418**	**–**	**–**	**–**	**–**
Exchange adjustments	**–**	**–**	**–**	**–**	**(3)**	**–**	**–**
At 31 December 2009	**448**	**–**	**696**	**–**	**756**	**–**	**–**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	**10**	**–**	**14**	**–**	**326**	**–**	**–**

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

	Bank						
	Assets				Liabilities		
	Available-for-sale	Held for trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
At 1 January 2009	34	–	–	–	2,338	–	–
Total gains or losses recognised in profit and loss	–	–	–	–	309	–	–
Total gains or losses recognised in other comprehensive income	(1)	–	–	–	–	–	–
Purchases	–	–	–	–	–	–	–
Issues	–	–	–	–	798	–	–
Sales	–	–	–	–	–	–	–
Settlements	–	–	–	–	(1,629)	–	–
Transfers out	–	–	–	–	(1,211)	–	–
Transfers in	–	–	–	–	–	–	–
Exchange adjustments	–	–	–	–	(3)	–	–
At 31 December 2009	33	–	–	–	602	–	–
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	5	–	–	–	325	–	–

For available-for-sale securities and financial assets designated at fair value, the transfers into Level 3 were due to valuations of certain debt securities becoming unobservable during the year.

For held-for-trading liabilities, transfers out of Level 3 were primarily due to an increase in the observability of equity correlation.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under “Trading income”.

The income statement line item “Net income/(expense) from financial instruments designated at fair value” captures fair value movements on all other financial instruments designated at fair value and related derivatives (including long-term subordinated notes issued).

Realised gains and losses from available-for-sale securities are presented under “Gains less losses from financial investments and fixed assets” in the income statement while unrealised gains and losses are presented in “Fair value changes taken to/(from) equity” within “Available-for-sale investment reserve” in other comprehensive income.

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

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

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

	Group			
	Reflected in profit/(loss)		Reflected in equity	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
2009				
Derivatives/trading assets/trading liabilities	**–**	**–**	**–**	**–**
Financial assets/liabilities designated at fair value	**70**	**(70)**	**–**	**–**
Available-for-sale financial investments	**–**	**–**	**45**	**(45)**
2008				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	22	(22)	–	–
Available-for-sale financial investments	–	–	14	(14)

	Bank			
	Reflected in profit/(loss)		Reflected in equity	
	favourable changes	unfavourable changes	favourable changes	unfavourable changes
2009				
Derivatives/trading assets/trading liabilities	**–**	**–**	**–**	**–**
Financial assets/liabilities designated at fair value	**–**	**–**	**–**	**–**
Available-for-sale financial investments	**–**	**–**	**3**	**(3)**
2008				
Derivatives/trading assets/trading liabilities	–	–	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Available-for-sale financial investments	–	–	3	(3)

Changes in fair value recorded in the income statement

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

– the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component;

– instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges.

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

	Group		Bank	
	2009	2008	**2009**	2008
Recorded profit/(loss):				
Derivatives/trading assets/trading liabilities	**310**	24	**309**	24
Financial assets/liabilities designated at fair value	**14**	(42)	**–**	–

Fair value of financial instruments not carried at fair value

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

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

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

(i) Loans and advances to customers

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

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

(ii) Financial investments

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

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(a) Determination of fair value (continued)

(iii) Deposits and customer accounts

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

(iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the date of statement of financial position where available, or by reference to quoted market prices for similar instruments.

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

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

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

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

Assets

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

Liabilities

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

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

63. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

(b) Fair value

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

	Group			
	2009		2008	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	**104,551**	**104,551**	69,579	69,635
Advances to customers	**344,621**	**346,459**	329,121	320,651
Held-to-maturity debt securities	**48,669**	**49,805**	36,205	39,315
Financial Liabilities				
Current, savings and other deposit accounts	**636,369**	**636,435**	562,183	562,257
Deposits from banks	**4,870**	**4,870**	11,556	11,556
Certificates of deposit and other debt securities in issue	**1,826**	**1,859**	2,772	2,838
Subordinated liabilities	**9,320**	**9,041**	9,309	7,849

	Bank			
	2009		2008	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial Assets				
Placings with and advances to banks and other financial institutions	**65,624**	**65,624**	38,097	38,154
Advances to customers	**299,179**	**301,054**	280,255	271,787
Financial Liabilities				
Current, savings and other deposit accounts	**612,014**	**612,080**	547,385	547,459
Deposits from banks	**4,469**	**4,469**	8,263	8,263
Certificates of deposit and other debt securities in issue	**1,826**	**1,859**	2,772	2,838
Subordinated liabilities	**9,320**	**9,041**	9,309	7,849

64. COMPARATIVE FIGURES

As a result of the application of HKAS 1 (revised 2007), Presentation of financial statements, certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2009. Further details of these developments are disclosed in note 5.

65. IMMEDIATE AND ULTIMATE HOLDING COMPANIES

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

66. APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 1 March 2010.