## 1. BASIS OF PREPARATION

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

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

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

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

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

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

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

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

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

## 2. NATURE OF BUSINESS

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

## 3. BASIS OF CONSOLIDATION

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

## 4. PRINCIPAL ACCOUNTING POLICIES

### (a) Interest income and expense

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

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

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

### (b) Non-interest income

#### (i) Fee income

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

- if the income is earned on the execution of a significant act, it is recognised as revenue when the significant act has been completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- if the income is earned as services are provided, it is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- if the income is an integral part of the effective interest rate of a financial instrument, it is recognised as an adjustment to the effective interest rate (for example, loan commitment fees) and reported in "Interest income" (see note 4(a)).

#### (ii) Rental income from operating lease

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

#### (iii) Dividend income

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (b) Non-interest income (continued)

#### (iv) Trading income

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

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

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

### (c) Segment reporting

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

### (d) Cash and cash equivalents

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

### (e) Loans and advances to banks and customers

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

### (f) Loan impairment

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

#### (i) Individually assessed loans

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (f) Loan impairment (continued)

#### (i) Individually assessed loans (continued)

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

– the Group's aggregate exposure to the borrower;

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

– the amount and timing of expected receipts and recoveries;

– the likely dividend available on liquidation or bankruptcy;

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

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

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

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

– the ability of the borrower to obtain and make payments in the relevant foreign currency if loans are not in local currency; and

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

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

#### (ii) Collectively assessed loans

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

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

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

*Incurred but not yet identified impairment*

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

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

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

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

*Homogeneous groups of loans*

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (f) Loan impairment (continued)

#### (iii) Loan write-offs

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

#### (iv) Reversals of impairment

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

#### (v) Repossessed assets

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

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

#### (vi) Renegotiated loans

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

### (g) Financial instruments

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

#### (i) Trading assets and trading liabilities

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (g) Financial instruments (continued)

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

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

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

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

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

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

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

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (g) Financial instruments (continued)

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

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

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

#### (iv) Held-to-maturity investments

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

### (h) Derivative financial instruments

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

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

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

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

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

### (i) Hedge accounting

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (i) Hedge accounting (continued)

#### (i) Fair value hedge

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

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

#### (ii) Cash flow hedge

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

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

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

#### (iii) Hedge effectiveness testing

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

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

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

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

#### (iv) Derivatives that do not qualify for hedge accounting

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

### (j) Sale and repurchase agreements

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (k) Offsetting financial instruments

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

### (l) Application of trade date accounting

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

### (m) Derecognition of financial assets and liabilities

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

### (n) Determination of fair value

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

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

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

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

### (o) Subsidiaries

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (p) Associates

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

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

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

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

### (q) Goodwill and intangible assets

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

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (r) Investment property

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

### (s) Premises, plant and equipment

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

– leasehold land and buildings where the fair value of the land cannot be reliably separated from the value of the building at inception of the lease and the premises are not clearly held under an operating lease; and

– leasehold land and buildings where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years.

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

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

– freehold land is not depreciated;

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

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

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

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

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

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

### (u) Finance and operating leases

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

#### (i) Finance leases

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

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

#### (ii) Operating leases

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

### (v) Impairment of assets

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

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

#### (i) Held-to-maturity investments

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (v) Impairment of assets (continued)

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

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

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

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

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

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

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

#### (iii) Other assets

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

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

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

- investments in subsidiaries and associates; and

- intangible assets.

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (v) Impairment of assets (continued)

#### (iii) Other assets (continued)

*Calculation of recoverable amount*

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

*Recognition of impairment losses*

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

*Reversals of impairment losses*

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

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

### (w) Income tax

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

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

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

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (x) Employee benefits

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

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

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

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

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

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

### (y) Share-based payments

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

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (z) Translation of foreign currencies

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

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

### (aa) Provisions

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

### (ab) Financial guarantees

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

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

### (ac) Insurance contracts

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

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

Insurance contracts are accounted for as follows:

*Net earned insurance premiums*

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

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

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (ac) Insurance contracts (continued)

*Claims and reinsurance recoveries*

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

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

*Deferred acquisition costs*

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

*Value of long-term insurance business*

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

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

### (ad) Investment contracts

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

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

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

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

### (ae) Debt securities in issue and subordinated liabilities

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

### (af) Assets held for sale

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

## 4. PRINCIPAL ACCOUNTING POLICIES (continued)

### (ag) Related parties

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

### (ah) Dividends

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

## 5. CHANGES IN ACCOUNTING POLICIES

The Group adopted a number of HKFRSs or amendments to HKFRSs which had an insignificant or no effect on the consolidated financial statements. These are:

- Amendment to HKFRS 3 "Business Combinations" and HKAS 27 "Consolidated and Separate Financial Statements".
- Amendment to HKAS 39 "Financial Instruments: Recognition and Measurement" – "Eligible Hedged Items";
- Amendments to HKFRS 2 "Share-based Payment" – "Group Cash-settled Share-based Payment Transactions";
- Hong Kong (IFRIC) Interpretation 17 "Distributions of Non-cash Assets to Owners";
- HKFRS 1 (Revised) "First-time Adoption of Hong Kong Financial Reporting Standards";
- Amendments to HKFRS 1 "First-time Adoption of Hong Kong Financial Reporting Standards" – "Additional Exemptions for First-time Adopters";
- Amendment to HKFRS 1 "First-time Adoption of Hong Kong Financial Reporting Standards" – "Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters";
- Hong Kong (IFRIC) Interpretation 18 "Transfer of Assets from Customers"; and
- Other amendments made under "Improvements to HKFRSs" in May 2009, except the amendment to leases as discussed below.

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

Hong Kong Accounting Standard 17, "Leases" (HKAS 17) has been amended with effect from 1 January 2010 ("the amendment") as part of the "Improvements to HKFRS" issued in May 2009. Since 2005, and prior to the amendment, a number of significant interests in long-term leasehold land owned by the Group have been recorded as operating leases, measured at historical cost less amortisation in the balance sheet. Following the application of the amendment in 2010, such interests are reclassified as finance leases, included within "Premises, plant and equipment" in the balance sheet and carried at valuation (as discussed in note 4(s)). The amendment has been applied retrospectively and the corresponding prior-year comparatives have been adjusted accordingly.

## 5. CHANGES IN ACCOUNTING POLICIES (continued)

The following primary statement lines have been impacted by the adoption of HKAS 17:

### (i) For the Group

| *Figures in HK$m* | As reported | Adjustment | Restated |
|---|---|---|---|
| Year ended 31 December 2009 | | | |
| Profit for the year | 13,221 | (83) | 13,138 |
| Total comprehensive income | 18,608 | 582 | 19,190 |
| Earnings per share (HK$) | 6.92 | (0.05) | 6.87 |
| As at 31 December 2009 | | | |
| Premises, plant and equipment | 7,178 | 5,236 | 12,414 |
| Interest in leasehold land held for own use under operating lease | 536 | (536) | – |
| Deferred tax liabilities | 1,684 | 776 | 2,460 |
| Other reserves | 7,313 | 3,891 | 11,204 |
| Retained profits | 37,719 | 33 | 37,752 |
| As at 31 December 2008 | | | |
| Premises, plant and equipment | 7,090 | 4,553 | 11,643 |
| Interest in leasehold land held for own use under operating lease | 551 | (551) | – |
| Deferred tax assets | 201 | (175) | 26 |
| Deferred tax liabilities | 711 | 485 | 1,196 |
| Other reserves | 3,813 | 3,336 | 7,149 |
| Retained profits | 32,518 | 6 | 32,524 |

### (ii) For the Bank

| *Figures in HK$m* | As reported | Adjustment | Restated |
|---|---|---|---|
| As at 31 December 2009 | | | |
| Premises, plant and equipment | 4,198 | 5,236 | 9,434 |
| Interest in leasehold land held for own use under operating lease | 536 | (536) | – |
| Deferred tax liabilities | 569 | 776 | 1,345 |
| Other reserves | 3,293 | 3,891 | 7,184 |
| Retained profits | 17,861 | 33 | 17,894 |
| As at 31 December 2008 | | | |
| Premises, plant and equipment | 4,294 | 4,553 | 8,847 |
| Interest in leasehold land held for own use under operating lease | 551 | (551) | – |
| Deferred tax assets | 187 | (175) | 12 |
| Deferred tax liabilities | – | 485 | 485 |
| Other reserves | 1,195 | 3,336 | 4,531 |
| Retained profits | 15,563 | 6 | 15,569 |

## 6. ACCOUNTING ESTIMATES AND JUDGEMENTS

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

### (a) Key sources of estimation uncertainty

#### (i) Impairment allowances on loans and advances

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

#### (ii) Valuation of financial instruments

The Group's accounting policy for valuation of financial instruments is included in note 4(n) and is discussed further within note 62 "Fair value of financial instruments".

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

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

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

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

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

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

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

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

## 6. ACCOUNTING ESTIMATES AND JUDGEMENTS (continued)

### (a) Key sources of estimation uncertainty (continued)

#### (iii) Insurance contracts

*Classification*

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

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

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in note 41(a). The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

*Insurance liabilities*

The estimation of insurance claims liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in note 61(d).

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

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

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

#### (ii) Held-to-maturity investments

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

#### (iii) Income taxes

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

## 7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2010

The HKICPA has issued a number of amendments to HKFRSs and Interpretations which are not yet effective for the year ended 31 December 2010 and which have not been adopted in these financial statements.

HKFRS 9 "Financial Instruments" ("HKFRS 9") was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. In November 2010, the HKICPA issued additions to HKFRS 9 dealing with financial liabilities. The main changes to the requirements of HKAS 39 are summarised below.

– All financial assets are classified into two measurement categories: amortised cost or fair value. These two categories replace the four categories under the current HKAS 39 "Financial Instruments: Recognition and Measurement".

– Financial assets are classified on the basis of both an entity's business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets.

## 7. POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

– Financial assets are measured at fair value through profit or loss, if they do not meet the criteria specified for measurement at amortised cost or if doing so significantly reduces or eliminates an accounting mismatch. An entity has the option to designate all subsequent changes in fair value of an equity instrument not held for trading at fair value through other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.

– Financial assets which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under HKFRS 9.

– HKFRS 9 retains all the existing requirements for derecognition of financial instruments and most of the requirements for financial liabilities, except that for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts, fair value changes attributable to changes in own credit risk are to be presented in the statement of other comprehensive income, and are not subsequently reclassified to income statement but may be transferred within equity.

HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2013 with earlier application permitted. It is required to be applied retrospectively, but if adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. The Group is presently studying the implications of applying HKFRS 9. It is impracticable to quantify the impact of HKFRS 9 as at the date of publication of these financial statements.

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

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

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

The HKICPA issued "Improvements to HKFRSs" in May 2010, which comprises a collection of necessary, but not urgent, amendments to HKFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2011, with earlier application permitted. The Group does not expect adoption of these amendments to have a significant effect on the consolidated financial statements.

The HKICPA issued an amendment to HKFRS 7 "Financial Instruments: Disclosures" in October 2010 which requires additional disclosures for risk exposures arising from transferred financial assets. The amendment will be effective for annual periods beginning on or after 1 July 2011, with earlier application permitted. No disclosures are required for prior periods. The Group is presently studying the implications of applying this amendment to HKFRS 7.

The HKICPA issued an amendment to HKAS 12 "Income Taxes" in December 2010 whereby deferred taxes on an investment property, carried under the fair value model in IAS 40, will be measured presuming that an investment property is recovered entirely through sale. The presumption is rebutted if the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The amendments will be effective for annual periods beginning on or after 1 January 2012 with earlier application permitted.

## 8. INTEREST INCOME/INTEREST EXPENSE

### (a) Interest income

| | 2010 | 2009 |
|---|---|---|
| Interest income arising from: | | |
| – financial assets that are not at fair value through profit or loss | **16,228** | 15,950 |
| – trading assets | **197** | 320 |
| – financial assets designated at fair value | **82** | 120 |
| | **16,507** | 16,390 |
| of which: | | |
| – interest income from listed investments | **1,436** | 1,801 |
| – interest income from unlisted investments | **3,072** | 3,569 |
| – interest income from impaired financial assets | **48** | 46 |

### (b) Interest expense

| | 2010 | 2009 |
|---|---|---|
| Interest expense arising from: | | |
| – financial liabilities that are not at fair value through profit or loss | **1,769** | 1,799 |
| – trading liabilities | **435** | 554 |
| – financial liabilities designated at fair value | **3** | 14 |
| | **2,207** | 2,367 |
| of which: | | |
| – interest expense from debt securities in issue maturing after five years | **–** | – |
| – interest expense from customer accounts maturing after five years | **–** | – |
| – interest expense from subordinated liabilities | **63** | 126 |

## 9. NET FEE INCOME

| | 2010 | 2009 |
|---|---|---|
| – stockbroking and related services | **1,468** | 1,566 |
| – retail investment funds | **1,039** | 604 |
| – structured investment products | **19** | 28 |
| – insurance agency | **256** | 190 |
| – account services | **349** | 291 |
| – private banking service fee | **160** | 129 |
| – remittances | **259** | 217 |
| – cards | **1,462** | 1,413 |
| – credit facilities | **195** | 135 |
| – trade services | **452** | 379 |
| – other | **236** | 238 |
| Fee income | **5,895** | 5,190 |
| Fee expense | **(998)** | (869) |
| | **4,897** | 4,321 |
| of which: | | |
| Net fee income, other than amounts included in determining the effective interest rate, arising from financial assets or financial liabilities that are not held for trading nor designated at fair value | **1,810** | 1,658 |
| – fee income | **2,452** | 2,217 |
| – fee expense | **(642)** | (559) |
| Net fee income on trust and other fiduciary activities where the Group holds or invests on behalf of its customers | **773** | 383 |
| – fee income | **973** | 557 |
| – fee expense | **(200)** | (174) |

## 10. TRADING INCOME

| | 2010 | 2009 |
|---|---|---|
| Foreign exchange | **1,768** | 1,792 |
| (Losses)/gains from hedging activities: | | |
| – fair value hedge | | |
| – on hedging instruments | **(261)** | 74 |
| – on the hedged items attributable to the hedged risk | **272** | (81) |
| – cash flow hedge | | |
| – net hedging income | **–** | 16 |
| Securities, derivatives and other trading activities | **280** | 122 |
| | **2,059** | 1,923 |

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

| | **2010** | 2009 |
|---|---|---|
| Net income/(loss) on assets designated at fair value which back insurance and investment contracts | **297** | (54) |
| Net change in fair value of other financial instruments designated at fair value | **(15)** | (21) |
| | **282** | (75) |
| of which dividend income from: | | |
| – listed investments | **3** | 1 |
| – unlisted investments | **1** | 1 |
| | **4** | 2 |

## 12. DIVIDEND INCOME

| | **2010** | 2009 |
|---|---|---|
| Dividend income: | | |
| – listed investments | **2** | 3 |
| – unlisted investments | **12** | 13 |
| | **14** | 16 |

## 13. NET EARNED INSURANCE PREMIUMS

| | **Non-life insurance** | **Life insurance (non-linked)** | **Life insurance (linked)** | **Total** |
|---|---|---|---|---|
| **2010** | | | | |
| Gross written premiums | **470** | **11,031** | **11** | **11,512** |
| Movement in unearned premiums | **(33)** | **–** | **–** | **(33)** |
| Gross earned premiums | **437** | **11,031** | **11** | **11,479** |
| Gross written premiums ceded to reinsurers | **(122)** | **(76)** | **–** | **(198)** |
| Reinsurers' share of movement in unearned premiums | **26** | **–** | **–** | **26** |
| Reinsurers' share of gross earned premiums | **(96)** | **(76)** | **–** | **(172)** |
| Net earned insurance premiums | **341** | **10,955** | **11** | **11,307** |
| 2009 | | | | |
| Gross written premiums | 422 | 11,237 | 15 | 11,674 |
| Movement in unearned premiums | (18) | – | – | (18) |
| Gross earned premiums | 404 | 11,237 | 15 | 11,656 |
| Gross written premiums ceded to reinsurers | (93) | (59) | – | (152) |
| Reinsurers' share of movement in unearned premiums | 15 | – | – | 15 |
| Reinsurers' share of gross earned premiums | (78) | (59) | – | (137) |
| Net earned insurance premiums | 326 | 11,178 | 15 | 11,519 |

## 14. OTHER OPERATING INCOME

| | 2010 | 2009 |
|---|---|---|
| Rental income from investment properties | 155 | 149 |
| Movement in present value of in-force long-term insurance business | 1,126 | 760 |
| Other | 277 | 180 |
| | 1,558 | 1,089 |

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

| | Non-life insurance | Life insurance (non-linked) | Life insurance (linked) | Total |
|---|---|---|---|---|
| **2010** | | | | |
| Claims, benefits and surrenders paid | 113 | 2,402 | 24 | 2,539 |
| Movement in provisions | 21 | 10,085 | 4 | 10,110 |
| Gross claims incurred and movement in policyholders' liabilities | 134 | 12,487 | 28 | 12,649 |
| Reinsurers' share of claims, benefits and surrenders paid | (26) | (22) | – | (48) |
| Reinsurers' share of movement in provisions | – | (14) | – | (14) |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | (26) | (36) | – | (62) |
| Net insurance claims incurred and movement in policyholders' liabilities | 108 | 12,451 | 28 | 12,587 |
| 2009 | | | | |
| Claims, benefits and surrenders paid | 119 | 1,811 | 19 | 1,949 |
| Movement in provisions | (16) | 10,066 | 35 | 10,085 |
| Gross claims incurred and movement in policyholders' liabilities | 103 | 11,877 | 54 | 12,034 |
| Reinsurers' share of claims, benefits and surrenders paid | (10) | (18) | – | (28) |
| Reinsurers' share of movement in provisions | (1) | (1) | – | (2) |
| Reinsurers' share of claims incurred and movement in policyholders' liabilities | (11) | (19) | – | (30) |
| Net insurance claims incurred and movement in policyholders' liabilities | 92 | 11,858 | 54 | 12,004 |

## 16. LOAN IMPAIRMENT CHARGES AND OTHER CREDIT RISK PROVISIONS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Loan impairment charges (note 35(b)): | | | | |
| – individually assessed | **(186)** | (310) | **(97)** | (285) |
| – collectively assessed | **(204)** | (502) | **(185)** | (503) |
| | **(390)** | (812) | **(282)** | (788) |
| of which: | | | | |
| – new and additional | **(609)** | (1,104) | **(475)** | (1,028) |
| – releases | **157** | 230 | **142** | 194 |
| – recoveries | **62** | 62 | **51** | 46 |
| | **(390)** | (812) | **(282)** | (788) |
| Other credit risk provisions | **–** | – | **–** | – |
| | **(390)** | (812) | **(282)** | (788) |

There was no impairment charge (2009: Nil) provided for available-for-sale debt securities by the Group and the Bank. There was also no impairment loss made in relation to held-to-maturity investments in 2010 (2009: Nil).

## 17. OPERATING EXPENSES

| | **2010** | 2009 (restated) |
|---|---|---|
| Employee compensation and benefits: | | |
| – salaries and other costs* | **3,448** | 3,091 |
| – retirement benefit costs | | |
| – defined benefit scheme (note 58(a)) | **191** | 213 |
| – defined contribution scheme (note 58(b)) | **78** | 74 |
| | **3,717** | 3,378 |
| General and administrative expenses: | | |
| – rental expenses | **464** | 430 |
| – other premises and equipment | **902** | 900 |
| – marketing and advertising expenses | **470** | 382 |
| – other operating expenses | **1,081** | 1,021 |
| | **2,917** | 2,733 |
| Depreciation of business premises and equipment (note 40(a)) | **619** | 591 |
| Amortisation of intangible assets (note 41(c)) | **102** | 84 |
| | **7,355** | 6,786 |
| * of which: | | |
| share based payments (note 59(e)) | **100** | 101 |
| Cost efficiency ratio | **33.7%** | 32.6% |

Included in operating expenses are minimum lease payments under operating leases of HK$493 million (2009: HK$461 million).

## 18. THE EMOLUMENTS OF THE FIVE HIGHEST PAID INDIVIDUALS

### (a) The aggregate emoluments

| | **2010** | 2009 |
|---|---|---|
| Salaries, allowances and benefits in kind | **20** | 17 |
| Retirement scheme contributions | **2** | 2 |
| Discretionary bonuses | **10** | 10 |
| Share-based payments | **7** | 6 |
| | **39** | 35 |

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

| | **2010 Number of Individuals** | 2009 Number of Individuals |
|---|---|---|
| HK$ | | |
| 4,000,001 – 4,500,000 | **1** | – |
| 5,000,001 – 5,500,000 | **1** | 1 |
| 5,500,001 – 6,000,000 | **–** | 1 |
| 6,000,001 – 6,500,000 | **–** | 1 |
| 6,500,001 – 7,000,000 | **2** | 1 |
| 10,500,001 – 11,000,000 | **–** | 1 |
| 16,000,001 – 16,500,000 | **1** | – |
| | **5** | 5 |

The emoluments of the five highest paid individuals set out above include the emoluments of two (2009: three) Executive Directors and one non-executive director (2009: one). Their respective directors' emoluments are included in note 19.

## 19. DIRECTORS' EMOLUMENTS

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

| | Fees '000 | Salaries, allowances and benefits in kind '000 | Pension and Pension contribution[(4)] '000 | Discretionary Bonuses '000 | Share-based payments[(5)] '000 | Total 2010 '000 | Total 2009 '000 |
|---|---|---|---|---|---|---|---|
| **Executive Directors** | | | | | | | |
| Ms Margaret Leung [(1)] (Appointed on 6 May 09) | – | 5,981 | 825 | 5,380 | 4,089 | 16,275 | 4,834 |
| Mr William W C Leung [(2)] (Appointed on 7 Aug 09) | – | 3,538 | 405 | 454 | 807 | 5,204 | 1,874 |
| Mr Raymond C F Or (Resigned on 6 May 09) | – | – | – | – | – | – | 10,700 |
| Mr Joseph C Y Poon (Resigned on 30 Sep 09) | – | – | – | – | – | – | 6,038 |
| Mr Patrick K W Chan (Resigned on 6 May 09) | – | – | – | – | – | – | 2,841 |
| **Non-Executive Directors** | | | | | | | |
| Dr Raymond K F Ch'ien [(3)] | 367 | – | – | – | – | 367 | 360 |
| Mr Edgar D Ancona [(1)] (Resigned on 31 Aug 09) | – | – | – | – | – | – | 187 |
| Mr Iain J Mackay [(1)] (Appointed on 1 Sep 09) | 280 | – | – | – | – | 280 | 93 |
| Ms Dorothy K Y P Sit [(2)] (Appointed on 7 Aug 09) | – | 3,868 | 387 | 1,183 | 1,281 | 6,719 | 2,091 |
| Mr Alexander A Flockhart [(1)] | 280 | – | – | – | – | 280 | 280 |
| Dr John C C Chan [(3)] | 340 | – | – | – | – | 340 | 340 |
| Dr Y T Cheng [(3)] (Resigned on 6 May 09) | – | – | – | – | – | – | 117 |
| Dr Marvin K T Cheung [(3)] | 360 | – | – | – | – | 360 | 360 |
| Mr Jenkin Hui [(3)] | 320 | – | – | – | – | 320 | 320 |
| Mr Peter T C Lee [(3)] (Deceased on 17 Oct 09) | – | – | – | – | – | – | 267 |
| Dr Eric K C Li [(3)] | 400 | – | – | – | – | 400 | 400 |
| Dr Vincent H S Lo | 280 | – | – | – | – | 280 | 280 |
| Dr David W K Sin [(3)] (Resigned on 6 May 09) | – | – | – | – | – | – | 117 |
| Mr Richard Y S Tang [(3)] | 478 | – | – | – | – | 478 | 473 |
| Mr Peter T S Wong [(1)] | 280 | – | – | – | – | 280 | 280 |
| Ms L Y Chiang [(3)] (Appointed on 20 Sep 10) | 93 | – | – | – | – | 93 | – |
| Mr Michael W K Wu [(3)] (Appointed on 20 Sep 10) | 93 | – | – | – | – | 93 | – |
| **Past Directors** | – | – | 2,169 | – | – | 2,169 | 2,169 |
| | 3,571 | 13,387 | 3,786 | 7,017 | 6,177 | 33,938 | 34,421 |
| 2009 | 3,901 | 14,859 | 3,871 | 7,399 | 4,391 | | |

Notes :

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

(2) Fee receivable as a Director of Hang Seng Bank Limited were waived by the Directors in 2010.

(3) Independent Non-Executive Director.

(4) The aggregate amount of pensions received by the past Directors of the Bank under the relevant pension schemes amounted to HK$2.2 million in 2010. The Bank made contributions during 2010 into the pension schemes of which the Bank's past Directors are among their members. The contributions serve to maintain the funding positions of these schemes in respect of liabilities to all scheme members, including but not limited to the past Directors. The amount of contribution attributable to any specific scheme member is not determinable.

(5) These represent the estimated fair value of share option granted to certain directors under the HSBC Group share option plan and the purchase cost of restricted share and performance share under the HSBC Group share plan, which is measured according to the Group's accounting policies for share-based payment as set out in note 4(y). The details of these benefits in kind are also set out in note 59.

## 20. AUDITORS' REMUNERATION

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Statutory audit services | **13** | 13 | **8** | 9 |
| Non-statutory audit services and others | **6** | 6 | **5** | 5 |
| | **19** | 19 | **13** | 14 |

## 21. GAINS LESS LOSSES FROM FINANCIAL INVESTMENTS AND FIXED ASSETS

| | **2010** | 2009 |
|---|---|---|
| Net gains from disposal of available–for–sale equity securities: | | |
| – reclassified from reserve | **9** | 165 |
| – net gains/(losses) arising in the year | **1** | (4) |
| | **10** | 161 |
| Net gains/(losses) from disposal of available-for-sale debt securities | **95** | (152) |
| Impairment of available-for-sale equity securities | **–** | (4) |
| Gains less losses on disposal of assets held for sale | **12** | 187 |
| Gains less losses on disposal of fixed assets | **(5)** | (6) |
| | **112** | 186 |

There was no impairment losses or gains less losses on disposal of held-to-maturity debt securities, loans and receivables and financial liabilities measured at amortised cost for 2010 and 2009.

## 22. NET SURPLUS ON PROPERTY REVALUATION

| | **2010** | 2009 (restated) |
|---|---|---|
| Surplus of revaluation on investment properties (note 39(a)) | **474** | 250 |
| Surplus of revaluation on assets held for sale | **10** | – |
| Reversal of revaluation deficit on premises (note 40(a)) | **3** | 2 |
| | **487** | 252 |

## 23. TAX EXPENSE

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

| | 2010 | 2009 (restated) |
|---|---|---|
| **Current tax – provision for Hong Kong profits tax** | | |
| Tax for the year | **1,967** | 1,844 |
| Adjustment in respect of prior year | **(19)** | (3) |
| | **1,948** | 1,841 |
| **Current tax – taxation outside Hong Kong** | | |
| Tax for the year | **38** | 50 |
| **Deferred tax** (note 49(b)) | | |
| Origination and reversal of temporary differences | **442** | 371 |
| **Total tax expense** | **2,428** | 2,262 |

The current tax provision is based on the estimated assessable profit for 2010, and is determined for the Bank and its subsidiaries operating in the Hong Kong SAR by using the Hong Kong profits tax rate of 16.5 per cent (2009: 16.5 per cent). For subsidiaries and branches operating in other jurisdictions, the appropriate tax rates prevailing in the relevant countries are used. Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised.

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

| | 2010 | 2009 (restated) |
|---|---|---|
| Profit before tax | **17,345** | 15,400 |
| Notional tax on profit before tax, calculated at Hong Kong tax rate of 16.5% (2009: 16.5%) | **2,862** | 2,541 |
| Tax effect of: | | |
| – different tax rates in other countries/areas | **(172)** | (139) |
| – non-taxable income and non-deductible expenses | **(41)** | (89) |
| – share of results of associates | **(439)** | (288) |
| – others | **218** | 237 |
| Actual charge for taxation | **2,428** | 2,262 |

## 24. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

Of the profit attributable to shareholders, HK$10,914 million (2009: HK$10,258 million) has been dealt with in the financial statements of the Bank.

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

| | 2010 | 2009 (restated) |
|---|---|---|
| Amount of consolidated profit attributable to shareholders dealt with in the Bank's financial statements | **10,914** | 10,258 |
| Dividends declared during the year by subsidiaries from retained profits | **565** | 5 |
| The Bank's profit for the year | **11,479** | 10,263 |

## 25. EARNINGS PER SHARE

The calculation of earnings per share for 2010 is based on earnings of HK$14,917 million (HK$13,138 million in 2009) and on the weighted average number of ordinary shares in issue of 1,911,842,736 shares (unchanged from 2009).

## 26. DIVIDENDS PER SHARE

### (a) Dividends attributable to the year:

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **per share HK$** | **HK$ million** | per share HK$ | HK$ million |
| First interim | **1.10** | **2,103** | 1.10 | 2,103 |
| Second interim | **1.10** | **2,103** | 1.10 | 2,103 |
| Third interim | **1.10** | **2,103** | 1.10 | 2,103 |
| Fourth interim | **1.90** | **3,633** | 1.90 | 3,633 |
| | **5.20** | **9,942** | 5.20 | 9,942 |

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

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

| | **2010** | 2009 |
|---|---|---|
| Fourth interim dividend in respect of the previous year, approved and paid during the year, of HK$1.90 per share (2009: HK$3.00 per share) | **3,633** | 5,736 |

## 27. SEGMENTAL ANALYSIS

The Group's business comprises five customer groups. To be consistent with the way in which information is reported internally for the purposes of resource allocation and performance assessment, the Group identified the following five reportable segments.

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

### (a) Segment result

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

## 27. SEGMENTAL ANALYSIS (continued)

### (a) Segment result (continued)

| | Personal Financial Services | Commercial Banking | Corporate Banking | Treasury | Other | Total reportable segments | Inter-segment elimination | Total |
|---|---|---|---|---|---|---|---|---|
| **2010** | | | | | | | | |
| Net interest income | 8,485 | 2,709 | 1,440 | 1,403 | 263 | 14,300 | – | 14,300 |
| Net fee income/(expense) | 3,423 | 1,209 | 188 | (29) | 106 | 4,897 | – | 4,897 |
| Trading income/(loss) | 630 | 334 | 11 | 1,162 | (78) | 2,059 | – | 2,059 |
| Net income/(loss) from financial instruments designated at fair value | 297 | – | – | (1) | (14) | 282 | – | 282 |
| Dividend income | – | 5 | – | – | 9 | 14 | – | 14 |
| Net earned insurance premiums | 11,059 | 246 | 2 | – | – | 11,307 | – | 11,307 |
| Other operating income | 1,271 | 23 | 1 | (1) | 712 | 2,006 | (448) | 1,558 |
| **Total operating income** | 25,165 | 4,526 | 1,642 | 2,534 | 998 | 34,865 | (448) | 34,417 |
| Net insurance claims incurred and movement in policyholders' liabilities | (12,436) | (152) | 1 | – | – | (12,587) | – | (12,587) |
| **Net operating income before loan impairment charges and other credit risk provisions** | 12,729 | 4,374 | 1,643 | 2,534 | 998 | 22,278 | (448) | 21,830 |
| Loan impairment charges and other credit risk provisions | (209) | (178) | (3) | – | – | (390) | – | (390) |
| **Net operating income** | 12,520 | 4,196 | 1,640 | 2,534 | 998 | 21,888 | (448) | 21,440 |
| Total operating expenses* | (4,864) | (1,703) | (379) | (327) | (530) | (7,803) | 448 | (7,355) |
| **Operating profit** | 7,656 | 2,493 | 1,261 | 2,207 | 468 | 14,085 | – | 14,085 |
| Gains less losses from financial investments and fixed assets | – | – | 5 | 95 | 12 | 112 | – | 112 |
| Net surplus on property revaluation | – | – | – | – | 487 | 487 | – | 487 |
| Share of profits from associates | 216 | 1,255 | – | 1,059 | 131 | 2,661 | – | 2,661 |
| **Profit before tax** | 7,872 | 3,748 | 1,266 | 3,361 | 1,098 | 17,345 | – | 17,345 |
| Share of profit before tax | 45.4% | 21.6% | 7.3% | 19.4% | 6.3% | 100.0% | – | 100.0% |
| Operating profit excluding loan impairment charges and other credit risk provisions | 7,865 | 2,671 | 1,264 | 2,207 | 468 | 14,475 | – | 14,475 |
| ** Depreciation/amortisation included in total operating expenses* | (175) | (34) | (5) | (4) | (503) | (721) | – | (721) |
| Total assets | 264,827 | 180,013 | 130,148 | 304,898 | 37,025 | 916,911 | – | 916,911 |
| Total liabilities | 581,118 | 141,518 | 50,862 | 39,268 | 34,133 | 846,899 | – | 846,899 |
| Interest in associates | 1,384 | 6,197 | – | 5,626 | 2,459 | 15,666 | – | 15,666 |
| Non-current assets incurred during the year | 128 | 39 | 5 | 4 | 739 | 915 | – | 915 |

## 27. SEGMENTAL ANALYSIS (continued)

### (a) Segment result (continued)

| | Personal Financial Services | Commercial Banking | Corporate Banking | Treasury | Other | Total reportable segments | Inter-segment elimination | Total |
|---|---|---|---|---|---|---|---|---|
| 2009 (restated) | | | | | | | | |
| Net interest income | 8,195 | 2,011 | 1,158 | 2,162 | 497 | 14,023 | – | 14,023 |
| Net fee income/(expense) | 3,000 | 1,114 | 145 | (35) | 97 | 4,321 | – | 4,321 |
| Trading income/(loss) | 662 | 245 | 8 | 1,054 | (46) | 1,923 | – | 1,923 |
| Net (loss)/income from financial instruments designated at fair value | (54) | – | – | 5 | (26) | (75) | – | (75) |
| Dividend income | 2 | 6 | – | – | 8 | 16 | – | 16 |
| Net earned insurance premiums | 11,293 | 225 | 1 | – | – | 11,519 | – | 11,519 |
| Other operating income | 898 | 29 | 1 | – | 632 | 1,560 | (471) | 1,089 |
| **Total operating income** | 23,996 | 3,630 | 1,313 | 3,186 | 1,162 | 33,287 | (471) | 32,816 |
| Net insurance claims incurred and movement in policyholders' liabilities | (11,868) | (134) | (2) | – | – | (12,004) | – | (12,004) |
| **Net operating income before loan impairment charges and other credit risk provisions** | 12,128 | 3,496 | 1,311 | 3,186 | 1,162 | 21,283 | (471) | 20,812 |
| Loan impairment charges and other credit risk provisions | (454) | (278) | (78) | (2) | – | (812) | – | (812) |
| **Net operating income** | 11,674 | 3,218 | 1,233 | 3,184 | 1,162 | 20,471 | (471) | 20,000 |
| Total operating expenses* | (4,671) | (1,507) | (332) | (268) | (479) | (7,257) | 471 | (6,786) |
| **Operating profit** | 7,003 | 1,711 | 901 | 2,916 | 683 | 13,214 | – | 13,214 |
| Gains less losses from financial investments and fixed assets | 96 | 53 | 14 | (152) | 175 | 186 | – | 186 |
| Net surplus on property revaluation | – | – | – | – | 252 | 252 | – | 252 |
| Share of profits from associates | 159 | 873 | – | 629 | 87 | 1,748 | – | 1,748 |
| **Profit before tax** | 7,258 | 2,637 | 915 | 3,393 | 1,197 | 15,400 | – | 15,400 |
| Share of profit before tax | 47.1% | 17.1% | 5.9% | 22.0% | 7.9% | 100.0% | – | 100.0% |
| Operating profit excluding loan impairment charges and other credit risk provisions | 7,457 | 1,989 | 979 | 2,918 | 683 | 14,026 | – | 14,026 |
| ** Depreciation/amortisation included in total operating expenses* | (173) | (31) | (7) | (4) | (460) | (675) | – | (675) |
| Total assets | 234,723 | 96,490 | 88,135 | 377,561 | 33,759 | 830,668 | – | 830,668 |
| Total liabilities | 554,357 | 123,996 | 37,477 | 21,503 | 31,187 | 768,520 | – | 768,520 |
| Interest in associates | 847 | 4,284 | – | 2,707 | 2,388 | 10,226 | – | 10,226 |
| Non-current assets incurred during the year | 181 | 34 | 5 | – | 92 | 312 | – | 312 |

## 27. SEGMENTAL ANALYSIS (continued)

### (b) Geographic information

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

| | 2010 | | 2009 (restated) | |
|---|---|---|---|---|
| | | % | | % |
| **Total operating income** | | | | |
| – Hong Kong | 32,124 | 93 | 30,923 | 94 |
| – Americas | 1,047 | 3 | 885 | 3 |
| – Mainland and others | 1,246 | 4 | 1,008 | 3 |
| | 34,417 | 100 | 32,816 | 100 |
| **Profit before tax** | | | | |
| – Hong Kong | 13,722 | 79 | 12,825 | 83 |
| – Americas | 996 | 6 | 799 | 5 |
| – Mainland and others | 2,627 | 15 | 1,776 | 12 |
| | 17,345 | 100 | 15,400 | 100 |
| **Total assets** | | | | |
| – Hong Kong | 752,206 | 82 | 710,167 | 85 |
| – Americas | 68,216 | 7 | 63,808 | 8 |
| – Mainland and others | 96,489 | 11 | 56,693 | 7 |
| | 916,911 | 100 | 830,668 | 100 |
| **Total liabilities** | | | | |
| – Hong Kong | 786,304 | 93 | 734,618 | 96 |
| – Americas | 1,187 | – | 1,109 | – |
| – Mainland and others | 59,408 | 7 | 32,793 | 4 |
| | 846,899 | 100 | 768,520 | 100 |
| **Interest in associates** | | | | |
| – Hong Kong | 989 | 6 | 916 | 9 |
| – Americas | – | – | – | – |
| – Mainland and others | 14,677 | 94 | 9,310 | 91 |
| | 15,666 | 100 | 10,226 | 100 |
| **Non-current assets*** | | | | |
| – Hong Kong | 22,262 | 96 | 19,183 | 98 |
| – Americas | – | – | – | – |
| – Mainland and others | 944 | 4 | 317 | 2 |
| | 23,206 | 100 | 19,500 | 100 |
| **Contingent liabilities and commitments** | | | | |
| – Hong Kong | 223,659 | 83 | 198,996 | 92 |
| – Americas | – | – | – | – |
| – Mainland and others | 44,589 | 17 | 18,038 | 8 |
| | 268,248 | 100 | 217,034 | 100 |

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

## 28. ANALYSIS OF ASSETS AND LIABILITIES BY REMAINING MATURITY

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

| | Group | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 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 |
| **2010** | | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 44,411 | – | – | – | – | – | – | – | 44,411 |
| Placings with and advances to banks and other financial institutions | 4,730 | 51,706 | 48,475 | 5,185 | – | 468 | – | – | 110,564 |
| Trading assets | – | – | – | – | – | – | 26,055 | – | 26,055 |
| Financial assets designated at fair value | – | 50 | 7 | 384 | 3,951 | 48 | – | 2,674 | 7,114 |
| Derivative financial instruments | – | 20 | 74 | 113 | 288 | 16 | 5,082 | – | 5,593 |
| Advances to customers | 10,198 | 65,179 | 34,733 | 71,444 | 151,430 | 139,653 | – | – | 472,637 |
| Financial investments: | | | | | | | | | |
| – available-for-sale investments | – | 8,957 | 12,112 | 56,453 | 63,465 | 1,216 | – | 855 | 143,058 |
| – held-to-maturity debt securities | – | 226 | 521 | 2,936 | 21,101 | 31,517 | – | – | 56,301 |
| Interest in associates | – | – | – | – | – | – | – | 15,666 | 15,666 |
| Investment properties | – | – | – | – | – | – | – | 3,251 | 3,251 |
| Premises, plant and equipment | – | – | – | – | – | – | – | 14,561 | 14,561 |
| Intangible assets | – | – | – | – | – | – | – | 5,394 | 5,394 |
| Other assets | 4,980 | 2,765 | 2,390 | 1,708 | 74 | 18 | – | 371 | 12,306 |
| Deferred tax assets | – | – | – | – | – | – | – | – | – |
| | 64,319 | 128,903 | 98,312 | 138,223 | 240,309 | 172,936 | 31,137 | 42,772 | 916,911 |
| **Liabilities** | | | | | | | | | |
| Current, savings and other deposit accounts | 536,363 | 78,218 | 37,862 | 29,611 | 1,574 | – | – | – | 683,628 |
| Deposits from banks | 6,387 | 7,688 | 1,394 | – | 117 | – | – | – | 15,586 |
| Trading liabilities | – | – | – | – | – | – | 42,581 | – | 42,581 |
| Financial liabilities designated at fair value | 2 | – | – | – | – | 455 | – | – | 457 |
| Derivative financial instruments | – | – | – | 99 | 819 | 56 | 3,709 | – | 4,683 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| – certificates of deposit in issue | – | 96 | 447 | 112 | 2,440 | – | – | – | 3,095 |
| Other liabilities | 6,954 | 3,293 | 2,597 | 1,598 | 97 | 25 | – | 2,454 | 17,018 |
| Liabilities to customers under insurance contracts | – | – | – | – | – | – | – | 64,425 | 64,425 |
| Current tax liabilities | – | – | – | 344 | – | – | – | – | 344 |
| Deferred tax liabilities | – | – | – | – | – | – | – | 3,234 | 3,234 |
| Subordinated liabilities | – | – | – | 3,495 | 2,328 | 6,025 | – | – | 11,848 |
| | 549,706 | 89,295 | 42,300 | 35,259 | 7,375 | 6,561 | 46,290 | 70,113 | 846,899 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | 18 | – | 18 |
| – financial assets designated at fair value | – | – | – | – | – | – | – | – | – |
| – available-for-sale investments | – | 120 | 700 | 1,813 | 1,246 | – | – | 43 | 3,922 |
| – held-to-maturity debt securities | – | 20 | 79 | 259 | 861 | 1,572 | – | – | 2,791 |
| | – | 140 | 779 | 2,072 | 2,107 | 1,572 | 18 | 43 | 6,731 |
| Debt securities included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | 25,305 | – | 25,305 |
| – financial assets designated at fair value | – | 50 | 7 | 384 | 3,951 | 48 | – | – | 4,440 |
| – available-for-sale investments | – | 8,837 | 11,412 | 54,640 | 62,219 | 1,216 | – | 486 | 138,810 |
| – held-to-maturity debt securities | – | 206 | 442 | 2,677 | 20,240 | 29,945 | – | – | 53,510 |
| | – | 9,093 | 11,861 | 57,701 | 86,410 | 31,209 | 25,305 | 486 | 222,065 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| – trading liabilities | – | – | – | – | – | – | 26 | – | 26 |
| – financial liabilities designated at fair value | – | – | – | – | – | – | – | – | – |
| – issue at amortised cost | – | 96 | 447 | 112 | 2,440 | – | – | – | 3,095 |
| | – | 96 | 447 | 112 | 2,440 | – | 26 | – | 3,121 |

## 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 |
| 2009 (restated) | | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 22,086 | – | – | – | – | – | – | – | 22,086 |
| Placings with and advances to banks and other financial institutions | 4,352 | 72,226 | 25,557 | 2,416 | – | – | – | – | 104,551 |
| Trading assets | – | – | – | – | – | – | 66,597 | – | 66,597 |
| Financial assets designated at fair value | – | – | 20 | 646 | 4,201 | 58 | – | 525 | 5,450 |
| Derivative financial instruments | – | 7 | 34 | 232 | 118 | – | 4,659 | – | 5,050 |
| Advances to customers | 9,254 | 22,927 | 25,005 | 51,673 | 121,394 | 114,368 | – | – | 344,621 |
| Financial investments: | | | | | | | | | |
| – available-for-sale investments | – | 18,050 | 16,426 | 48,560 | 108,360 | 628 | – | 809 | 192,833 |
| – held-to-maturity debt securities | – | 31 | 282 | 1,395 | 21,538 | 25,423 | – | – | 48,669 |
| Interest in associates | – | – | – | – | – | – | – | 10,226 | 10,226 |
| Investment properties | – | – | – | – | – | – | – | 2,872 | 2,872 |
| Premises, plant and equipment | – | – | – | – | – | – | – | 12,414 | 12,414 |
| Intangible assets | – | – | – | – | – | – | – | 4,214 | 4,214 |
| Other assets | 4,558 | 2,682 | 1,838 | 1,511 | 126 | 14 | – | 340 | 11,069 |
| Deferred tax assets | – | – | – | – | – | – | – | 16 | 16 |
| | 40,250 | 115,923 | 69,162 | 106,433 | 255,737 | 140,491 | 71,256 | 31,416 | 830,668 |
| **Liabilities** | | | | | | | | | |
| Current, savings and other deposit accounts | 494,026 | 81,129 | 38,108 | 22,427 | 679 | – | – | – | 636,369 |
| Deposits from banks | 2,964 | 1,737 | 28 | 25 | 116 | – | – | – | 4,870 |
| Trading liabilities | – | – | – | – | – | – | 38,391 | – | 38,391 |
| Financial liabilities designated at fair value | 3 | – | – | 1,000 | – | – | – | 453 | 1,456 |
| Derivative financial instruments | – | – | 6 | 21 | 630 | 13 | 3,581 | – | 4,251 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| – certificates of deposit in issue | – | 159 | 171 | 1,177 | 319 | – | – | – | 1,826 |
| Other liabilities | 6,044 | 3,158 | 1,955 | 1,452 | 150 | 116 | – | 2,410 | 15,285 |
| Liabilities to customers under insurance contracts | – | – | – | – | – | – | – | 54,240 | 54,240 |
| Current tax liabilities | – | – | – | 52 | – | – | – | – | 52 |
| Deferred tax liabilities | – | – | – | – | – | – | – | 2,460 | 2,460 |
| Subordinated liabilities | – | – | – | 3,516 | 5,804 | – | – | – | 9,320 |
| | 503,037 | 86,183 | 40,268 | 29,670 | 7,698 | 129 | 41,972 | 59,563 | 768,520 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | – | – | – |
| – financial assets designated at fair value | – | – | – | 130 | – | – | – | (1) | 129 |
| – available-for-sale investments | – | – | 1,493 | 2,061 | 2,026 | 116 | – | 38 | 5,734 |
| – held-to-maturity debt securities | – | – | 23 | 161 | 941 | 806 | – | – | 1,931 |
| | – | – | 1,516 | 2,352 | 2,967 | 922 | – | 37 | 7,794 |
| Debt securities included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | 66,590 | – | 66,590 |
| – financial assets designated at fair value | – | – | 20 | 516 | 4,201 | 58 | – | 3 | 4,798 |
| – available-for-sale investments | – | 18,050 | 14,933 | 46,499 | 106,334 | 512 | – | 424 | 186,752 |
| – held-to-maturity debt securities | – | 31 | 259 | 1,234 | 20,597 | 24,617 | – | – | 46,738 |
| | – | 18,081 | 15,212 | 48,249 | 131,132 | 25,187 | 66,590 | 427 | 304,878 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| – trading liabilities | – | – | – | – | – | – | 478 | – | 478 |
| – financial liabilities designated at fair value | – | – | – | – | – | – | – | – | – |
| – issue at amortised cost | – | 159 | 171 | 1,177 | 319 | – | – | – | 1,826 |
| | – | 159 | 171 | 1,177 | 319 | – | 478 | – | 2,304 |

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

| | Bank | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 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 |
| **2010** | | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 41,062 | – | – | – | – | – | – | – | 41,062 |
| Placings with and advances to banks and other financial institutions | 2,120 | 16,999 | 28,875 | 4,137 | – | – | – | – | 52,131 |
| Trading assets | – | – | – | – | – | – | 25,232 | – | 25,232 |
| Financial assets designated at fair value | – | – | – | – | 148 | – | – | – | 148 |
| Derivative financial instruments | – | 19 | 72 | 92 | 55 | 16 | 4,772 | – | 5,026 |
| Advances to customers | 10,187 | 61,578 | 25,706 | 62,337 | 134,127 | 129,139 | – | – | 423,074 |
| Amounts due from subsidiaries | 66,716 | 1,577 | 13,028 | 6,494 | 5,630 | – | – | – | 93,445 |
| Financial investments: | | | | | | | | | |
| – available-for-sale investments | – | 7,321 | 6,918 | 47,381 | 39,857 | 1,047 | – | 582 | 103,106 |
| Investments in subsidiaries | – | – | – | – | – | – | – | 11,584 | 11,584 |
| Interest in associates | – | – | – | – | – | – | – | 5,172 | 5,172 |
| Investment properties | – | – | – | – | – | – | – | 2,100 | 2,100 |
| Premises, plant and equipment | – | – | – | – | – | – | – | 10,588 | 10,588 |
| Intangible assets | – | – | – | – | – | – | – | 442 | 442 |
| Other assets | 4,652 | 2,176 | 1,298 | 538 | 17 | – | – | 106 | 8,787 |
| Deferred tax assets | – | – | – | – | – | – | – | – | – |
| | 124,737 | 89,670 | 75,897 | 120,979 | 179,834 | 130,202 | 30,004 | 30,574 | 781,897 |
| **Liabilities** | | | | | | | | | |
| Current, savings and other deposit accounts | 526,103 | 73,458 | 32,405 | 16,145 | 1,033 | – | – | – | 649,144 |
| Deposits from banks | 6,386 | 7,688 | 1,394 | – | 117 | – | – | – | 15,585 |
| Trading liabilities | – | – | – | – | – | – | 30,106 | – | 30,106 |
| Derivative financial instruments | – | – | – | 95 | 587 | 44 | 3,802 | – | 4,528 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| – certificates of deposit in issue | – | 96 | 447 | 112 | 2,440 | – | – | – | 3,095 |
| Amounts due to subsidiaries | 4,222 | 4,337 | 338 | 2 | – | – | – | – | 8,899 |
| Other liabilities | 6,704 | 2,912 | 1,739 | 805 | 26 | 18 | – | 3,230 | 15,434 |
| Current tax liabilities | – | – | – | 320 | – | – | – | – | 320 |
| Deferred tax liabilities | – | – | – | – | – | – | – | 1,617 | 1,617 |
| Subordinated liabilities | – | – | – | 3,495 | 2,328 | 6,025 | – | – | 11,848 |
| | 543,415 | 88,491 | 36,323 | 20,974 | 6,531 | 6,087 | 33,908 | 4,847 | 740,576 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | 18 | – | 18 |
| – financial assets designated at fair value | – | – | – | – | – | – | – | – | – |
| – available-for-sale investments | – | 120 | 75 | 1,444 | 1,246 | – | – | 43 | 2,928 |
| – held-to-maturity debt securities | – | – | – | – | – | – | – | – | – |
| | – | 120 | 75 | 1,444 | 1,246 | – | 18 | 43 | 2,946 |
| Debt securities included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | 24,482 | – | 24,482 |
| – financial assets designated at fair value | – | – | – | – | 148 | – | – | – | 148 |
| – available-for-sale investments | – | 7,201 | 6,843 | 45,937 | 38,611 | 1,047 | – | 418 | 100,057 |
| – held-to-maturity debt securities | – | – | – | – | – | – | – | – | – |
| | – | 7,201 | 6,843 | 45,937 | 38,759 | 1,047 | 24,482 | 418 | 124,687 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| – trading liabilities | – | – | – | – | – | – | 26 | – | 26 |
| – financial liabilities designated at fair value | – | – | – | – | – | – | – | – | – |
| – issue at amortised cost | – | 96 | 447 | 112 | 2,440 | – | – | – | 3,095 |
| | – | 96 | 447 | 112 | 2,440 | – | 26 | – | 3,121 |

## 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 (restated) | | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances with banks and other financial institutions | 18,461 | – | – | – | – | – | – | – | 18,461 |
| Placings with and advances to banks and other financial institutions | 1,326 | 45,657 | 17,809 | 832 | – | – | – | – | 65,624 |
| Trading assets | – | – | – | – | – | – | 65,288 | – | 65,288 |
| Financial assets designated at fair value | – | – | – | 20 | 144 | – | – | 10 | 174 |
| Derivative financial instruments | – | 7 | 24 | 227 | 101 | – | 4,557 | – | 4,916 |
| Advances to customers | 9,248 | 20,461 | 20,035 | 42,646 | 105,426 | 101,363 | – | – | 299,179 |
| Amounts due from subsidiaries | 61,771 | 1,783 | 18,373 | 3,449 | 1,984 | – | – | – | 87,360 |
| Financial investments: | | | | | | | | | |
| – available-for-sale investments | – | 15,619 | 11,365 | 39,353 | 89,143 | 629 | – | 606 | 156,715 |
| Investments in subsidiaries | – | – | – | – | – | – | – | 11,584 | 11,584 |
| Interest in associates | – | – | – | – | – | – | – | 2,546 | 2,546 |
| Investment properties | – | – | – | – | – | – | – | 1,883 | 1,883 |
| Premises, plant and equipment | – | – | – | – | – | – | – | 9,434 | 9,434 |
| Intangible assets | – | – | – | – | – | – | – | 399 | 399 |
| Other assets | 4,464 | 2,210 | 1,013 | 389 | 74 | – | – | 86 | 8,236 |
| Deferred tax assets | – | – | – | – | – | – | – | 2 | 2 |
| | 95,270 | 85,737 | 68,619 | 86,916 | 196,872 | 101,992 | 69,845 | 26,550 | 731,801 |
| **Liabilities** | | | | | | | | | |
| Current, savings and other deposit accounts | 485,929 | 78,600 | 33,958 | 13,177 | 350 | – | – | – | 612,014 |
| Deposits from banks | 2,963 | 1,337 | 28 | 25 | 116 | – | – | – | 4,469 |
| Trading liabilities | – | – | – | – | – | – | 35,071 | – | 35,071 |
| Financial liabilities designated at fair value | – | – | – | 1,000 | – | – | – | 3 | 1,003 |
| Derivative financial instruments | – | – | 6 | 21 | 568 | 13 | 3,572 | – | 4,180 |
| Certificates of deposit and other debt securities in issue: | | | | | | | | | |
| – certificates of deposit in issue | – | 159 | 171 | 1,177 | 319 | – | – | – | 1,826 |
| Amounts due to subsidiaries | 4,749 | 4,974 | 237 | – | – | – | – | – | 9,960 |
| Other liabilities | 5,834 | 3,046 | 1,431 | 708 | 82 | 17 | – | 3,215 | 14,333 |
| Current tax liabilities | – | – | – | 10 | – | – | – | – | 10 |
| Deferred tax liabilities | – | – | – | – | – | – | – | 1,345 | 1,345 |
| Subordinated liabilities | – | – | – | 3,516 | 5,804 | – | – | – | 9,320 |
| | 499,475 | 88,116 | 35,831 | 19,634 | 7,239 | 30 | 38,643 | 4,563 | 693,531 |
| of which: | | | | | | | | | |
| Certificates of deposit included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | – | – | – |
| – financial assets designated at fair value | – | – | – | – | – | – | – | – | – |
| – available-for-sale investments | – | – | 621 | 1,194 | 1,158 | 116 | – | 37 | 3,126 |
| – held-to-maturity debt securities | – | – | – | – | – | – | – | – | – |
| | – | – | 621 | 1,194 | 1,158 | 116 | – | 37 | 3,126 |
| Debt securities included in: | | | | | | | | | |
| – trading assets | – | – | – | – | – | – | 65,281 | – | 65,281 |
| – financial assets designated at fair value | – | – | – | 20 | 144 | – | – | 10 | 174 |
| – available-for-sale investments | – | 15,619 | 10,744 | 38,159 | 87,985 | 513 | – | 422 | 153,442 |
| – held-to-maturity debt securities | – | – | – | – | – | – | – | – | – |
| | – | 15,619 | 10,744 | 38,179 | 88,129 | 513 | 65,281 | 432 | 218,897 |
| Certificates of deposit in issue included in: | | | | | | | | | |
| – trading liabilities | – | – | – | – | – | – | 478 | – | 478 |
| – financial liabilities designated at fair value | – | – | – | – | – | – | – | – | – |
| – issue at amortised cost | – | 159 | 171 | 1,177 | 319 | – | – | – | 1,826 |
| | – | 159 | 171 | 1,177 | 319 | – | 478 | – | 2,304 |

## 29. ACCOUNTING CLASSIFICATIONS

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

| | Group | | | | | | |
|---|---|---|---|---|---|---|---|
| | Trading | Designated at fair value | Available-for-sale/ hedging | Held-to-maturity | Loans and receivables | Other amortised cost | Total |
| **2010** | | | | | | | |
| Cash and balances with banks and other financial institutions | – | – | – | – | – | 44,411 | 44,411 |
| Placings with and advances to banks and other financial institutions | – | – | – | – | 110,564 | – | 110,564 |
| Derivative financial instruments | 5,082 | – | 511 | – | – | – | 5,593 |
| Advances to customers | – | – | – | – | 472,637 | – | 472,637 |
| Investment securities | 25,331 | 7,114 | 143,058 | 56,301 | – | – | 231,804 |
| Acceptances and endorsements | – | – | – | – | – | 3,751 | 3,751 |
| Other financial assets | 724 | – | – | – | – | 7,881 | 8,605 |
| Total financial assets | 31,137 | 7,114 | 143,569 | 56,301 | 583,201 | 56,043 | 877,365 |
| Non-financial assets | | | | | | | 39,546 |
| **Total assets** | | | | | | | 916,911 |
| Current, savings and other deposit accounts | 20,852 | – | – | – | – | 683,628 | 704,480 |
| Deposits from banks | – | – | – | – | – | 15,586 | 15,586 |
| Derivative financial instruments | 3,697 | 12 | 974 | – | – | – | 4,683 |
| Certificates of deposit and other debt securities in issue | 2,738 | – | – | – | – | 3,095 | 5,833 |
| Other financial liabilities | 18,991 | – | – | – | – | 10,716 | 29,707 |
| Subordinated liabilities | – | – | – | – | – | 11,848 | 11,848 |
| Liabilities to customers under investment contracts | – | 457 | – | – | – | – | 457 |
| Acceptances and endorsements | – | – | – | – | – | 3,751 | 3,751 |
| Total financial liabilities | 46,278 | 469 | 974 | – | – | 728,624 | 776,345 |
| Non-financial liabilities | | | | | | | 70,554 |
| **Total liabilities** | | | | | | | 846,899 |

## 29. ACCOUNTING CLASSIFICATIONS (continued)

| | Group | | | | | | |
|---|---|---|---|---|---|---|---|
| | Trading | Designated at fair value | Available-for-sale/ hedging | Held-to-maturity | Loans and receivables | Other amortised cost | Total |
| 2009 (restated) | | | | | | | |
| Cash and balances with banks and other financial institutions | – | – | – | – | – | 22,086 | 22,086 |
| Placings with and advances to banks and other financial institutions | – | – | – | – | 104,551 | – | 104,551 |
| Derivative financial instruments | 4,641 | 18 | 391 | – | – | – | 5,050 |
| Advances to customers | – | – | – | – | 344,621 | – | 344,621 |
| Investment securities | 66,596 | 5,450 | 192,833 | 48,669 | – | – | 313,548 |
| Acceptances and endorsements | – | – | – | – | – | 3,584 | 3,584 |
| Other financial assets | 1 | – | – | – | – | 7,142 | 7,143 |
| Total financial assets | 71,238 | 5,468 | 193,224 | 48,669 | 449,172 | 32,812 | 800,583 |
| Non-financial assets | | | | | | | 30,085 |
| **Total assets** | | | | | | | 830,668 |
| Current, savings and other deposit accounts | 22,212 | – | – | – | – | 636,369 | 658,581 |
| Deposits from banks | – | – | – | – | – | 4,870 | 4,870 |
| Derivative financial instruments | 3,568 | 13 | 670 | – | – | – | 4,251 |
| Certificates of deposit and other debt securities in issue | 3,247 | – | – | – | – | 1,826 | 5,073 |
| Other financial liabilities | 12,932 | – | – | – | – | 9,242 | 22,174 |
| Subordinated liabilities | – | 1,003 | – | – | – | 9,320 | 10,323 |
| Liabilities to customers under investment contracts | – | 453 | – | – | – | – | 453 |
| Acceptances and endorsements | – | – | – | – | – | 3,584 | 3,584 |
| Total financial liabilities | 41,959 | 1,469 | 670 | – | – | 665,211 | 709,309 |
| Non-financial liabilities | | | | | | | 59,211 |
| **Total liabilities** | | | | | | | 768,520 |

## 29. ACCOUNTING CLASSIFICATIONS (continued)

| | Bank | | | | | | |
|---|---|---|---|---|---|---|---|
| | Trading | Designated at fair value | Available-for-sale/ hedging | Held-to-maturity | Loans and receivables | Other amortised cost | Total |
| **2010** | | | | | | | |
| Cash and balances with banks and other financial institutions | – | – | – | – | – | 41,062 | 41,062 |
| Placings with and advances to banks and other financial institutions | – | – | – | – | 52,131 | – | 52,131 |
| Derivative financial instruments | 4,772 | – | 254 | – | – | – | 5,026 |
| Advances to customers | – | – | – | – | 423,074 | – | 423,074 |
| Investment securities | 24,508 | 148 | 103,106 | – | – | – | 127,762 |
| Amounts due from subsidiaries | – | – | – | – | – | 93,445 | 93,445 |
| Acceptances and endorsements | – | – | – | – | – | 2,363 | 2,363 |
| Other financial assets | 724 | – | – | – | – | 6,026 | 6,750 |
| Total financial assets | 30,004 | 148 | 103,360 | – | 475,205 | 142,896 | 751,613 |
| Non-financial assets | | | | | | | 30,284 |
| **Total assets** | | | | | | | 781,897 |
| Current, savings and other deposit accounts | 8,377 | – | – | – | – | 649,144 | 657,521 |
| Deposits from banks | – | – | – | – | – | 15,585 | 15,585 |
| Derivative financial instruments | 3,793 | 9 | 726 | – | – | – | 4,528 |
| Certificates of deposit and other debt securities in issue | 2,738 | – | – | – | – | 3,095 | 5,833 |
| Amounts due to subsidiaries | – | – | – | – | – | 8,899 | 8,899 |
| Other financial liabilities | 18,991 | – | – | – | – | 10,672 | 29,663 |
| Subordinated liabilities | – | – | – | – | – | 11,848 | 11,848 |
| Acceptances and endorsements | – | – | – | – | – | 2,363 | 2,363 |
| Total financial liabilities | 33,899 | 9 | 726 | – | – | 701,606 | 736,240 |
| Non-financial liabilities | | | | | | | 4,336 |
| **Total liabilities** | | | | | | | 740,576 |

## 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 (restated) | | | | | | | |
| Cash and balances with banks and other financial institutions | – | – | – | – | – | 18,461 | 18,461 |
| Placings with and advances to banks and other financial institutions | – | – | – | – | 65,624 | – | 65,624 |
| Derivative financial instruments | 4,540 | 17 | 359 | – | – | – | 4,916 |
| Advances to customers | – | – | – | – | 299,179 | – | 299,179 |
| Investment securities | 65,287 | 174 | 156,715 | – | – | – | 222,176 |
| Amounts due from subsidiaries | – | – | – | – | – | 87,360 | 87,360 |
| Acceptances and endorsements | – | – | – | – | – | 2,435 | 2,435 |
| Other financial assets | 1 | – | – | – | – | 5,606 | 5,607 |
| Total financial assets | 69,828 | 191 | 157,074 | – | 364,803 | 113,862 | 705,758 |
| Non-financial assets | | | | | | | 26,043 |
| **Total assets** | | | | | | | 731,801 |
| Current, savings and other deposit accounts | 18,892 | – | – | – | – | 612,014 | 630,906 |
| Deposits from banks | – | – | – | – | – | 4,469 | 4,469 |
| Derivative financial instruments | 3,559 | 13 | 608 | – | – | – | 4,180 |
| Certificates of deposit and other debt securities in issue | 3,247 | – | – | – | – | 1,826 | 5,073 |
| Amounts due to subsidiaries | – | – | – | – | – | 9,960 | 9,960 |
| Other financial liabilities | 12,932 | – | – | – | – | 9,525 | 22,457 |
| Subordinated liabilities | – | 1,003 | – | – | – | 9,320 | 10,323 |
| Acceptances and endorsements | – | – | – | – | – | 2,435 | 2,435 |
| Total financial liabilities | 38,630 | 1,016 | 608 | – | – | 649,549 | 689,803 |
| Non-financial liabilities | | | | | | | 3,728 |
| **Total liabilities** | | | | | | | 693,531 |

## 30. CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Cash in hand | **6,101** | 4,299 | **5,857** | 4,079 |
| Balances with central banks | **6,591** | 3,397 | **4,250** | 924 |
| Balances with banks and other financial institutions | **31,719** | 14,390 | **30,955** | 13,458 |
| | **44,411** | 22,086 | **41,062** | 18,461 |

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Placings with and advances to banks and other financial institutions maturing within one month | **56,437** | 76,579 | **19,119** | 46,984 |
| Placings with and advances to banks and other financial institutions maturing after one month but less than one year | **53,659** | 27,972 | **33,012** | 18,640 |
| Placings with and advances to banks and other financial institutions maturing after one year | **468** | – | **–** | – |
| | **110,564** | 104,551 | **52,131** | 65,624 |

There were no overdue advances, impaired advances and rescheduled advances to banks and other financial institutions at 31 December 2010 by the Group and the Bank (2009: Nil).

## 32. TRADING ASSETS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Treasury bills | **20,204** | 62,028 | **20,204** | 62,028 |
| Certificates of deposit | **18** | – | **18** | – |
| Other debt securities | **5,101** | 4,562 | **4,278** | 3,253 |
| Debt securities | **25,323** | 66,590 | **24,500** | 65,281 |
| Equity shares | **8** | 6 | **8** | 6 |
| **Total trading securities** | **25,331** | 66,596 | **24,508** | 65,287 |
| Other* | **724** | 1 | **724** | 1 |
| **Total trading assets** | **26,055** | 66,597 | **25,232** | 65,288 |
| **Debt securities:** | | | | |
| – listed in Hong Kong | **3,876** | 2,712 | **3,876** | 2,712 |
| – listed outside Hong Kong | **170** | 157 | **170** | 157 |
| | **4,046** | 2,869 | **4,046** | 2,869 |
| – unlisted | **21,277** | 63,721 | **20,454** | 62,412 |
| | **25,323** | 66,590 | **24,500** | 65,281 |
| **Equity shares:** | | | | |
| – listed in Hong Kong | **8** | 6 | **8** | 6 |
| – unlisted | **–** | – | **–** | – |
| | **8** | 6 | **8** | 6 |
| **Total trading securities** | **25,331** | 66,596 | **24,508** | 65,287 |
| **Debt securities** | | | | |
| Issued by public bodies: | | | | |
| – central governments and central banks | **24,905** | 65,817 | **24,129** | 64,508 |
| – other public sector entities | **101** | 369 | **101** | 369 |
| | **25,006** | 66,186 | **24,230** | 64,877 |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | **149** | 292 | **102** | 292 |
| – corporate entities | **168** | 112 | **168** | 112 |
| | **317** | 404 | **270** | 404 |
| | **25,323** | 66,590 | **24,500** | 65,281 |
| **Equity shares** | | | | |
| Issued by corporate entities | **8** | 6 | **8** | 6 |
| **Total trading securities** | **25,331** | 66,596 | **24,508** | 65,287 |

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

## 33. FINANCIAL ASSETS DESIGNATED AT FAIR VALUE

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Certificates of deposit | **–** | 129 | **–** | – |
| Other debt securities | **4,440** | 4,798 | **148** | 174 |
| Debt securities | **4,440** | 4,927 | **148** | 174 |
| Equity shares | **583** | 21 | **–** | – |
| Investment funds | **2,091** | 502 | **–** | – |
| | **7,114** | 5,450 | **148** | 174 |
| **Debt securities:** | | | | |
| – listed in Hong Kong | **11** | 3 | **–** | – |
| – listed outside Hong Kong | **184** | 194 | **148** | 154 |
| | **195** | 197 | **148** | 154 |
| – unlisted | **4,245** | 4,730 | **–** | 20 |
| | **4,440** | 4,927 | **148** | 174 |
| **Equity shares:** | | | | |
| – listed in Hong Kong | **583** | 21 | **–** | – |
| **Investment funds:** | | | | |
| – listed in Hong Kong | **23** | – | **–** | – |
| – listed outside Hong Kong | **65** | 69 | **–** | – |
| | **88** | 69 | **–** | – |
| – unlisted | **2,003** | 433 | **–** | – |
| | **2,091** | 502 | **–** | – |
| | **7,114** | 5,450 | **148** | 174 |
| **Debt securities** | | | | |
| Issued by public bodies: | | | | |
| – central governments and central banks | **148** | 154 | **148** | 154 |
| – other public sector entities | **105** | 168 | **–** | – |
| | **253** | 322 | **148** | 154 |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | **4,113** | 4,464 | **–** | – |
| – corporate entities | **74** | 141 | **–** | 20 |
| | **4,187** | 4,605 | **–** | 20 |
| | **4,440** | 4,927 | **148** | 174 |
| **Equity shares** | | | | |
| Issued by banks and other financial institutions | **69** | – | **–** | – |
| Issued by corporate entities | **514** | 21 | **–** | – |
| | **583** | 21 | **–** | – |
| **Investment funds** | | | | |
| Issued by corporate entities | **2,091** | 502 | **–** | – |
| | **7,114** | 5,450 | **148** | 174 |

## 34. DERIVATIVE FINANCIAL INSTRUMENTS

Derivatives are financial contracts whose values and characteristics are derived from underlying assets, exchange and interest rates, and indices. Derivative instruments are subject to both credit risk and market risk. The credit risk relating to a derivative contract is principally the replacement cost of the contract when it has a positive mark-to-market value and the estimated potential future change in value over the residual maturity of the contract. The nominal value of the contracts does not represent the amount of the Group's exposure to credit risk. All activities relating to derivatives are subject to the same credit approval and monitoring procedures used for other credit transactions. Market risk from derivative positions is controlled individually and in combination with on-balance sheet market risk positions within the Group's market risk limits regime as described in note 61(c).

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

### Trading derivatives

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

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

### Hedging instruments

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

### (a) Fair value hedge

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

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

### (b) Cash flow hedge

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

Gains and losses are initially recognised in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2010, the amount of cash flow hedging reserve transferred to the income statement comprised HK$414 million (2009: HK$848 million) included in net interest income and nil balance included in net trading income (2009: HK$16 million) .

There was insignificant ineffectiveness recognised in the Group's income statement arising from cash flow hedge during the years of 2010 and 2009. During the years of 2010 and 2009, there were forecast transactions for which hedge accounting had previously been used but which were no longer expected to occur. In 2010, there was no gain recognised due to termination of such forecast transactions (2009: HK$16 million).

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

| | Group | | |
|---|---|---|---|
| | Three months or less | Over three months but within one year | Over one year but within five years |
| **At 31 December 2010** | | | |
| Cash inflows from assets | **78,389** | **40,443** | **21,869** |
| Cash outflows from liabilities | **–** | **–** | **–** |
| Net cash inflows | **78,389** | **40,443** | **21,869** |
| At 31 December 2009 | | | |
| Cash inflows from assets | 45,526 | 39,564 | 20,587 |
| Cash outflows from liabilities | – | – | – |
| Net cash inflows | 45,526 | 39,564 | 20,587 |

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | 2010 | | | 2009 | | |
| | **Contract amounts** | **Derivative assets** | **Derivative liabilities** | Contract amounts | Derivative assets | Derivative liabilities |
| **Derivatives held for trading** | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | **495,913** | **2,471** | **1,802** | 382,260 | 2,289 | 608 |
| – currency swaps | **17,366** | **190** | **139** | 20,837 | 261 | 132 |
| – currency options purchased | **41,183** | **59** | **–** | 30,561 | 83 | – |
| – currency options written | **46,657** | **–** | **87** | 40,105 | – | 197 |
| – other exchange rate contracts | **101** | **1** | **3** | 226 | 3 | 1 |
| | **601,220** | **2,721** | **2,031** | 473,989 | 2,636 | 938 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **234,425** | **1,748** | **1,557** | 162,662 | 1,552 | 1,622 |
| – interest rate options purchased | **25** | **–** | **–** | 143 | – | – |
| – interest rate options written | **25** | **–** | **–** | 142 | – | – |
| – other interest rate contracts | **1,555** | **–** | **–** | 407 | – | 1 |
| | **236,030** | **1,748** | **1,557** | 163,354 | 1,552 | 1,623 |
| Equity and other contracts: | | | | | | |
| – equity swaps | **5,980** | **32** | **99** | 5,706 | 29 | 994 |
| – equity options purchased | **5,503** | **168** | **–** | 1,705 | 91 | – |
| – equity options written | **1,731** | **–** | **8** | 1,317 | – | 13 |
| – other equity contracts | **8** | **–** | **–** | 6 | – | – |
| – spot and forward contracts and others | **3,669** | **413** | **2** | 2,651 | 333 | – |
| | **16,891** | **613** | **109** | 11,385 | 453 | 1,007 |
| Total derivatives held for trading | **854,141** | **5,082** | **3,697** | 648,728 | 4,641 | 3,568 |
| **Derivatives embedded in financial assets designated at fair value** | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | **769** | **–** | **3** | 89 | 1 | – |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **140** | **–** | **9** | 1,160 | 17 | 13 |
| | **909** | **–** | **12** | 1,249 | 18 | 13 |
| **Cash flow hedge derivatives** | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **78,389** | **256** | **19** | 45,526 | 366 | 13 |
| **Fair value hedge derivatives** | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **27,122** | **255** | **955** | 21,028 | 25 | 657 |
| **Total derivatives** | **960,561** | **5,593** | **4,683** | 716,531 | 5,050 | 4,251 |

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

| | Bank | | | | | |
|---|---|---|---|---|---|---|
| | **2010** | | | 2009 | | |
| | **Contract amounts** | **Derivative assets** | **Derivative liabilities** | Contract amounts | Derivative assets | Derivative liabilities |
| **Derivatives held for trading** | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | **496,363** | **2,379** | **1,880** | 381,799 | 2,275 | 602 |
| – currency swaps | **17,366** | **190** | **139** | 20,837 | 260 | 132 |
| – currency options purchased | **41,220** | **60** | **–** | 30,606 | 83 | – |
| – currency options written | **46,694** | **–** | **127** | 40,105 | – | 199 |
| – other exchange rate contracts | **101** | **1** | **3** | 226 | 3 | 1 |
| | **601,744** | **2,630** | **2,149** | 473,573 | 2,621 | 934 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **227,205** | **1,662** | **1,509** | 166,030 | 1,543 | 1,612 |
| – interest rate options purchased | **25** | **–** | **–** | 143 | – | – |
| – interest rate options written | **25** | **–** | **–** | 142 | – | – |
| – other interest rate contracts | **1,554** | **–** | **–** | 407 | – | 1 |
| | **228,809** | **1,662** | **1,509** | 166,722 | 1,543 | 1,613 |
| Equity and other contracts: | | | | | | |
| – equity swaps | **7,997** | **59** | **125** | 7,366 | 29 | 998 |
| – equity options purchased | **1,732** | **8** | **–** | 1,296 | 13 | – |
| – equity options written | **1,731** | **–** | **8** | 1,317 | – | 13 |
| – other equity contracts | **8** | **–** | **–** | 6 | – | – |
| – spot and forward contracts and others | **3,695** | **413** | **2** | 2,808 | 334 | 1 |
| | **15,163** | **480** | **135** | 12,793 | 376 | 1,012 |
| Total derivatives held for trading | **845,716** | **4,772** | **3,793** | 653,088 | 4,540 | 3,559 |
| **Derivatives embedded in financial assets designated at fair value** | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **140** | **–** | **9** | 1,160 | 17 | 13 |
| **Cash flow hedge derivatives** | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **76,495** | **232** | **19** | 43,898 | 351 | 13 |
| **Fair value hedge derivatives** | | | | | | |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | **14,976** | **22** | **707** | 16,634 | 8 | 595 |
| **Total derivatives** | **937,327** | **5,026** | **4,528** | 714,780 | 4,916 | 4,180 |

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

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

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

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

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

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

The Group uses the approaches approved by the Hong Kong Monetary Authority to calculate the capital adequacy ratio in accordance with the Capital Rules. The risk-weighted assets at 31 December 2010 and 2009 were calculated based on the advanced internal ratings-based approach.

| | Group | | | Bank | | |
|---|---|---|---|---|---|---|
| | Contract amounts | Credit equivalent amounts | Risk-weighted amounts | Contract amounts | Credit equivalent amounts | Risk-weighted amounts |
| **2010** | | | | | | |
| Exchange rate contracts: | | | | | | |
| – spot and forward foreign exchange | 431,732 | 2,738 | 1,417 | 428,192 | 2,599 | 1,337 |
| – currency swaps | 17,366 | 433 | 70 | 17,366 | 433 | 70 |
| – currency options purchased | 41,755 | 820 | 642 | 41,762 | 820 | 642 |
| – other exchange rate contracts | 101 | 5 | – | 101 | 5 | – |
| | 490,954 | 3,996 | 2,129 | 487,421 | 3,857 | 2,049 |
| Interest rate contracts: | | | | | | |
| – interest rate swaps | 340,076 | 2,522 | 602 | 318,816 | 2,084 | 472 |
| – interest rate options purchased | 25 | – | – | 25 | – | – |
| – other interest rate contracts | – | – | – | – | – | – |
| | 340,101 | 2,522 | 602 | 318,841 | 2,084 | 472 |
| Equity and other contracts: | | | | | | |
| – equity swaps | 5,980 | 391 | 65 | 7,997 | 525 | 72 |
| – equity options purchased | 1,732 | 112 | 72 | 1,732 | 112 | 72 |
| – others | 17 | 2 | – | 33 | 4 | – |
| | 7,729 | 505 | 137 | 9,762 | 641 | 144 |

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

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

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

## 35. ADVANCES TO CUSTOMERS

### (a) Advances to customers

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Gross advances to customers | **474,473** | 346,586 | **424,506** | 300,842 |
| Less: loan impairment allowances | | | | |
| – individually assessed | **(1,118)** | (1,151) | **(844)** | (957) |
| – collectively assessed | **(718)** | (814) | **(588)** | (706) |
| | **472,637** | 344,621 | **423,074** | 299,179 |

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010 %** | 2009 % | **2010 %** | 2009 % |
| Loan impairment allowances: | | | | |
| – individually assessed | **0.24** | 0.33 | **0.20** | 0.32 |
| – collectively assessed | **0.15** | 0.23 | **0.14** | 0.23 |
| Total loan impairment allowances | **0.39** | 0.56 | **0.34** | 0.55 |

## 35. ADVANCES TO CUSTOMERS (continued)

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

| | Group | | |
|---|---|---|---|
| | Individually assessed | Collectively assessed | Total |
| **2010** | | | |
| At 1 January | **1,151** | **814** | **1,965** |
| Amounts written off | **(227)** | **(345)** | **(572)** |
| Recoveries of advances written off in previous years | **18** | **44** | **62** |
| New impairment allowances charged to income statement (note 16) | **296** | **313** | **609** |
| Impairment allowances released to income statement (note 16) | **(110)** | **(109)** | **(219)** |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | **(16)** | **(3)** | **(19)** |
| Exchange | **6** | **4** | **10** |
| At 31 December | **1,118** | **718** | **1,836** |
| 2009 | | | |
| At 1 January | 1,241 | 802 | 2,043 |
| Amounts written off | (394) | (526) | (920) |
| Recoveries of advances written off in previous years | 24 | 38 | 62 |
| New impairment allowances charged to income statement (note 16) | 564 | 540 | 1,104 |
| Impairment allowances released to income statement (note 16) | (254) | (38) | (292) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (30) | (2) | (32) |
| At 31 December | 1,151 | 814 | 1,965 |

| | Bank | | |
|---|---|---|---|
| | Individually assessed | Collectively assessed | Total |
| **2010** | | | |
| At 1 January | **957** | **706** | **1,663** |
| Amounts written off | **(211)** | **(344)** | **(555)** |
| Recoveries of advances written off in previous years | **7** | **44** | **51** |
| New impairment allowances charged to income statement (note 16) | **162** | **313** | **475** |
| Impairment allowances released to income statement (note 16) | **(65)** | **(128)** | **(193)** |
| Other movement | **–** | **–** | **–** |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | **(6)** | **(3)** | **(9)** |
| At 31 December | **844** | **588** | **1,432** |
| 2009 | | | |
| At 1 January | 1,046 | 695 | 1,741 |
| Amounts written off | (349) | (526) | (875) |
| Recoveries of advances written off in previous years | 9 | 37 | 46 |
| New impairment allowances charged to income statement (note 16) | 488 | 540 | 1,028 |
| Impairment allowances released to income statement (note 16) | (203) | (37) | (240) |
| Other movement | (16) | – | (16) |
| Unwinding of discount of loan impairment allowances recognised as "interest income" | (18) | (3) | (21) |
| At 31 December | 957 | 706 | 1,663 |

## 35. ADVANCES TO CUSTOMERS (continued)

### (c) Impaired advances and allowances

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Gross impaired advances | **1,990** | 2,508 | **1,462** | 1,761 |
| Individually assessed allowances | **(1,118)** | (1,151) | **(844)** | (957) |
| Net impaired advances | **872** | 1,357 | **618** | 804 |
| Individually assessed allowances as a percentage of gross impaired advances | **56.2%** | 45.9% | **57.7%** | 54.3% |
| Gross impaired advances as a percentage of gross advances to customers | **0.4%** | 0.7% | **0.3%** | 0.6% |

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Gross individually assessed impaired advances | **1,886** | 2,434 | **1,358** | 1,687 |
| Individually assessed allowances | **(1,118)** | (1,151) | **(844)** | (957) |
| | **768** | 1,283 | **514** | 730 |
| Gross individually assessed impaired advances as a percentage of gross advances to customers | **0.4%** | 0.7% | **0.3%** | 0.6% |
| Amount of collateral which has been taken into account in respect of individually assessed impaired advances to customers | **682** | 1,024 | **464** | 569 |

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

## 35. ADVANCES TO CUSTOMERS (continued)

### (d) Overdue advances

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

| | Group | | Bank | |
|---|---|---|---|---|
| | | % | | % |
| **2010** | | | | |
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of: | | | | |
| – more than three months but not more than six months | **137** | **–** | **126** | **–** |
| – more than six months but not more than one year | **89** | **–** | **88** | **–** |
| – more than one year | **1,147** | **0.3** | **904** | **0.3** |
| | **1,373** | **0.3** | **1,118** | **0.3** |
| of which: | | | | |
| – individually impaired allowances | **(994)** | | **(805)** | |
| – covered portion of overdue loans and advances | **354** | | **291** | |
| – uncovered portion of overdue loans and advances | **1,019** | | **827** | |
| – current market value held against the covered portion of overdue loans and advances | **586** | | **514** | |
| 2009 | | | | |
| Gross advances to customers which have been overdue with respect to either principal or interest for periods of: | | | | |
| – more than three months but not more than six months | 241 | 0.1 | 204 | 0.1 |
| – more than six months but not more than one year | 353 | 0.1 | 333 | 0.1 |
| – more than one year | 864 | 0.2 | 539 | 0.2 |
| | 1,458 | 0.4 | 1,076 | 0.4 |
| of which: | | | | |
| – individually impaired allowances | (984) | | (879) | |
| – covered portion of overdue loans and advances | 553 | | 231 | |
| – uncovered portion of overdue loans and advances | 905 | | 845 | |
| – current market value held against the covered portion of overdue loans and advances | 1,095 | | 580 | |

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

## 35. ADVANCES TO CUSTOMERS (continued)

### (e) Rescheduled advances

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

| | Group | | Bank | |
|---|---|---|---|---|
| | | % | | % |
| **2010** | **194** | **–** | **95** | **–** |
| 2009 | 703 | 0.2 | 423 | 0.1 |

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

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

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

Advances to customers by geographical area are classified according to the location of the counterparties after taking into account the transfer of risk. In general, risk transfer applies when an advance is guaranteed by a party located in an area that is different from that of the counterparty.

| | Group | | | | |
|---|---|---|---|---|---|
| | Gross advances to customers | Individually impaired advances to customers | Overdue advances to customers | Individually assessed allowances | Collectively assessed allowances |
| **At 31 December 2010** | | | | | |
| Hong Kong | **392,836** | **1,452** | **1,112** | **838** | **545** |
| Rest of Asia-Pacific | **76,308** | **345** | **257** | **234** | **162** |
| Others | **5,329** | **89** | **4** | **46** | **11** |
| | **474,473** | **1,886** | **1,373** | **1,118** | **718** |
| At 31 December 2009 | | | | | |
| Hong Kong | 308,457 | 1,842 | 1,076 | 915 | 695 |
| Rest of Asia-Pacific | 30,872 | 565 | 380 | 225 | 101 |
| Others | 7,257 | 27 | 2 | 11 | 18 |
| | 346,586 | 2,434 | 1,458 | 1,151 | 814 |

| | Bank | | | | |
|---|---|---|---|---|---|
| | Gross advances to customers | Individually impaired advances to customers | Overdue advances to customers | Individually assessed allowances | Collectively assessed allowances |
| **At 31 December 2010** | | | | | |
| Hong Kong | **374,776** | **1,308** | **1,094** | **831** | **528** |
| Rest of Asia-Pacific | **46,404** | **32** | **20** | **12** | **56** |
| Others | **3,326** | **18** | **4** | **1** | **4** |
| | **424,506** | **1,358** | **1,118** | **844** | **588** |
| At 31 December 2009 | | | | | |
| Hong Kong | 288,474 | 1,588 | 1,029 | 898 | 682 |
| Rest of Asia-Pacific | 7,265 | 82 | 45 | 58 | 14 |
| Others | 5,103 | 17 | 2 | 1 | 10 |
| | 300,842 | 1,687 | 1,076 | 957 | 706 |

## 35. ADVANCES TO CUSTOMERS (continued)

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

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

| | Group | | | |
|---|---|---|---|---|
| | **2010** | | 2009 | |
| | | **% of gross advances covered by collateral** | | % of gross advances covered by collateral |
| **Gross advances to customers for use in Hong Kong** | | | | |
| **Industrial, commercial and financial sectors** | | | | |
| – property development | **41,818** | **34.6** | 23,618 | 36.1 |
| – property investment | **99,023** | **84.1** | 75,264 | 82.3 |
| – financial concerns | **3,047** | **32.1** | 2,720 | 33.9 |
| – stockbrokers | **165** | **82.1** | 480 | 42.9 |
| – wholesale and retail trade | **11,439** | **43.3** | 7,812 | 49.5 |
| – manufacturing | **16,988** | **30.7** | 12,080 | 30.4 |
| – transport and transport equipment | **7,938** | **69.2** | 6,503 | 83.3 |
| – recreational activities | **532** | **99.6** | 37 | 41.4 |
| – information technology | **1,957** | **0.7** | 1,247 | 2.4 |
| – other | **27,815** | **43.1** | 24,405 | 43.9 |
| | **210,722** | **60.3** | 154,166 | 61.8 |
| **Individuals** | | | | |
| – advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme | **14,834** | **100.0** | 14,647 | 99.9 |
| – advances for the purchase of other residential properties | **112,394** | **100.0** | 96,651 | 99.7 |
| – credit card advances | **15,735** | **–** | 13,818 | – |
| – other | **13,776** | **30.9** | 11,961 | 45.3 |
| | **156,739** | **83.9** | 137,077 | 84.9 |
| **Total gross advances for use in Hong Kong** | **367,461** | **70.4** | 291,243 | 72.7 |
| **Trade finance** | **63,660** | **18.3** | 19,215 | 35.6 |
| **Gross advances for use outside Hong Kong** | **43,352** | **57.4** | 36,128 | 55.4 |
| **Gross advances to customers** | **474,473** | **62.2** | 346,586 | 68.8 |

## 35. ADVANCES TO CUSTOMERS (continued)

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

| | Bank | | | |
|---|---|---|---|---|
| | 2010 | | 2009 | |
| | | % of gross advances covered by collateral | | % of gross advances covered by collateral |
| **Gross advances to customers for use in Hong Kong** | | | | |
| **Industrial, commercial and financial sectors** | | | | |
| – property development | **41,818** | **34.6** | 23,618 | 36.1 |
| – property investment | **97,994** | **84.5** | 74,128 | 82.8 |
| – financial concerns | **3,047** | **32.1** | 2,720 | 33.9 |
| – stockbrokers | **165** | **82.1** | 480 | 42.9 |
| – wholesale and retail trade | **11,439** | **43.3** | 7,812 | 49.5 |
| – manufacturing | **16,987** | **30.7** | 12,079 | 30.4 |
| – transport and transport equipment | **7,102** | **65.9** | 4,841 | 77.6 |
| – recreational activities | **532** | **99.6** | 37 | 41.4 |
| – information technology | **1,957** | **0.7** | 1,247 | 2.4 |
| – other | **27,796** | **43.1** | 24,335 | 44.1 |
| | **208,837** | **60.2** | 151,297 | 61.5 |
| **Individuals** | | | | |
| – advances for the purchase of flats under the Government Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme | **5,695** | **100.0** | 3,446 | 99.6 |
| – advances for the purchase of other residential properties | **109,776** | **100.0** | 93,028 | 99.7 |
| – credit card advances | **15,735** | **–** | 13,818 | – |
| – other | **13,773** | **30.9** | 11,954 | 45.3 |
| | **144,979** | **82.6** | 122,246 | 83.1 |
| **Total gross advances for use in Hong Kong** | **353,816** | **69.4** | 273,543 | 71.2 |
| **Trade finance** | **63,660** | **18.3** | 19,215 | 35.6 |
| **Gross advances for use outside Hong Kong** | **7,030** | **22.4** | 8,084 | 17.2 |
| **Gross advances to customers** | **424,506** | **61.0** | 300,842 | 67.4 |

## 35. ADVANCES TO CUSTOMERS (continued)

### (h) Net investments in finance leases

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Finance leases | **9** | 24 | **9** | 24 |
| Hire purchase contracts | **5,751** | 5,630 | **4,918** | 3,963 |
| | **5,760** | 5,654 | **4,927** | 3,987 |

| | Group | | |
|---|---|---|---|
| | **Present value of minimum lease payments receivable** | **Interest income relating to future periods** | **Total minimum lease payments receivable** |
| **2010** | | | |
| Amounts receivable: | | | |
| – within one year | **260** | **54** | **314** |
| – after one year but within five years | **1,026** | **166** | **1,192** |
| – after five years | **4,500** | **1,029** | **5,529** |
| | **5,786** | **1,249** | **7,035** |
| Loans impairment allowances | **(26)** | | |
| Net investments in finance leases and hire purchase contracts | **5,760** | | |
| 2009 | | | |
| Amounts receivable: | | | |
| – within one year | 371 | 93 | 464 |
| – after one year but within five years | 1,486 | 312 | 1,798 |
| – after five years | 3,813 | 614 | 4,427 |
| | 5,670 | 1,019 | 6,689 |
| Loans impairment allowances | (16) | | |
| Net investments in finance leases and hire purchase contracts | 5,654 | | |

## 35. ADVANCES TO CUSTOMERS (continued)

### (h) Net investments in finance leases (continued)

| | Bank | | |
|---|---|---|---|
| | **Present value of minimum lease payments receivable** | **Interest income relating to future periods** | **Total minimum lease payments receivable** |
| **2010** | | | |
| Amounts receivable: | | | |
| – within one year | **189** | **36** | **225** |
| – after one year but within five years | **766** | **111** | **877** |
| – after five years | **3,994** | **977** | **4,971** |
| | **4,949** | **1,124** | **6,073** |
| Loans impairment allowances | **(22)** | | |
| Net investments in finance leases and hire purchase contracts | **4,927** | | |
| 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 | | |

## 36. FINANCIAL INVESTMENTS

| | Group 2010 | Group 2009 | Bank 2010 | Bank 2009 |
|---|---|---|---|---|
| Financial investments: | | | | |
| – which may be repledged or resold by counterparties | **207** | 141 | **207** | 141 |
| – which may not be repledged or resold or are not subject to repledge or resale by counterparties | **199,152** | 241,361 | **102,899** | 156,574 |
| | **199,359** | 241,502 | **103,106** | 156,715 |
| Held-to-maturity debt securities at amortised cost | **56,301** | 48,669 | **–** | – |
| Available-for-sale at fair value: | | | | |
| – debt securities | **142,732** | 192,486 | **102,985** | 156,568 |
| – equity shares | **326** | 347 | **121** | 147 |
| | **199,359** | 241,502 | **103,106** | 156,715 |
| Treasury bills | **18,010** | 53,973 | **17,225** | 49,277 |
| Certificates of deposit | **6,713** | 7,665 | **2,928** | 3,126 |
| Other debt securities | **174,310** | 179,517 | **82,832** | 104,165 |
| Debt securities | **199,033** | 241,155 | **102,985** | 156,568 |
| Equity shares | **326** | 347 | **121** | 147 |
| | **199,359** | 241,502 | **103,106** | 156,715 |

There was no overdue debt securities at 31 December 2010 (31 December 2009: Nil).

### (a) Held-to-maturity debt securities

| | Group 2010 | Group 2009 | Bank 2010 | Bank 2009 |
|---|---|---|---|---|
| Listed in Hong Kong | **997** | 634 | **–** | – |
| Listed outside Hong Kong | **9,822** | 5,627 | **–** | – |
| | **10,819** | 6,261 | **–** | – |
| Unlisted | **45,482** | 42,408 | **–** | – |
| | **56,301** | 48,669 | **–** | – |
| Issued by public bodies: | | | | |
| – central governments and central banks | **272** | 244 | **–** | – |
| – other public sector entities | **7,563** | 7,235 | **–** | – |
| | **7,835** | 7,479 | **–** | – |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | **36,225** | 32,145 | **–** | – |
| – corporate entities | **12,241** | 9,045 | **–** | – |
| | **48,466** | 41,190 | **–** | – |
| | **56,301** | 48,669 | **–** | – |
| Fair value of held-to-maturity debt securities: | | | | |
| – listed | **11,189** | 6,384 | **–** | – |
| – unlisted | **47,138** | 43,421 | **–** | – |
| | **58,327** | 49,805 | **–** | – |

There was no held-to-maturity debt securities determined to be impaired at 31 December 2010 for the Group and the Bank (31 December 2009: Nil).

## 36. FINANCIAL INVESTMENTS (continued)

### (b) Available-for-sale debt securities

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Listed in Hong Kong | **8,786** | 6,973 | **8,780** | 6,960 |
| Listed outside Hong Kong | **57,317** | 60,991 | **43,528** | 45,769 |
| | **66,103** | 67,964 | **52,308** | 52,729 |
| Unlisted | **76,629** | 124,522 | **50,677** | 103,839 |
| | **142,732** | 192,486 | **102,985** | 156,568 |
| Issued by public bodies: | | | | |
| – central governments and central banks | **38,735** | 64,532 | **28,757** | 58,372 |
| – other public sector entities | **15,478** | 17,830 | **10,371** | 14,974 |
| | **54,213** | 82,362 | **39,128** | 73,346 |
| Issued by other bodies: | | | | |
| – banks and other financial institutions | **83,075** | 101,167 | **60,100** | 77,782 |
| – corporate entities | **5,444** | 8,957 | **3,757** | 5,440 |
| | **88,519** | 110,124 | **63,857** | 83,222 |
| | **142,732** | 192,486 | **102,985** | 156,568 |

At 31 December 2010 and 2009, there were no available-for-sale debt securities individually determined to be impaired on the basis that there was objective evidence of impairment in the value of the debt securities for the Group and the Bank.

### (c) Available-for-sale equity shares

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Listed in Hong Kong | **47** | 60 | **–** | 5 |
| Listed outside Hong Kong | **64** | 85 | **64** | 85 |
| | **111** | 145 | **64** | 90 |
| Unlisted | **215** | 202 | **57** | 57 |
| | **326** | 347 | **121** | 147 |
| Issued by corporate entities | **326** | 347 | **121** | 147 |

There were no available-for-sale equity securities individually determined to be impaired during the year of 2010 for the Group and the Bank. For the year of 2009, certain available-for-sale equity securities of the Group and the Bank were individually determined to be impaired. Impairment losses on these investments were recognised in the income statement in accordance with the accounting policy set out in note 4(v)(ii).

## 37. INVESTMENTS IN SUBSIDIARIES

| | Bank | |
|---|---|---|
| | **2010** | 2009 |
| Unlisted shares, at cost | **11,584** | 11,584 |

The principal subsidiaries of the Bank are:

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

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

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

## 38. INTEREST IN ASSOCIATES

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Unlisted investments, at cost | **–** | – | **912** | 912 |
| Listed investments, at cost | **–** | – | **4,260** | 1,634 |
| Share of net assets | **15,119** | 9,691 | **–** | – |
| Intangible asset | **84** | 106 | **–** | – |
| Goodwill | **463** | 429 | **–** | – |
| | **15,666** | 10,226 | **5,172** | 2,546 |

The associates are:

| Name of company | Place of incorporation and operation | Principal activity | Group's interest in equity capital | Issued equity capital |
|---|---|---|---|---|
| **Unlisted** | | | | |
| Barrowgate Limited | Hong Kong SAR | Property investment | 24.64% | HK$10,000 |
| Yantai Bank Co., Ltd. (Formerly known as Yantai City Commercial Bank) | People's Republic of China | Banking | 20.00% | RMB2,000,000,000 |
| **Listed** | | | | |
| Industrial Bank Co., Ltd. | People's Republic of China | Banking | 12.80% | RMB5,992,000,000 |

Interest in associates included listed investment of HK$13,752 million (2009: HK$8,406 million). At the balance sheet date, the fair value of these investments, based on quoted market prices was HK$21,753 million (2009: HK$29,261 million).

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

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

The Group's interest in IB has been accounted for as an associate using the equity method as the Group has representation in both the Board and Executive Committee of IB, and the ability to participate in the decision making process.

For the year ended 31 December 2010, the financial results of IB and Yantai Bank were included in the financial statements based on financial statements drawn up to 30 September 2010, but taking into account any changes in the subsequent period from 1 October 2010 to 31 December 2010 that would materially affect the results. The Group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 "Investments in Associates" whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference must be no greater than three months.

## 38. INTEREST IN ASSOCIATES (continued)

The Bank participated IB rights issue in the first half of 2010 at an investment cost of RMB2.3 billion. This increased the Bank's equity interest in IB from 12.78 per cent to 12.80 per cent as at 31 December 2010. As there has been no change in the composition of major shareholders in IB or in the Bank's representation on its Board of Directors or Executive Committee, the Bank will continue to have the power to participate in the financial and operating policy decisions of IB, and will continue to account for its results using the equity method.

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

| | Assets | Liabilities | Equity | Revenue | Expenses | Profit |
|---|---|---|---|---|---|---|
| **2010** | | | | | | |
| 100 per cent | **2,173,920** | **2,061,507** | **112,413** | **49,336** | **29,003** | **20,333** |
| Group's effective interest | **281,332** | **266,213** | **15,119** | **6,462** | **3,801** | **2,661** |
| 2009 | | | | | | |
| 100 per cent | 1,473,189 | 1,402,699 | 70,490 | 34,418 | 21,038 | 13,380 |
| Group's effective interest | 191,044 | 181,353 | 9,691 | 4,496 | 2,748 | 1,748 |

There was no impairment loss on our interest in associates for the years ended 31 December 2010 and 2009.

## 39. INVESTMENT PROPERTIES

The Group's investment properties were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2010, and were updated for any material changes in the valuation as at 31 December 2010. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation for investment properties was open market value.

### (a) Movement of investment properties

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| At 1 January | **2,872** | 2,593 | **1,883** | 1,714 |
| Surplus on revaluation credited to income statement (note 22) | **474** | 250 | **291** | 153 |
| Transfer (to)/from assets held for sale | **(78)** | 16 | **(78)** | 16 |
| Transfer (to)/from premises (note 40(a)) | **(17)** | 13 | **4** | – |
| At 31 December | **3,251** | 2,872 | **2,100** | 1,883 |

### (b) Terms of lease

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| **Leaseholds** | | | | |
| Held in Hong Kong: | | | | |
| – long leases (over 50 years unexpired) | **1,086** | 1,272 | **533** | 506 |
| – medium leases (10 to 50 years unexpired) | **2,165** | 1,600 | **1,567** | 1,377 |
| Held outside Hong Kong: | | | | |
| – medium leases (10 to 50 years unexpired) | **–** | – | **–** | – |
| | **3,251** | 2,872 | **2,100** | 1,883 |

## 39. INVESTMENT PROPERTIES (continued)

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

The direct operating expenses arising from investment properties were HK$21 million in 2010 (2009: HK$21 million) for the Group and the Bank. Of this amount, HK$19 million (2009: HK$20 million) was the direct operating expenses from investment properties that generated rental income.

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Less than one year | **120** | 107 | **72** | 67 |
| Over one year but within five years | **91** | 54 | **59** | 35 |
| | **211** | 161 | **131** | 102 |

## 40. PREMISES, PLANT AND EQUIPMENT

The Group's premises were revalued by DTZ Debenham Tie Leung Limited, an independent professional valuer, at 30 November 2010, and were updated for any material changes in the valuation as at 31 December 2010. The valuations were carried out by qualified persons who are members of the Hong Kong Institute of Surveyors. The basis of the valuation of premises was open market value for existing use.

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

| | Group | | |
|---|---|---|---|
| | **Premises** | **Plant and equipment** | **Total** |
| **2010** | | | |
| Cost or valuation: | | | |
| At 1 January | **11,638** | **3,387** | **15,025** |
| Exchange adjustments | **20** | **15** | **35** |
| Additions | **585** | **175** | **760** |
| Disposals | **–** | **(75)** | **(75)** |
| Elimination of accumulated depreciation on revalued premises | **(329)** | **–** | **(329)** |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | **2,102** | **–** | **2,102** |
| – credited to income statement (note 22) | **3** | **–** | **3** |
| Transfer to assets held for sale | **(137)** | **–** | **(137)** |
| Transfer from investment property (note 39(a)) | **17** | **–** | **17** |
| At 31 December | **13,899** | **3,502** | **17,401** |
| Accumulated depreciation: | | | |
| At 1 January | **–** | **(2,611)** | **(2,611)** |
| Exchange adjustments | **–** | **(9)** | **(9)** |
| Charge for the year (note 17) | **(330)** | **(289)** | **(619)** |
| Written off on disposal | **–** | **70** | **70** |
| Elimination of accumulated depreciation on revalued premises | **329** | **–** | **329** |
| At 31 December | **(1)** | **(2,839)** | **(2,840)** |
| Net book value at 31 December | **13,898** | **663** | **14,561** |

## 40. PREMISES, PLANT AND EQUIPMENT (continued)

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

| | Group | | |
|---|---|---|---|
| | Premises (restated) | Plant and equipment | Total (restated) |
| 2009 | | | |
| Cost or valuation: | | | |
| At 1 January | 10,714 | 3,421 | 14,135 |
| Exchange adjustments | – | – | – |
| Additions | – | 160 | 160 |
| Disposals | – | (192) | (192) |
| Elimination of accumulated depreciation on revalued premises | (287) | – | (287) |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | 1,475 | – | 1,475 |
| – credited to income statement (note 22) | 2 | – | 2 |
| Transfer to assets held for sale | (253) | – | (253) |
| Transfer to investment property (note 39(a)) | (13) | – | (13) |
| Other | – | (2) | (2) |
| At 31 December | 11,638 | 3,387 | 15,025 |
| Accumulated depreciation: | | | |
| At 1 January | – | (2,492) | (2,492) |
| Charge for the year (note 17) | (287) | (304) | (591) |
| Written off on disposal | – | 185 | 185 |
| Elimination of accumulated depreciation on revalued premises | 287 | – | 287 |
| At 31 December | – | (2,611) | (2,611) |
| Net book value at 31 December | 11,638 | 776 | 12,414 |

## 40. PREMISES, PLANT AND EQUIPMENT (continued)

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

| | Bank | | |
|---|---|---|---|
| | Premises | Plant and equipment | Total |
| **2010** | | | |
| Cost or valuation: | | | |
| At 1 January | **8,837** | **3,006** | **11,843** |
| Additions | **–** | **114** | **114** |
| Disposals | **–** | **(66)** | **(66)** |
| Elimination of accumulated depreciation on revalued premises | **(259)** | **–** | **(259)** |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | **1,667** | **–** | **1,667** |
| – credited to income statement | **3** | **–** | **3** |
| Transfer to assets held for sale | **(137)** | **–** | **(137)** |
| Transfer to investment property (note 39(a)) | **(4)** | **–** | **(4)** |
| At 31 December | **10,107** | **3,054** | **13,161** |
| Accumulated depreciation: | | | |
| At 1 January | **–** | **(2,409)** | **(2,409)** |
| Charge for the year | **(259)** | **(226)** | **(485)** |
| Written off on disposal | **–** | **62** | **62** |
| Elimination of accumulated depreciation on revalued premises | **259** | **–** | **259** |
| At 31 December | **–** | **(2,573)** | **(2,573)** |
| Net book value at 31 December | **10,107** | **481** | **10,588** |

| | Bank | | |
|---|---|---|---|
| | Premises (restated) | Plant and equipment | Total (restated) |
| 2009 | | | |
| Cost or valuation: | | | |
| At 1 January | 8,144 | 3,050 | 11,194 |
| Additions | – | 142 | 142 |
| Disposals | – | (186) | (186) |
| Elimination of accumulated depreciation on revalued premises | (225) | – | (225) |
| Surplus on revaluation: | | | |
| – credited to premises revaluation reserve | 1,170 | – | 1,170 |
| – credited to income statement | 2 | – | 2 |
| Transfer to assets held for sale | (254) | – | (254) |
| At 31 December | 8,837 | 3,006 | 11,843 |
| Accumulated depreciation: | | | |
| At 1 January | – | (2,347) | (2,347) |
| Charge for the year | (225) | (243) | (468) |
| Written off on disposal | – | 181 | 181 |
| Elimination of accumulated depreciation on revalued premises | 225 | – | 225 |
| At 31 December | – | (2,409) | (2,409) |
| Net book value at 31 December | 8,837 | 597 | 9,434 |

## 40. PREMISES, PLANT AND EQUIPMENT (continued)

### (b) Terms of lease

The net book value of premises comprises:

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 (restated) | **2010** | 2009 (restated) |
| **Leaseholds** | | | | |
| Held in Hong Kong: | | | | |
| – long leases (over 50 years unexpired) | **1,031** | 1,583 | **759** | 796 |
| – medium leases (10 to 50 years unexpired) | **12,099** | 9,906 | **9,311** | 8,009 |
| – short leases (under 10 years unexpired) | **36** | 31 | **36** | 31 |
| Held outside Hong Kong: | | | | |
| – long leases (over 50 years unexpired) | **8** | 7 | **–** | – |
| – medium leases (10 to 50 years unexpired) | **725** | 111 | **1** | 1 |
| | **13,899** | 11,638 | **10,107** | 8,837 |

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 (restated) | **2010** | 2009 (restated) |
| Cost less accumulated depreciation at 31 December | **2,923** | 2,358 | **1,209** | 1,237 |

## 41. INTANGIBLE ASSETS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Present value of in-force long-term insurance business | **4,593** | 3,466 | **–** | – |
| Internally developed software | **429** | 385 | **428** | 384 |
| Acquired software | **43** | 34 | **14** | 15 |
| Goodwill | **329** | 329 | **–** | – |
| | **5,394** | 4,214 | **442** | 399 |

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

| | Group | |
|---|---|---|
| | **2010** | 2009 |
| At 1 January | **3,466** | 2,707 |
| Addition from current year new business | **803** | 747 |
| Movement from in-force business | **324** | 12 |
| At 31 December | **4,593** | 3,466 |

## 41. INTANGIBLE ASSETS (continued)

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

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

| | **2010** | 2009 |
|---|---|---|
| Risk discount rate | **11.0%** | 11.0% |
| Expenses inflation | **3.0%** | 3.0% |
| Average lapse rate: | | |
| – 1st year | **3.4%** | 3.4% |
| – 2nd year onwards | **1.3%** | 1.4% |

The sensitivity of PVIF valuation to changes in individual assumptions at the balance sheet dates is shown in note 61(d).

### (b) Goodwill

| | **Group** | | **Bank** | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| At 1 January and at 31 December | **329** | 329 | **–** | – |

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

During 2010, there was no impairment of goodwill (2009: Nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash-generating unit based on appraisal value with the carrying amount of its net assets, including attributable goodwill.

The appraisal value comprises HSIC's net assets (other than value of business acquired and goodwill) as at 31 December 2010, the present value of in-force long-term insurance business and the expected value of future business. The present value of the in-force long-term insurance business is determined by discounting future earnings expected from the current business, taking into account factors such as future mortality, lapse rates, levels of expenses and risk discount rate. The above details are shown in notes 41(a) and 61(d).

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

| | **Group** | | **Bank** | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Cost: | | | | |
| At 1 January | **666** | 532 | **641** | 522 |
| Additions | **155** | 152 | **140** | 138 |
| Disposals | **(5)** | (20) | **(5)** | (19) |
| Exchange and others | **1** | 2 | **–** | – |
| At 31 December | **817** | 666 | **776** | 641 |
| Accumulated amortisation: | | | | |
| At 1 January | **(247)** | (183) | **(242)** | (180) |
| Charge for the year (note 17) | **(102)** | (84) | **(96)** | (81) |
| Written off on disposals | **5** | 20 | **4** | 19 |
| Exchange and others | **(1)** | – | **–** | – |
| At 31 December | **(345)** | (247) | **(334)** | (242) |
| Net book value at 31 December | **472** | 419 | **442** | 399 |

During 2010, there was no impairment on internally developed application software and acquired software (2009: Nil).

## 42. OTHER ASSETS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Items in the course of collection from other banks | **4,673** | 4,343 | **4,673** | 4,343 |
| Prepayments and accrued income | **2,259** | 1,835 | **835** | 804 |
| Assets held for sale* | | | | |
| – repossessed assets | **12** | 47 | **7** | 30 |
| – other assets held for sale | **206** | – | **206** | – |
| Acceptances and endorsements | **3,751** | 3,584 | **2,363** | 2,435 |
| Retirement benefit assets | **95** | 86 | **95** | 86 |
| Other accounts | **1,310** | 1,174 | **608** | 538 |
| | **12,306** | 11,069 | **8,787** | 8,236 |

* There was no accumulated loss recognised directly in equity relating to assets held for sale for 2010 and 2009.

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

## 43. CURRENT, SAVINGS AND OTHER DEPOSIT ACCOUNTS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Current, savings and other deposit accounts: | | | | |
| – as stated in balance sheet | **683,628** | 636,369 | **649,144** | 612,014 |
| – structured deposits reported as trading liabilities (note 44) | **20,852** | 22,212 | **8,377** | 18,892 |
| | **704,480** | 658,581 | **657,521** | 630,906 |
| By type: | | | | |
| – demand and current accounts | **59,116** | 53,450 | **59,104** | 53,409 |
| – savings accounts | **466,158** | 437,440 | **456,818** | 429,062 |
| – time and other deposits | **179,206** | 167,691 | **141,599** | 148,435 |
| | **704,480** | 658,581 | **657,521** | 630,906 |

## 44. TRADING LIABILITIES

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Structured certificates of deposit in issue (note 46) | **26** | 478 | **26** | 478 |
| Other debt securities in issue (note 46) | **2,712** | 2,769 | **2,712** | 2,769 |
| Structured deposits (note 43) | **20,852** | 22,212 | **8,377** | 18,892 |
| Short positions in securities and others | **18,991** | 12,932 | **18,991** | 12,932 |
| | **42,581** | 38,391 | **30,106** | 35,071 |

## 45. FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| 4.125% callable fixed rate subordinated notes (note 50) | **–** | 1,003 | **–** | 1,003 |
| Liabilities to customers under investment contracts | **457** | 453 | **–** | – |
| | **457** | 1,456 | **–** | 1,003 |

The Bank has exercised its option to redeem the callable fixed rate notes at par of HK$1,000 million in June 2010. At 31 December 2009, the difference between the carrying amount and the contractual amount of subordinated notes payable at maturity for the Group and the Bank amounted to HK$3 million. The accumulated amount of the change in fair value attributable to change in credit risk for the Group and the Bank was HK$46 million and the change for the year ended 31 December 2009 was HK$8 million for the Group and the Bank.

## 46. CERTIFICATES OF DEPOSIT AND OTHER DEBT SECURITIES IN ISSUE

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Certificates of deposit and other debt securities in issue: | | | | |
| – as stated in balance sheet | **3,095** | 1,826 | **3,095** | 1,826 |
| – structured certificates of deposit in issue reported as trading liabilities (note 44) | **26** | 478 | **26** | 478 |
| – other structured debt securities in issue reported as trading liabilities (note 44) | **2,712** | 2,769 | **2,712** | 2,769 |
| | **5,833** | 5,073 | **5,833** | 5,073 |
| By type: | | | | |
| – certificates of deposit in issue | **3,121** | 2,304 | **3,121** | 2,304 |
| – other debt securities in issue | **2,712** | 2,769 | **2,712** | 2,769 |
| | **5,833** | 5,073 | **5,833** | 5,073 |

## 47. OTHER LIABILITIES

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Items in the course of transmission to other banks | **7,208** | 6,304 | **7,208** | 6,303 |
| Accruals | **2,385** | 2,039 | **1,783** | 1,668 |
| Acceptances and endorsements | **3,751** | 3,584 | **2,363** | 2,435 |
| Retirement benefit liabilities | **1,718** | 1,712 | **1,718** | 1,712 |
| Other | **1,956** | 1,646 | **2,362** | 2,215 |
| | **17,018** | 15,285 | **15,434** | 14,333 |

## 48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | 2010 | | | 2009 | | |
| | **Gross** | **Reinsurance** | **Net** | Gross | Reinsurance | Net |
| **Non-life insurance** | | | | | | |
| Unearned premiums | **227** | **(75)** | **152** | 192 | (52) | 140 |
| Notified claims | **160** | **(18)** | **142** | 146 | (19) | 127 |
| Claims incurred but not reported | **41** | **(9)** | **32** | 43 | (8) | 35 |
| Other | **49** | **(1)** | **48** | 47 | (1) | 46 |
| | **477** | **(103)** | **374** | 428 | (80) | 348 |
| **Policyholders' liabilities** | | | | | | |
| Life (non-linked) | **63,722** | **(35)** | **63,687** | 53,588 | (19) | 53,569 |
| Life (linked) | **226** | **–** | **226** | 224 | – | 224 |
| | **63,948** | **(35)** | **63,913** | 53,812 | (19) | 53,793 |
| | **64,425** | **(138)** | **64,287** | 54,240 | (99) | 54,141 |

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

The movement of liabilities under insurance contracts was as follows:

### (a) Non-life insurance

| | Group | | |
|---|---|---|---|
| | **Gross** | **Reinsurance** | **Net** |
| **2010** | | | |
| **Unearned premiums** | | | |
| At 1 January | **192** | **(52)** | **140** |
| Gross written premiums | **470** | **(122)** | **348** |
| Gross earned premiums | **(437)** | **96** | **(341)** |
| Exchange and other movements | **2** | **3** | **5** |
| At 31 December | **227** | **(75)** | **152** |
| **Notified and incurred but not reported claims** | | | |
| At 1 January | | | |
| – notified claims | **146** | **(19)** | **127** |
| – claims incurred but not reported | **43** | **(8)** | **35** |
| | **189** | **(27)** | **162** |
| Claims paid | **(113)** | **26** | **(87)** |
| Claims incurred | **134** | **(26)** | **108** |
| | **21** | **–** | **21** |
| Exchange and other movements | **(9)** | **–** | **(9)** |
| At 31 December | | | |
| – notified claims | **160** | **(18)** | **142** |
| – claims incurred but not reported | **41** | **(9)** | **32** |
| | **201** | **(27)** | **174** |
| **Other** | **49** | **(1)** | **48** |
| | **477** | **(103)** | **374** |

## 48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

### (a) Non-life insurance (continued)

| | 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 |

## 48. LIABILITIES TO CUSTOMERS UNDER INSURANCE CONTRACTS (continued)

### (b) Policyholders' liabilities

| | Group | | |
|---|---|---|---|
| | **Gross** | **Reinsurance** | **Net** |
| **2010** | | | |
| **Life (non-linked)** | | | |
| At 1 January | **53,588** | **(19)** | **53,569** |
| Benefits paid | **(2,402)** | **22** | **(2,380)** |
| Claims incurred and movement in policyholders' liabilities | **12,487** | **(36)** | **12,451** |
| Exchange and other movements | **49** | **(2)** | **47** |
| At 31 December | **63,722** | **(35)** | **63,687** |
| **Life (linked)** | | | |
| At 1 January | **224** | **–** | **224** |
| Benefits paid | **(24)** | **–** | **(24)** |
| Claims incurred and movement in policyholders' liabilities | **28** | **–** | **28** |
| Exchange and other movements | **(2)** | **–** | **(2)** |
| At 31 December | **226** | **–** | **226** |
| | **63,948** | **(35)** | **63,913** |

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

## 49. CURRENT TAX AND DEFERRED TAX

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 (restated) | **2010** | 2009 (restated) |
| Current taxation recoverable (included in "Other assets") | **12** | 5 | **–** | – |
| Deferred tax assets | **–** | 16 | **–** | 2 |
| | **12** | 21 | **–** | 2 |
| Current tax liabilities: | | | | |
| Provision for Hong Kong profits tax | **337** | 41 | **316** | 2 |
| Provision for taxation outside Hong Kong | **7** | 11 | **4** | 8 |
| | **344** | 52 | **320** | 10 |
| Deferred tax liabilities | **3,234** | 2,460 | **1,617** | 1,345 |
| | **3,578** | 2,512 | **1,937** | 1,355 |

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

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

| | Group | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Depreciation allowances in excess of related depreciation** | **Revaluation of properties** | **Loan impairment allowances** | **Fair value adjustments for available-for-sale financial assets** | **Cash flow hedge** | **Other** | **Total** |
| **2010** | | | | | | | |
| At 1 January | **119** | **1,964** | **(99)** | **5** | **35** | **420** | **2,444** |
| (Credited)/charged to income statement (note 23(a)) | **(13)** | **40** | **14** | **–** | **–** | **401** | **442** |
| Charged/(credited) to reserves | **–** | **344** | **–** | **23** | **(21)** | **2** | **348** |
| At 31 December | **106** | **2,348** | **(85)** | **28** | **14** | **823** | **3,234** |
| 2009 (restated) | | | | | | | |
| At 1 January | 124 | 1,758 | (99) | (476) | 104 | (241) | 1,170 |
| (Credited)/charged to income statement (note 23(a)) | (5) | 24 | – | – | – | 352 | 371 |
| Charged/(credited) to reserves | – | 182 | – | 481 | (69) | 309 | 903 |
| At 31 December | 119 | 1,964 | (99) | 5 | 35 | 420 | 2,444 |

## 49. CURRENT TAX AND DEFERRED TAX (continued)

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

Bank

| | Depreciation allowances in excess of related depreciation | Revaluation of properties | Loan impairment allowances | Fair value adjustments for available-for-sale financial assets | Cash flow hedge | Other | Total |
|---|---|---|---|---|---|---|---|
| **2010** | | | | | | | |
| At 1 January | **118** | **1,578** | **(98)** | **4** | **35** | **(294)** | **1,343** |
| (Credited)/charged to income statement | **(17)** | **16** | **14** | **–** | **–** | **(15)** | **(2)** |
| Charged/(credited) to reserves | **–** | **274** | **–** | **21** | **(21)** | **2** | **276** |
| At 31 December | **101** | **1,868** | **(84)** | **25** | **14** | **(307)** | **1,617** |
| 2009 (restated) | | | | | | | |
| At 1 January | 126 | 1,431 | (98) | (480) | 104 | (610) | 473 |
| (Credited)/charged to income statement | (8) | 14 | – | – | – | 7 | 13 |
| Charged/(credited) to reserves | – | 133 | – | 484 | (69) | 309 | 857 |
| At 31 December | 118 | 1,578 | (98) | 4 | 35 | (294) | 1,343 |

### (c) Deferred tax assets not recognised

At the end of the balance sheet dates, the Group has not recognised deferred tax assets in respect of tax losses and revaluation loss on debt securities of subsidiaries amounting to HK$70 million (2009: HK$25 million) which are considered unlikely to be utilised. Of this amount, HK$40 million (2009: HK$25 million) has no expiry date and HK$30 million (2009: Nil) is scheduled to expire within five years.

### (d) Deferred tax liabilities not recognised

There were no deferred tax liabilities not recognised in 2010 (2009: Nil).

## 50. SUBORDINATED LIABILITIES

| | | Group 2010 | Group 2009 | Bank 2010 | Bank 2009 |
|---|---|---|---|---|---|
| Nominal value | Description | | | | |
| **Amount owed to third parties** | | | | | |
| HK$1,500 million | Callable floating rate subordinated notes due June 2015 (1) | **–** | 1,499 | **–** | 1,499 |
| HK$1,000 million | 4.125% callable fixed rate subordinated notes due June 2015 (1) | **–** | 1,003 | **–** | 1,003 |
| US$450 million | Callable floating rate subordinated notes due July 2016 (2) | **3,495** | 3,483 | **3,495** | 3,483 |
| US$300 million | Callable floating rate subordinated notes due July 2017 (3) | **2,328** | 2,321 | **2,328** | 2,321 |
| **Amount owed to HSBC Group undertakings** | | | | | |
| US$260 million | Callable floating rate subordinated loan debt due December 2015 (4) | **–** | 2,017 | **–** | 2,017 |
| US$775 million | Floating rate subordinated loan debt due December 2020 (4) | **6,025** | – | **6,025** | – |
| | | **11,848** | 10,323 | **11,848** | 10,323 |
| Representing: | | | | | |
| – measured at amortised cost | | **11,848** | 9,320 | **11,848** | 9,320 |
| – designated at fair value (note 45) | | **–** | 1,003 | **–** | 1,003 |
| | | **11,848** | 10,323 | **11,848** | 10,323 |

The above subordinated notes (excluding the subordinated loan debt due December 2020) each carries a one-time call option exercisable by the Group on a day falling five years plus one day after the relevant date of issue/drawdown.

(1) The Bank has exercised its option to redeem these subordinated notes at par of HK$2,500 million in aggregate in June 2010.

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

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

(4) The Bank has exercised its option to redeem this subordinated loan debt at par of US$260 million and replenished by a new issue of US$775 million subordinated loan debt in December 2010.

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

## 51. SHARE CAPITAL

Authorised:

The authorised share capital of the Bank is HK$11,000 million (2009: HK$11,000 million) divided into 2,200 million shares (2009: 2,200 million shares) of HK$5 each.

| | 2010 | 2009 |
|---|---|---|
| Issued and fully paid: | | |
| 1,911,842,736 shares (2009: 1,911,842,736 shares) of HK$5 each | **9,559** | 9,559 |

During the year, the Bank made no repurchase of its own shares (2009: Nil).

## 52. RESERVES

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

| | Bank | |
|---|---|---|
| | **2010** | 2009 (restated) |
| Retained profits (including proposed dividends) | **23,270** | 21,527 |
| Premises revaluation reserve | **7,654** | 6,447 |
| Cash flow hedging reserve | **72** | 180 |
| Available-for-sale investment reserve: | | |
| – on debt securities | **109** | (51) |
| – on equity securities | **34** | 50 |
| Capital redemption reserve | **99** | 99 |
| Other reserves | **524** | 459 |
| Total reserves (including proposed dividends) | **31,762** | 28,711 |
| **Retained profits (including proposed dividends)** | | |
| At beginning of the year | **21,527** | 21,305 |
| Dividends to shareholders: | | |
| – dividends approved in respect of the previous year | **(3,633)** | (5,736) |
| – dividends declared in respect of the current year | **(6,309)** | (6,309) |
| Transfer | **185** | 429 |
| Total comprehensive income for the year | **11,500** | 11,838 |
| | **23,270** | 21,527 |
| **Premises revaluation reserve** | | |
| At beginning of the year | **6,447** | 5,839 |
| Transfer | **(185)** | (429) |
| Total comprehensive income for the year | **1,392** | 1,037 |
| | **7,654** | 6,447 |
| **Cash flow hedging reserve** | | |
| At beginning of the year | **180** | 528 |
| Total comprehensive income for the year | **(108)** | (348) |
| | **72** | 180 |
| **Available-for-sale investment reserve** | | |
| At beginning of the year | **(1)** | (2,355) |
| Total comprehensive income for the year | **144** | 2,354 |
| | **143** | (1) |
| **Capital redemption reserve** | | |
| At beginning of the year | **99** | 99 |
| Total comprehensive income for the year | **–** | – |
| | **99** | 99 |
| **Other reserve** | | |
| At beginning of the year | **459** | 420 |
| Costs of share-based payment arrangements | **64** | 35 |
| Total comprehensive income for the year | **1** | 4 |
| | **524** | 459 |
| Total reserves (including proposed dividends) | **31,762** | 28,711 |

## 52. RESERVES (continued)

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

### Regulatory reserve

To satisfy the provisions of the Hong Kong Banking Ordinance and local regulatory requirements for prudential supervision purposes, the Group has earmarked a "regulatory reserve" from retained profits. Movements in the reserve are made directly through retained earnings. As at 31 December 2010, the effect of this requirement is to restrict the amount of reserves which can be distributed by the Group to shareholders by HK$1,654 million (2009: HK$920 million).

### Retained profits

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

### Premises revaluation reserve

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

The premises revaluation reserve included HK$117 million in relation to a premise classified as assets held for sale, included in "Other assets" in the consolidated balance sheet at 31 December 2010 (31 December 2009: Nil).

### Cash flow hedging reserve

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

### Available-for-sale investment reserve

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

### Capital redemption reserve

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

### Other reserves

Other reserves mainly comprise foreign exchange reserve and share-based payment reserve. The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations. The share-based payment reserve is used to record the corresponding amount of share options granted by ultimate holding company to the Group's employees and other cost of share-based payment arrangement. Other reserves also included the gain on dilution of investment in an associate of HK$1,465 million transferred from retained profits.

At 31 December 2010, the aggregate amount of reserves available for distribution to equity shareholders of the Bank as calculated under the provision of section 79B of the Hong Kong Companies Ordinance amounted to HK$20,556 million (2009: HK$19,568 million). After considering regulatory capital requirement and business development needs, an amount of HK$3,633 million has been declared as the proposed fourth interim dividends in respect of the financial year ended 31 December 2010 (2009: HK$3,633 million). The difference between the aggregate distributable reserves of HK$20,556 million and the Bank's retained profit of HK$23,270 million as reported above mainly represents the exclusion of unrealised revaluation gain on investment properties and the above regulatory reserve of the Bank.

## 53. RECONCILIATION OF CASH FLOW STATEMENT

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

| | 2010 | 2009 (restated) |
|---|---|---|
| Operating profit | **14,085** | 13,214 |
| Net interest income | **(14,300)** | (14,023) |
| Dividend income | **(14)** | (16) |
| Loan impairment charges and other credit risk provisions | **390** | 812 |
| Impairment of available-for-sale equity securities | **–** | 4 |
| Depreciation | **619** | 591 |
| Amortisation of intangible assets | **102** | 84 |
| Amortisation of available-for-sale investments | **80** | 76 |
| Amortisation of held-to-maturity debt securities | **5** | 1 |
| Advances written off net of recoveries | **(510)** | (858) |
| Interest received | **15,219** | 11,126 |
| Interest paid | **(2,301)** | (1,478) |
| **Operating profit before changes in working capital** | **13,375** | 9,533 |
| Change in treasury bills and certificates of deposit with original maturity more than three months | **32,409** | (41,353) |
| Change in placings with and advances to banks maturing after one month | **(26,155)** | (5,418) |
| Change in trading assets | **24,451** | 77,386 |
| Change in financial assets designated at fair value | **501** | 797 |
| Change in derivative financial instruments | **(111)** | (8,640) |
| Change in advances to customers | **(127,906)** | (15,454) |
| Change in other assets | **(15,680)** | (4,416) |
| Change in financial liabilities designated at fair value | **(2)** | 8 |
| Change in current, savings and other deposit accounts | **47,259** | 74,186 |
| Change in deposits from banks | **10,716** | (6,566) |
| Change in trading liabilities | **4,190** | (9,891) |
| Change in certificates of deposit and other debt securities in issue | **1,269** | (946) |
| Change in other liabilities | **15,448** | 4,048 |
| Elimination of exchange differences and other non-cash items | **(8,158)** | (5,538) |
| **Cash (used in)/generated from operating activities** | **(28,394)** | 67,736 |
| Taxation paid | **(1,704)** | (1,921) |
| **Net cash (outflow)/inflow from operating activities** | **(30,098)** | 65,815 |

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

| | 2010 | 2009 |
|---|---|---|
| Cash and balances with banks and other financial institutions | **44,411** | 22,086 |
| Placings with and advances to banks and other financial institutions maturing within one month | **53,457** | 74,459 |
| Treasury bills | **20,692** | 40,214 |
| | **118,560** | 136,759 |

The balances of cash and cash equivalents included cash balances with central banks and financial institutions that are subject to exchange control and regulatory restrictions, amounting to HK$13,331 million at 31 December 2010 (2009: HK$8,410 million).

## 54. CONTINGENT LIABILITIES AND COMMITMENTS

### a) Off-balance sheet contingent liabilities and commitments

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

For the purposes of these financial statements, acceptances and endorsements are recognised on the balance sheet in "Other assets" and "Other liabilities" in accordance with HKAS 39. For the purpose of the Banking (Capital) Rules ("the Capital Rules"), acceptances and endorsements are included in the capital adequacy calculation as if they were contingencies. The contract amount of acceptances and endorsements included in the below tables for the Group and the Bank were HK$3,751 million (2009: HK$3,584 million) and HK$2,363 million (2009: HK$2,435 million) respectively.

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

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

The risk-weighted assets at balance sheet dates were calculated based on the "Advanced internal ratings-based approach".

| | Group | | | Bank | | |
|---|---|---|---|---|---|---|
| | **Contract amounts** | **Credit equivalent amounts** | **Risk-weighted amounts** | **Contract amounts** | **Credit equivalent amounts** | **Risk-weighted amounts** |
| **2010** | | | | | | |
| Direct credit substitutes | **4,365** | **4,220** | **3,231** | **3,263** | **3,118** | **2,129** |
| Transaction-related contingencies | **455** | **337** | **168** | **351** | **300** | **134** |
| Trade-related contingencies | **10,593** | **3,516** | **2,008** | **8,935** | **2,737** | **1,530** |
| Forward asset purchases | **51** | **51** | **51** | **51** | **51** | **51** |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | | | | | |
| – not unconditionally cancellable* | **38,273** | **17,788** | **7,479** | **34,363** | **15,191** | **5,767** |
| – unconditionally cancellable | **198,724** | **66,852** | **20,649** | **170,333** | **60,379** | **15,042** |
| | **252,461** | **92,764** | **33,586** | **217,296** | **81,776** | **24,653** |

## 54. CONTINGENT LIABILITIES AND COMMITMENTS (continued)

### a) Off-balance sheet contingent liabilities and commitments (continued)

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

* The contract amount for undrawn formal standby facilities, credit lines and other commitments to lend with original maturity of "not more than one year" and "more than one year" as at 31 December 2010 were HK$13,264 million and HK$25,009 million respectively (2009: HK$13,371 million and HK$15,698 million).

### b) Contingencies

There is no material litigation expected to result in a significant adverse effect on the financial position of the Group, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

## 55. ASSETS PLEDGED AS SECURITY FOR LIABILITIES

At 31 December 2010, liabilities of the Group and the Bank which were secured by the deposit of assets, including assets subject to sale and repurchase arrangements for the Group and the Bank amounted to HK$18,971 million (Group and Bank in 2009: HK$12,929 million). The amounts of assets pledged to secure these liabilities by the Group and the Bank amounted to HK$19,270 million (Group and Bank in 2009: HK$13,153 million) and mainly comprised items included in "Trading assets" and "Financial investments".

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

## 56. CAPITAL COMMITMENTS

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Expenditure authorised and contracted for | **162** | 73 | **121** | 65 |
| Expenditure authorised but not contracted for | **–** | – | **–** | – |

## 57. LEASE COMMITMENTS

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

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Within one year | **454** | 414 | **338** | 296 |
| Between one and five years | **717** | 360 | **611** | 256 |
| Over five years | **14** | – | **–** | – |
| | **1,185** | 774 | **949** | 552 |

## 58. EMPLOYEE RETIREMENT BENEFITS

### (a) Defined benefit schemes

The Group operates three defined benefit schemes, the Hang Seng Bank Limited Defined Benefit Scheme ("HSBDBS"), which is the principal scheme which covers about 40 per cent of the Group's employees, and two other schemes, the Hang Seng Bank Limited Pension Scheme ("HSBPS") and the Hang Seng Bank Limited Non-contributory Terminal Benefits Scheme ("HSBNTBS"). HSBDBS was closed to new entrants with effect from 1 April 1999, and HSBPS and HSBNTBS were closed to new entrants with effect from 31 December 1986.

These schemes are funded defined benefit schemes and are administered by trustees with assets held separately from those of the Group. The latest annual actuarial valuations at 31 December 2010 were performed by E Chiu, fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Ltd, a fellow subsidiary company of the Bank, using the Projected Unit Credit Method. The amounts recognised in the balance sheet at year-end and retirement benefits costs recognised in the income statement for the year in respect of these defined benefit schemes are set out below.

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

| | Group and Bank | | |
|---|---|---|---|
| | **HSBDBS** | **HSBPS** | **HSBNTBS** |
| **2010** | | | |
| Present value of funded obligations (note 58(a)(iii)) | **(5,710)** | **(157)** | **(2)** |
| Fair value of scheme assets (note 58(a)(iv)) | **3,992** | **222** | **32** |
| Net (liabilities)/assets recognised in the balance sheet (note 58(a)(v)) | **(1,718)** | **65** | **30** |
| Reported as "Assets" | **–** | **65** | **30** |
| Reported as "Liabilities" | **(1,718)** | **–** | **–** |
| | **(1,718)** | **65** | **30** |
| Obligations covered by scheme assets (%) | **70** | **141** | **1,600** |
| 2009 | | | |
| Present value of funded obligations (note 58(a)(iii)) | (5,557) | (170) | (2) |
| Fair value of scheme assets (note 58(a)(iv)) | 3,845 | 225 | 33 |
| Net (liabilities)/assets recognised in the balance sheet (note 58(a)(v)) | (1,712) | 55 | 31 |
| Reported as "Assets" | – | 55 | 31 |
| Reported as "Liabilities" | (1,712) | – | – |
| | (1,712) | 55 | 31 |
| Obligations covered by scheme assets (%) | 69 | 132 | 1,650 |

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

On an on-going basis, the actuarial value of the principal scheme assets of HSBDBS represented 97 per cent (2009: 100 per cent) of the benefits accrued to scheme members, after allowing for expected future increases in salaries, and the resulting deficit amounted to HK$109 million (surplus in 2009: HK$14 million). On a wind-up basis, the actuarial value of the scheme assets represented 102 per cent (2009: 100 per cent) of the members' vested benefits, based on salaries at that date, and the resulting surplus amounted to HK$71 million (surplus in 2009: HK$19 million).

## 58. EMPLOYEE RETIREMENT BENEFITS (continued)

### (a) Defined benefit schemes (continued)

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

| | Group and Bank | | |
|---|---|---|---|
| | **HSBDBS** | **HSBPS** | **HSBNTBS** |
| **2010** | | | |
| Equity | **1,297** | **29** | **–** |
| Bonds | **2,570** | **170** | **–** |
| Certificates of deposit issued by the Bank | **–** | **–** | **–** |
| Ordinary shares issued by ultimate holding company | **45** | **–** | **–** |
| Other | **80** | **23** | **32** |
| | **3,992** | **222** | **32** |
| 2009 | | | |
| Equity | 945 | 28 | – |
| Bonds | 2,724 | 171 | – |
| Certificates of deposit issued by the Bank | – | – | – |
| Ordinary shares issued by ultimate holding company | 48 | – | – |
| Other | 128 | 26 | 33 |
| | 3,845 | 225 | 33 |

#### (iii) Change in the present value of scheme obligations

| | Group and Bank | | |
|---|---|---|---|
| | **HSBDBS** | **HSBPS** | **HSBNTBS** |
| **2010** | | | |
| At 1 January | **5,557** | **170** | **2** |
| Current service cost | **267** | **–** | **–** |
| Interest cost | **141** | **4** | **–** |
| Actuarial losses/(gains) | **51** | **(3)** | **1** |
| Benefits paid | **(306)** | **(14)** | **(1)** |
| At 31 December | **5,710** | **157** | **2** |
| 2009 | | | |
| At 1 January | 6,961 | 219 | 3 |
| Current service cost | 349 | – | – |
| Interest cost | 82 | 3 | – |
| Actuarial gains | (1,491) | (37) | (1) |
| Benefits paid | (344) | (15) | – |
| At 31 December | 5,557 | 170 | 2 |

## 58. EMPLOYEE RETIREMENT BENEFITS (continued)
### (a) Defined benefit schemes (continued)
### (iv) Change in the fair value of scheme assets

| | Group and Bank | | |
|---|---|---|---|
| | HSBDBS | HSBPS | HSBNTBS |
| **2010** | | | |
| At 1 January | **3,845** | **225** | **33** |
| Contributions by the Bank | **183** | **–** | **–** |
| Expected return on scheme assets | **212** | **8** | **1** |
| Experience gains/(losses) | **58** | **3** | **(1)** |
| Benefits paid | **(306)** | **(14)** | **(1)** |
| At 31 December | **3,992** | **222** | **32** |
| 2009 | | | |
| At 1 January | 3,430 | 218 | 33 |
| Contributions by the Bank | 212 | – | – |
| Expected return on scheme assets | 211 | 9 | 1 |
| Experience gains/(losses) | 336 | 13 | (1) |
| Benefits paid | (344) | (15) | – |
| At 31 December | 3,845 | 225 | 33 |

The Group and the Bank expect to make HK$231 million of contributions to defined benefit schemes during the following year (2009: HK$188 million).

### (v) Movements in the net (liabilities)/assets recognised in the balance sheet are as follows:

| | Group and Bank | | |
|---|---|---|---|
| | HSBDBS | HSBPS | HSBNTBS |
| **2010** | | | |
| At 1 January | **(1,712)** | **55** | **31** |
| Contributions by the Bank | **183** | **–** | **–** |
| Net (expense)/income recognised in the income statement (note 58(a)(vi)) | **(196)** | **4** | **1** |
| Net actuarial gains/(losses) | **7** | **6** | **(2)** |
| At 31 December | **(1,718)** | **65** | **30** |
| Experience losses on scheme liabilities | **(14)** | **(1)** | **(1)** |
| Experience gains/(losses) on scheme assets | **58** | **3** | **(1)** |
| (Losses)/gains from change in actuarial assumptions | **(37)** | **4** | **–** |
| Net actuarial gains/(losses) | **7** | **6** | **(2)** |
| 2009 | | | |
| At 1 January | (3,531) | (1) | 30 |
| Contributions by the Bank | 212 | – | – |
| Net (expense)/income recognised in the income statement (note 58(a)(vi)) | (220) | 6 | 1 |
| Net actuarial gains | 1,827 | 50 | – |
| At 31 December | (1,712) | 55 | 31 |
| Experience gains on scheme liabilities | 288 | 5 | – |
| Experience gains/(losses) on scheme assets | 336 | 13 | (1) |
| Gains from change in actuarial assumptions | 1,203 | 32 | 1 |
| Net actuarial gains | 1,827 | 50 | – |

## 58. EMPLOYEE RETIREMENT BENEFITS (continued)

### (a) Defined benefit schemes (continued)

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

| | Group | | |
|---|---|---|---|
| | HSBDBS | HSBPS | HSBNTBS |
| **2010** | | | |
| Current service cost | **(267)** | **–** | **–** |
| Interest cost | **(141)** | **(4)** | **–** |
| Expected return on scheme assets | **212** | **8** | **1** |
| Net (expense)/income for the year (note 17) | **(196)** | **4** | **1** |
| Actual return on scheme assets | **270** | **11** | **–** |
| 2009 | | | |
| Current service cost | (349) | – | – |
| Interest cost | (82) | (3) | – |
| Expected return on scheme assets | 211 | 9 | 1 |
| Net (expense)/income for the year (note 17) | (220) | 6 | 1 |
| Actual return on scheme assets | 547 | 22 | – |

The net actuarial gains recognised in the Group's retained profit during 2010 in respect of defined benefit schemes were HK$9 million (net actuarial gains of HK$1,568 million during 2009). The total cumulative amount of actuarial losses recognised in the retained profit was HK$1,902 million (2009: the cumulative amount of actuarial losses was HK$1,911 million). The total effect of the limit on schemes surpluses in 2010 and 2009 in respect of defined benefit schemes was nil.

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

| | Group and Bank | | |
|---|---|---|---|
| | HSBDBS % | HSBPS % | HSBNTBS % |
| **2010** | | | |
| Discount rate | **2.9** | **2.9** | **2.9** |
| Expected rate of return on scheme assets | **4.5** | **4.0** | **2.5** |
| Expected rate of salary increases | **5.0** | **5.0** | **5.0** |
| Expected rate of pension increases | **–** | **1.0** | **–** |
| 2009 | % | % | % |
| Discount rate | 2.6 | 2.6 | 2.6 |
| Expected rate of return on scheme assets | 5.5 | 4.0 | 3.0 |
| Expected rate of salary increases | 5.0 | 5.0 | 5.0 |
| Expected rate of pension increases | – | 1.0 | – |

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

## 58. EMPLOYEE RETIREMENT BENEFITS (continued)

### (a) Defined benefit schemes (continued)

#### (viii) Amounts for the current and previous years

| | Group and Bank | | | | |
|---|---|---|---|---|---|
| | **2010** | 2009 | 2008 | 2007 | 2006 |
| Defined benefit obligations | **5,869** | 5,729 | 7,183 | 5,913 | 3,905 |
| Plan assets | **4,246** | 4,103 | 3,681 | 5,388 | 4,728 |
| Net (deficits)/surpluses | **(1,623)** | (1,626) | (3,502) | (525) | 823 |
| Experience (losses)/gains on scheme liabilities | **(16)** | 293 | 260 | (212) | (36) |
| Experience gains/(losses) on scheme assets | **60** | 348 | (1,989) | 416 | 413 |
| (Losses)/gains from change in actuarial assumptions | **(33)** | 1,236 | (1,287) | (1,711) | (113) |

### (b) Defined contribution schemes

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

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

| | **2010** | 2009 |
|---|---|---|
| Amounts charged to the income statement (note 17) | **78** | 74 |

Under the schemes, the Group's contributions are reduced by contributions forfeited by those employees who leave the schemes prior to the contributions vesting fully. There was no forfeited contributions utilised during the year or available at the year-end to reduce future contributions (2009: Nil).

## 59. SHARE-BASED PAYMENTS

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

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

The Savings-Related Share Option Plan, invites eligible employees to enter into savings contracts to save Hong Kong dollar equivalent of up to £250 per month, with the option to use the savings to acquire shares. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contract depending on conditions set at grant. There is generally one Savings-Related Share Option Plan grant each year (in April or May). The exercise price is at a 20 per cent (2009: 20 per cent) discount to the market value at the date of grant.

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

## 59. SHARE-BASED PAYMENTS (continued)

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

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

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

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **Weighted average exercise price £** | **Number ('000)** | Weighted average exercise price £ | Number ('000) |
| Outstanding at 1 January | **5.82** | **29** | 6.55 | 543 |
| Exercised in the year | **5.82** | **(23)** | 5.64 | (171) |
| Lapsed in the year | **5.82** | **(6)** | 6.55 | (387) |
| Adjustment for rights issue | **–** | **–** | 5.69 | 44 |
| Outstanding at 31 December | **–** | **–** | 5.82 | 29 |
| Exercisable at 31 December | **–** | **–** | – | – |

The weighted average share price at the date of exercise for share options exercised during the year was £6.53 (2009: £6.56).

There was no option outstanding at the end of the year 2010. The option outstanding at 31 December 2009 had an exercise price of £5.82 with a weighted average remaining contractual life of 1.08 years.

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

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **Weighted average exercise price HK$** | **Number ('000)** | Weighted average exercise price HK$ | Number ('000) |
| Outstanding at 1 January | **38.30** | **12,193** | 106.14 | 2,296 |
| Granted in the year | **62.97** | **1,561** | 37.88 | 12,292 |
| Exercised in the year | **37.98** | **(1,749)** | 90.14 | (11) |
| Lapsed in the year | **38.30** | **(713)** | 102.99 | (2,526) |
| Adjustment for rights issue | **–** | **–** | 92.30 | 142 |
| Outstanding at 31 December | **41.18** | **11,292** | 38.30 | 12,193 |
| Exercisable at 31 December | **–** | **–** | – | – |

The weighted average share price at the date of exercise for share options exercised during the year was HK$79.38 (2009: HK$83.33).

The options outstanding at the year end of 2010 had an exercise price in the range of HK$37.88 to HK$94.51 (2009: HK$37.88 to HK$94.51), and a weighted average remaining contractual life of 2.82 years (2009: 3.50 years).

The weighted average fair value of options granted during 2010 was HK$18.80 (2009: HK$15.74).

## 59. SHARE-BASED PAYMENTS (continued)

### (b) Executive/Group Share Option Plan

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

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

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **Weighted average exercise price £** | **Number ('000)** | Weighted average exercise price £ | Number ('000) |
| Outstanding at 1 January | **7.04** | **2,652** | 7.93 | 2,747 |
| Exercised in the year | **7.35** | **(145)** | 7.55 | (60) |
| Lapsed in the year | **7.04** | **(256)** | 7.93 | (441) |
| Adjustment for rights issue | **–** | **–** | 6.99 | 406 |
| Outstanding at 31 December | **7.10** | **2,251** | 7.04 | 2,652 |
| Exercisable at 31 December | **7.10** | **2,251** | 7.04 | 2,652 |

The weighted average share price at the date of exercise for share options exercised during the year was £6.65 (2009: £5.86).

The options outstanding at the year end of 2010 had an exercise price in the range of £6.02 to £7.59 (2009: £6.02 to £7.59), and a weighted average remaining contractual life of 2.15 years (2009: 2.89 years).

### (c) Calculation of fair value

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

## 59. SHARE-BASED PAYMENTS (continued)

### (c) Calculation of fair value (continued)

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

| | 1-year Savings-Related Share Option Plan | 3-year Savings-Related Share Option Plan | 5-year Savings-Related Share Option Plan |
|---|---|---|---|
| **2010** | | | |
| Risk-free interest rate (%) | **0.7** | **1.9** | **2.9** |
| Expected life (years) | **1** | **3** | **5** |
| Expected volatility (%) | **30** | **30** | **30** |
| Share price at grant date (HK$) | **82.05** | **82.05** | **82.05** |
| 2009 | | | |
| Risk-free interest rate (%) | 0.7 | 2.1 | 2.4 |
| Expected life (years) | 1 | 3 | 5 |
| Expected volatility (%) | 50 | 35 | 30 |
| Share price at grant date (HK$) | 53.34 | 53.34 | 53.34 |

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

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

Restricted share awards are made to eligible employees for retention purposes or as part of deferral of annual bonus. According to the terms of the share scheme, the shares awarded has a vesting period of three years, commencing from the first anniversary of the date of award.

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

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

| | **2010 Number ('000)** | 2009 Number ('000) |
|---|---|---|
| Outstanding at 1 January | **957** | 917 |
| Additions during the year | **28** | 181 |
| Released in the year | **(182)** | (141) |
| Outstanding at 31 December | **803** | 957 |

The closing price of the HSBC Holdings plc share at 31 December 2010 was £6.51 (2009: £7.09).

The weighted average remaining vesting period as at 31 December 2010 was 1.21 years (2009: 1.33 years).

## 59. SHARE-BASED PAYMENTS (continued)

### (e) Employee expenses

During 2010, HK$100 million was charged to the income statement in respect of share-based payment transactions settled in equity (2009: HK$101 million). This expense, which was computed from the fair values of the share-based payment transactions when granted, arose under employee share awards made in accordance with the Group's reward structures.

## 60. MATERIAL RELATED-PARTY TRANSACTIONS

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

In 2010, the Group entered into transactions with its immediate holding company and its subsidiaries and fellow subsidiary companies in the ordinary course of its interbank activities including lending activities, acceptance and placement of interbank deposits, correspondent banking transactions, off-balance sheet transactions and the provision of other banking and financial services. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

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

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

In May 2010, Hang Seng Bank (China) Limited entered into a conditional agreement with HSBC Bank (China) Company Limited to purchase a property situated in Shanghai, PRC for a total consideration of RMB510 million. The transaction was completed in November 2010 after obtaining regulatory and government approvals.

## 60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

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

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | Immediate holding company and its subsidiaries | | Fellow subsidiaries | | Associates | |
| | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 |
| Interest income | **84** | 245 | **–** | – | **11** | 2 |
| Interest expense | **(39)** | (43) | **(3)** | (3) | **–** | (3) |
| Other operating income | **104** | 17 | **–** | 1 | **1** | 2 |
| Operating expenses* | **(740)** | (736) | **(442)** | (415) | **(14)** | (12) |
| **Amounts due from:** | | | | | | |
| Cash and balances with banks and other financial institutions | **463** | 1,495 | **2,081** | 758 | **5** | 13 |
| Placings with and advances to banks and other financial institutions | **8,915** | 10,841 | **–** | – | **1,141** | – |
| Derivative financial instruments | **586** | 373 | **19** | 10 | **–** | – |
| Financial assets designated at fair value | **3,541** | 3,346 | **–** | – | **–** | – |
| Advances to customers | **–** | – | **–** | – | **233** | 233 |
| Financial investments | **334** | 412 | **–** | – | **–** | – |
| Other assets | **64** | 55 | **–** | 10 | **3** | 3 |
| | **13,903** | 16,522 | **2,100** | 778 | **1,382** | 249 |
| **Amounts due to:** | | | | | | |
| Current, savings and other deposit accounts | **332** | 1,527 | **–** | 126 | **68** | 63 |
| Deposits from banks | **2,484** | 1,309 | **8** | 4 | **117** | 116 |
| Derivative financial instruments | **494** | 1,238 | **59** | 76 | **–** | – |
| Subordinated liabilities | **6,025** | 2,017 | **–** | – | **–** | – |
| Other liabilities | **326** | 246 | **67** | 84 | **–** | – |
| | **9,661** | 6,337 | **134** | 290 | **185** | 179 |
| **Derivative contracts:** | | | | | | |
| Contract amount | **75,230** | 46,180 | **15,780** | 18,280 | **–** | – |
| **Guarantees:** | | | | | | |
| Guarantees issued | **2** | – | **–** | – | **116** | 116 |
| **Committed facilities:** | | | | | | |
| Committed facilities from | **826** | – | **–** | – | **–** | – |
| Committed facilities to | **–** | – | **–** | – | **–** | – |

* 2010 Operating expenses included payment of HK$97 million (2009: HK$107 million) of software costs which were capitalised as intangible assets in the balance sheet of the Group.

## 60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

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

| | Bank | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Immediate holding company and its subsidiaries | | Fellow subsidiaries | | Subsidiaries | | Associates | |
| | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 |
| **Amounts due from:** | | | | | | | | |
| Cash and balances with banks and other financial institutions | **390** | 1,397 | **2,018** | 701 | **–** | – | **–** | – |
| Placings with and advances to banks and other financial institutions | **4,683** | 5,196 | **–** | – | **–** | – | **552** | – |
| Derivative financial instruments | **418** | 280 | **19** | 10 | **88** | 1 | **–** | – |
| Financial assets designated at fair value | **–** | – | **–** | – | **–** | – | **–** | – |
| Advances to customers | **–** | – | **–** | – | **–** | – | **–** | – |
| Amounts due from subsidiaries | **–** | – | **–** | – | **93,445** | 87,360 | **–** | – |
| Financial investments | **–** | – | **–** | – | **–** | – | **–** | – |
| Other assets | **18** | 17 | **–** | 5 | **–** | – | **3** | 3 |
| | **5,509** | 6,890 | **2,037** | 716 | **93,533** | 87,361 | **555** | 3 |
| **Amounts due to:** | | | | | | | | |
| Current, savings and other deposit accounts | **233** | 1,527 | **–** | 126 | **–** | – | **68** | 63 |
| Deposits from banks | **2,484** | 1,309 | **8** | 4 | **–** | – | **117** | 116 |
| Derivative financial instruments | **334** | 1,230 | **59** | 75 | **298** | 18 | **–** | – |
| Subordinated liabilities | **6,025** | 2,017 | **–** | – | **–** | – | **–** | – |
| Amounts due to subsidiaries | **–** | – | **–** | – | **8,899** | 9,960 | **–** | – |
| Other liabilities | **276** | 194 | **65** | 82 | **–** | – | **–** | – |
| | **9,352** | 6,277 | **132** | 287 | **9,197** | 9,978 | **185** | 179 |
| **Derivative contracts:** | | | | | | | | |
| Contract amount | **57,371** | 40,975 | **15,780** | 18,280 | **33,333** | 12,220 | **–** | – |
| **Guarantees:** | | | | | | | | |
| Guarantees issued | **2** | – | **–** | – | **559** | 543 | **116** | 116 |
| Guarantees received | **–** | – | **–** | – | **159** | 142 | **–** | – |
| **Committed facilities:** | | | | | | | | |
| Committed facilities from | **–** | – | **–** | – | **–** | – | **–** | – |
| Committed facilities to | **–** | – | **–** | – | **2,332** | – | **–** | – |

## 60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

### (b) Key management personnel remuneration

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Employee benefits | **30** | 39 | **30** | 39 |
| Post-employment benefits | **4** | 5 | **4** | 5 |
| Share-based payments | **7** | 6 | **7** | 6 |
| | **41** | 50 | **41** | 50 |

### (c) Material transactions with key management personnel

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

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Interest received | **173** | 232 | **173** | 230 |
| Interest paid | **4** | 5 | **4** | 5 |
| Fees and exchange income received | **18** | 16 | **18** | 16 |
| Loans and advances | **12,153** | 9,834 | **11,361** | 9,254 |
| Deposits | **2,906** | 2,096 | **2,906** | 2,085 |
| Undrawn commitments | **1,969** | 3,206 | **1,670** | 3,167 |
| Maximum aggregate amount of loans and advances during the year | **14,539** | 21,401 | **13,398** | 19,836 |

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

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

## 60. MATERIAL RELATED-PARTY TRANSACTIONS (continued)

### (d) Loans to officers

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Aggregate amount of relevant transactions outstanding at 31 December | **11** | 73 | **11** | 69 |
| Maximum aggregate amount of relevant transactions during the year | **20** | 132 | **20** | 127 |

### (e) Associates

Information relating to associates and transactions with associates can be found in notes 38 and 60(a).

The Group maintains a shareholders' loan to an associate. The shareholders' loan is unsecured, interest free and with no fixed term of repayment. The balance at 31 December 2010 was HK$233 million (2009: HK$233 million).

The Bank has been assisting Industrial Bank Co., Ltd. in managing and growing the credit card business.

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

### (f) Ultimate holding company

The Group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the Group. As disclosed in note 59, the Group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under "Other reserves". The balance of this reserve as at 31 December 2010 amounted to HK$510 million comprising HK$514 million relating to share option schemes and negative reserve amounted to HK$4 million relating to share award schemes (2009: HK$446 million comprising HK$445 million relating to share option schemes and HK$1 million relating to share award schemes).

### (g) Employee retirement benefits

At 31 December 2010, defined benefit scheme assets amounted to HK$1,269 million (2009: HK$1,341 million) were under management by fellow subsidiary companies. The amount of management fee paid to these companies amounted to HK$10 million (2009: HK$10 million).

## 61. FINANCIAL RISK MANAGEMENT

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

The Group's risk management policy is designed to identify and analyse risks, to set appropriate risk limits and to monitor these risks and limits continually by means of reliable and up-to-date management information systems. The Group's risk management policies and major control limits are approved by the Board of Directors and they are monitored and reviewed regularly by various management committees, including the Executive Committee, Audit Committee, Asset and Liability Management Committee ("ALCO") and Risk Management Committee ("RMC").

For new products and services, in addition to the existing due diligence process, a Product Oversight Committee reporting to the RMC and comprising of senior executives from Risk, Legal, Compliance, Finance, and Operations/IT, is responsible for reviewing and approving the launch of such new products and services. Each new service and product launch is also subject to an operational risk self-assessment process, which includes identification, evaluation and mitigation of risk arising from the new initiative. Internal Audit is consulted on the internal control aspect of new products and services in development prior to implementation.

### (a) Credit risk

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

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

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

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

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

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

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

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

– managing and directing credit-related systems initiatives; and

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

#### Impaired loan management and recovery

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

#### Risk rating framework

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

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

#### Collateral and other credit enhancements

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

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

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

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

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

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

#### Settlement risk

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

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

#### Concentration of credit risk

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

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

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Cash and balances with banks and other financial institutions | **44,411** | 22,086 | **41,062** | 18,461 |
| Placings with and advances to banks and other financial institutions | **110,564** | 104,551 | **52,131** | 65,624 |
| Trading assets | **26,047** | 66,591 | **25,224** | 65,282 |
| Financial assets designated at fair value | **4,440** | 4,927 | **148** | 174 |
| Derivative financial instruments | **5,593** | 5,050 | **5,026** | 4,916 |
| Advances to customers | **472,637** | 344,621 | **423,074** | 299,179 |
| Financial investments | **199,033** | 241,155 | **102,985** | 156,568 |
| Amounts due from subsidiaries | **–** | – | **93,445** | 87,360 |
| Other assets | **11,754** | 10,726 | **8,419** | 8,040 |
| Financial guarantees and other credit related contingent liabilities | **11,392** | 9,137 | **9,916** | 9,294 |
| Loan commitments and other credit related commitments | **347,019** | 295,084 | **314,108** | 280,093 |
| | **1,232,890** | 1,103,928 | **1,075,538** | 994,991 |

#### (ii) Credit quality

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

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

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

### (ii) Credit quality (continued)

*Quality classification definitions:*

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

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

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

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

The Group's policy in respect of impairment on loans and advances and debt securities is set out in note 4 on the financial statements. Analysis of impairment allowances as at 31 December 2010 and the movement of such allowances during the year are disclosed in note 35.

*Granular risk rating scales:*

The CRR ("Customer Risk Rating") 10-grade scale maps to a more granular underlying 23-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures, although there is no fixed correlation between internal and external ratings.

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

### (ii) Credit quality (continued)

*Distribution of financial instruments by credit quality*

| | Group | | | | | | |
|---|---|---|---|---|---|---|---|
| | Neither past due nor impaired | | | | | | |
| | Strong | Medium* | Sub-standard | Past due not impaired | Impaired | Impairment allowances | Total |
| **2010** | | | | | | | |
| Items in the course of collection from other banks | 4,589 | 84 | – | – | – | – | 4,673 |
| Trading assets: | | | | | | | |
| – treasury and eligible bills | 20,204 | – | – | – | – | – | 20,204 |
| – debt securities | 5,063 | 56 | – | – | – | – | 5,119 |
| – loans and advances to banks | 700 | – | – | – | – | – | 700 |
| – loans and advances to customers | 24 | – | – | – | – | – | 24 |
| | 25,991 | 56 | – | – | – | – | 26,047 |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,438 | 2 | – | – | – | – | 4,440 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – | – |
| | 4,438 | 2 | – | – | – | – | 4,440 |
| Derivatives | 4,235 | 1,284 | 74 | – | – | – | 5,593 |
| Loans and advances held at amortised cost: | | | | | | | |
| – loans and advances to banks | 135,797 | 13,077 | – | – | – | – | 148,874 |
| – loans and advances to customers | 271,974 | 194,139 | 2,990 | 3,380 | 1,990 | (1,836) | 472,637 |
| | 407,771 | 207,216 | 2,990 | 3,380 | 1,990 | (1,836) | 621,511 |
| Financial investments: | | | | | | | |
| – treasury and similar bills | 18,010 | – | – | – | – | – | 18,010 |
| – debt securities | 175,887 | 5,136 | – | – | – | – | 181,023 |
| | 193,897 | 5,136 | – | – | – | – | 199,033 |
| Other assets: | | | | | | | |
| – acceptances and endorsements | 1,034 | 2,688 | 29 | – | – | – | 3,751 |
| – other | 1,752 | 1,538 | 5 | 35 | – | – | 3,330 |
| | 2,786 | 4,226 | 34 | 35 | – | – | 7,081 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

### (ii) Credit quality (continued)

| | 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 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

#### (ii) Credit quality (continued)

| | Bank | | | | | | |
|---|---|---|---|---|---|---|---|
| | Neither past due nor impaired | | | Past due not impaired | Impaired | Impairment allowances | Total |
| | Strong | Medium* | Sub-standard | | | | |
| **2010** | | | | | | | |
| Items in the course of collection from other banks | 4,589 | 84 | – | – | – | – | 4,673 |
| Trading assets: | | | | | | | |
| – treasury and eligible bills | 20,204 | – | – | – | – | – | 20,204 |
| – debt securities | 4,240 | 56 | – | – | – | – | 4,296 |
| – loans and advances to banks | 700 | – | – | – | – | – | 700 |
| – loans and advances to customers | 24 | – | – | – | – | – | 24 |
| | 25,168 | 56 | – | – | – | – | 25,224 |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – | – |
| – debt securities | 148 | – | – | – | – | – | 148 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – | – |
| | 148 | – | – | – | – | – | 148 |
| Derivatives | 3,744 | 1,220 | 62 | – | – | – | 5,026 |
| Loans and advances held at amortised cost: | | | | | | | |
| – loans and advances to banks | 80,171 | 7,165 | – | – | – | – | 87,336 |
| – loans and advances to customers | 247,256 | 171,341 | 1,984 | 2,463 | 1,462 | (1,432) | 423,074 |
| | 327,427 | 178,506 | 1,984 | 2,463 | 1,462 | (1,432) | 510,410 |
| Financial investments: | | | | | | | |
| – treasury and similar bills | 17,225 | – | – | – | – | – | 17,225 |
| – debt securities | 83,325 | 2,435 | – | – | – | – | 85,760 |
| | 100,550 | 2,435 | – | – | – | – | 102,985 |
| Other assets: | | | | | | | |
| – acceptances and endorsements | 681 | 1,666 | 16 | – | – | – | 2,363 |
| – other | 607 | 775 | – | 1 | – | – | 1,383 |
| | 1,288 | 2,441 | 16 | 1 | – | – | 3,746 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

#### (ii) Credit quality (continued)

| | Bank | | | | | | |
|---|---|---|---|---|---|---|---|
| | 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 | 3,253 | – | – | – | – | – | 3,253 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | 1 | – | – | – | – | 1 |
| | 65,281 | 1 | – | – | – | – | 65,282 |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – | – |
| – debt securities | 174 | – | – | – | – | – | 174 |
| – loans and advances to banks | – | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – | – |
| | 174 | – | – | – | – | – | 174 |
| Derivatives | 3,930 | 971 | 15 | – | – | – | 4,916 |
| Loans and advances held at amortised cost: | | | | | | | |
| – loans and advances to banks | 76,150 | 3,856 | – | – | – | – | 80,006 |
| – loans and advances to customers | 170,878 | 122,500 | 2,779 | 2,924 | 1,761 | (1,663) | 299,179 |
| | 247,028 | 126,356 | 2,779 | 2,924 | 1,761 | (1,663) | 379,185 |
| Financial investments: | | | | | | | |
| – treasury and similar bills | 49,277 | – | – | – | – | – | 49,277 |
| – debt securities | 101,905 | 5,386 | – | – | – | – | 107,291 |
| | 151,182 | 5,386 | – | – | – | – | 156,568 |
| Other assets: | | | | | | | |
| – acceptances and endorsements | 763 | 1,641 | 31 | – | – | – | 2,435 |
| – other | 974 | 282 | 2 | 4 | – | – | 1,262 |
| | 1,737 | 1,923 | 33 | 4 | – | – | 3,697 |

* Includes HK$1,623 million (2009: HK$3,006 million) and HK$283 million (2009: HK$1,557 million) of debt securities that have been classified as BBB- to BBB+ for the Group and the Bank respectively in 2010, based on Standard and Poor's ratings or their equivalent to the respective issues of the financial securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating. In the absence of such issue ratings, the ratings designated for the issuers are reported.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

### (ii) Credit quality (continued)

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

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

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | Up to 29 days | 30-59 days | 60-89 days | 90-180 days | Over 180 days | Total |
| **2010** | | | | | | |
| Items in the course of collection from other banks | – | – | – | – | – | – |
| Trading assets: | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – |
| – debt securities | – | – | – | – | – | – |
| – loans and advances to banks | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – |
| | – | – | – | – | – | – |
| Financial assets designated at fair value: | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – |
| – debt securities | – | – | – | – | – | – |
| – loans and advances to banks | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – |
| | – | – | – | – | – | – |
| Derivatives | – | – | – | – | – | – |
| Loans and advances held at amortised cost: | | | | | | |
| – loans and advances to banks | – | – | – | – | – | – |
| – loans and advances to customers# | 2,892 | 419 | 51 | 13 | 5 | 3,380 |
| | 2,892 | 419 | 51 | 13 | 5 | 3,380 |
| Financial investments: | | | | | | |
| – treasury and similar bills | – | – | – | – | – | – |
| – debt securities | – | – | – | – | – | – |
| | – | – | – | – | – | – |
| Other assets: | | | | | | |
| – acceptances and endorsements | – | – | – | – | – | – |
| – other | 17 | 5 | 2 | 5 | 6 | 35 |
| | 17 | 5 | 2 | 5 | 6 | 35 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

#### (ii) Credit quality (continued)

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | 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 |

## 61. 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 |
| **2010** | | | | | | |
| Items in the course of collection from other banks | – | – | – | – | – | – |
| Trading assets: | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – |
| – debt securities | – | – | – | – | – | – |
| – loans and advances to banks | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – |
| | – | – | – | – | – | – |
| Financial assets designated at fair value: | | | | | | |
| – treasury and eligible bills | – | – | – | – | – | – |
| – debt securities | – | – | – | – | – | – |
| – loans and advances to banks | – | – | – | – | – | – |
| – loans and advances to customers | – | – | – | – | – | – |
| | – | – | – | – | – | – |
| Derivatives | – | – | – | – | – | – |
| Loans and advances held at amortised cost: | | | | | | |
| – loans and advances to banks | – | – | – | – | – | – |
| – loans and advances to customers[#] | 2,173 | 236 | 39 | 13 | 2 | 2,463 |
| | 2,173 | 236 | 39 | 13 | 2 | 2,463 |
| Financial investments: | | | | | | |
| – treasury and similar bills | – | – | – | – | – | – |
| – debt securities | – | – | – | – | – | – |
| | – | – | – | – | – | – |
| Other assets: | | | | | | |
| – acceptances and endorsements | – | – | – | – | – | – |
| – other | 1 | – | – | – | – | 1 |
| | 1 | – | – | – | – | 1 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

### (ii) Credit quality (continued)

| | Bank | | | | | |
|---|---|---|---|---|---|---|
| | 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 |

# The majority of the loans and advances to customers that are operating within revised terms following restructuring are excluded from this table.

*Impaired loans and advances*

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

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

Analyses of impairment allowances at 31 December 2010 and the movement of such allowances during the year are disclosed in note 35.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (a) Credit risk (continued)

#### (ii) Credit quality (continued)

*Renegotiated loans that would otherwise be past due or impaired*

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Renegotiated loans that would otherwise be past due or impaired | **695** | 1,110 | **424** | 801 |

#### (iii) Collateral and other credit enhancements obtained

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Nature of assets: | | | | |
| Residential properties | **24** | 19 | **11** | 12 |
| Commercial and industrial properties | **–** | – | **–** | – |
| Other | **–** | – | **–** | – |
| | **24** | 19 | **11** | 12 |

### (b) Liquidity risk

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

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (b) Liquidity risk (continued)

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

– projecting cash flows and considering the level of liquid assets necessary in relation thereto;

– monitoring balance sheet liquidity ratios against internal and regulatory requirements;

– maintaining a diverse range of funding sources with adequate back-up facilities;

– managing debt financing plans;

– monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and

– monitoring of depositor concentration contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systematic or other crises, while minimising adverse long-term implications for the business.

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

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

| | Group | |
|---|---|---|
| | **2010** | 2009 |
| The Bank and its subsidiaries designated by the Hong Kong Monetary Authority | **38.1%** | 48.1% |

The below tables are an analysis of undiscounted cash flows on the Group's financial liabilities including future interest payments on the basis of their earliest possible contractual maturity.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (b) Liquidity risk (continued)

The balances in the below table will not agree with the balances in the balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and all future coupon payments (except for trading liabilities and trading derivatives). Also, loans commitments are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the "On demand" time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loans commitments expire without being drawn upon. The undiscounted cash flows potentially payable under loan commitments and financial guarantee are classified on the basis of the earliest date they can be called instead of behaviour maturity as previous reported. Accordingly, the comparative figures are restated to conform with current year presentation.

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | **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 2010** | | | | | | |
| Current, savings and other deposit accounts | **536,442** | **116,288** | **29,956** | **1,660** | **–** | **684,346** |
| Deposits from banks | **6,387** | **9,084** | **–** | **117** | **–** | **15,588** |
| Financial liabilities designated at fair value | **2** | **–** | **–** | **–** | **455** | **457** |
| Trading liabilities | **42,581** | **–** | **–** | **–** | **–** | **42,581** |
| Derivative financial instruments | **3,709** | **104** | **400** | **616** | **(18)** | **4,811** |
| Certificates of deposit and other debt securities in issue | **–** | **553** | **135** | **2,489** | **–** | **3,177** |
| Other financial liabilities | **6,719** | **5,643** | **1,499** | **70** | **25** | **13,956** |
| Subordinated liabilities | **–** | **54** | **3,609** | **2,843** | **6,655** | **13,161** |
| | **595,840** | **131,726** | **35,599** | **7,795** | **7,117** | **778,077** |
| Commitments | **222,111** | **37,081** | **179** | **575** | **–** | **259,946** |
| Financial guarantee contracts | **4,094** | **–** | **2** | **–** | **–** | **4,096** |
| | **226,205** | **37,081** | **181** | **575** | **–** | **264,042** |
| At 31 December 2009 | | | | | | |
| Current, savings and other deposit accounts | 494,372 | 119,462 | 22,508 | 753 | – | 637,095 |
| Deposits from banks | 2,964 | 1,771 | 25 | 117 | – | 4,877 |
| Financial liabilities designated at fair value | 3 | 10 | 1,010 | – | 451 | 1,474 |
| Trading liabilities | 38,391 | – | – | – | – | 38,391 |
| Derivative financial instruments | 3,581 | 75 | 365 | 242 | (8) | 4,255 |
| Certificates of deposit and other debt securities in issue | – | 344 | 1,214 | 328 | – | 1,886 |
| Other financial liabilities | 5,881 | 4,935 | 1,103 | 114 | 116 | 12,149 |
| Subordinated liabilities | – | 12 | 3,547 | 5,846 | – | 9,405 |
| | 545,192 | 126,609 | 29,772 | 7,400 | 559 | 709,532 |
| Commitments | 182,134 | 27,781 | 82 | 183 | – | 210,180 |
| Financial guarantee contracts | 2,719 | 2 | 4 | 2 | – | 2,727 |
| | 184,853 | 27,783 | 86 | 185 | – | 212,907 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (b) Liquidity risk (continued)

| | Bank | | | | | |
|---|---|---|---|---|---|---|
| | 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 2010** | | | | | | |
| Current, savings and other deposit accounts | **526,177** | **105,993** | **16,276** | **1,106** | **–** | **649,552** |
| Deposits from banks | **6,386** | **9,084** | **–** | **117** | **–** | **15,587** |
| Financial liabilities designated at fair value | **–** | **–** | **–** | **–** | **–** | **–** |
| Trading liabilities | **30,106** | **–** | **–** | **–** | **–** | **30,106** |
| Derivative financial instruments | **3,803** | **91** | **280** | **381** | **(21)** | **4,534** |
| Certificates of deposit and other debt securities in issue | **–** | **553** | **135** | **2,489** | **–** | **3,177** |
| Amounts due to subsidiaries | **4,222** | **4,675** | **2** | **–** | **–** | **8,899** |
| Other financial liabilities | **6,596** | **4,514** | **770** | **1** | **910** | **12,791** |
| Subordinated liabilities | **–** | **54** | **3,609** | **2,843** | **6,655** | **13,161** |
| | **577,290** | **124,964** | **21,072** | **6,937** | **7,544** | **737,807** |
| Commitments | **190,235** | **36,455** | **75** | **1** | **–** | **226,766** |
| Financial guarantee contracts | **2,992** | **–** | **2** | **–** | **–** | **2,994** |
| | **193,227** | **36,455** | **77** | **1** | **–** | **229,760** |
| At 31 December 2009 | | | | | | |
| Current, savings and other deposit accounts | 486,023 | 112,668 | 13,207 | 403 | – | 612,301 |
| Deposits from banks | 2,963 | 1,365 | 25 | 117 | – | 4,470 |
| Financial liabilities designated at fair value | – | 10 | 1,010 | – | – | 1,020 |
| Trading liabilities | 35,071 | – | – | – | – | 35,071 |
| Derivative financial instruments | 3,572 | 71 | 324 | 217 | (8) | 4,176 |
| Certificates of deposit and other debt securities in issue | – | 344 | 1,214 | 328 | – | 1,886 |
| Amounts due to subsidiaries | 4,749 | 4,973 | 238 | – | – | 9,960 |
| Other financial liabilities | 5,794 | 4,053 | 646 | 50 | 909 | 11,452 |
| Subordinated liabilities | – | 12 | 3,547 | 5,846 | – | 9,405 |
| | 538,172 | 123,496 | 20,211 | 6,961 | 901 | 689,741 |
| Commitments | 169,270 | 26,463 | 69 | 2 | – | 195,804 |
| Financial guarantee contracts | 2,713 | 2 | 4 | 2 | – | 2,721 |
| | 171,983 | 26,465 | 73 | 4 | – | 198,525 |

### (c) Market risk

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

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

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

*Value at risk ("VAR")*

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

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

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

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

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

The Group's VAR, both trading and non-trading, for total positions and on individual risk portfolios during 2010 and 2009 are shown in the table below.

| | **At 31 December 2010** | **Minimum during the year** | **Maximum during the year** | **Average for the year** |
|---|---|---|---|---|
| Total VAR | **69** | **53** | **149** | **99** |
| Total trading VAR | **9** | **5** | **25** | **10** |
| VAR for foreign exchange risk (trading) | **5** | **1** | **10** | **3** |
| VAR for interest rate risk: | | | | |
| – trading | **6** | **5** | **23** | **10** |
| – non-trading | **18** | **17** | **100** | **62** |

| | At 31 December 2009 | Minimum during the year | Maximum during the year | Average for the year |
|---|---|---|---|---|
| Total VAR | 76 | 46 | 130 | 86 |
| Total trading VAR | 6 | 6 | 20 | 10 |
| VAR for foreign exchange risk (trading) | 2 | 1 | 24 | 7 |
| VAR for interest rate risk: | | | | |
| – trading | 7 | 5 | 13 | 8 |
| – non-trading | 73 | 47 | 115 | 83 |

**Total Value at Risk for 2010**


**Total Value at Risk for 2009**

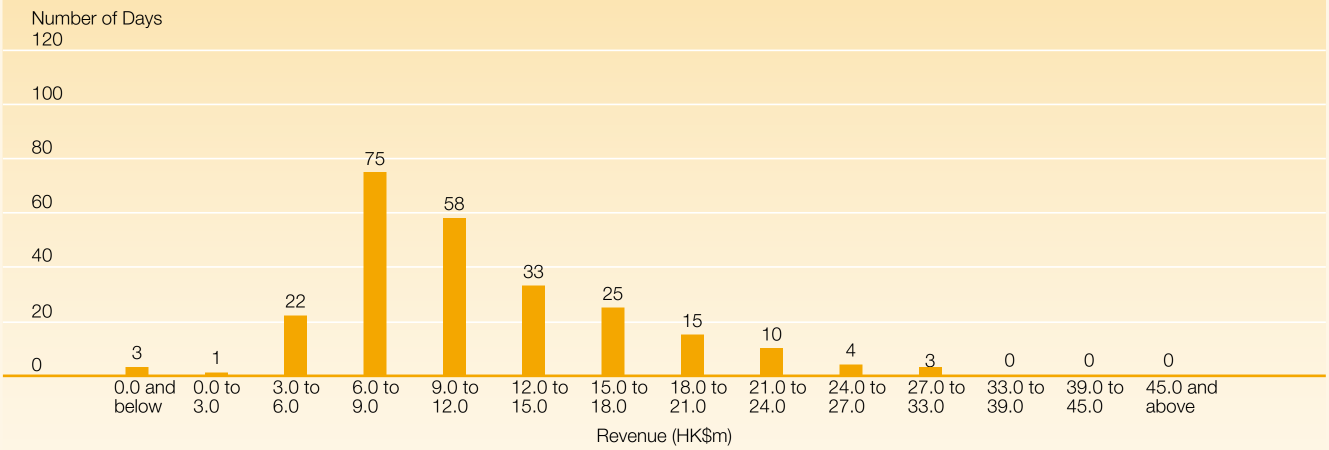
## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

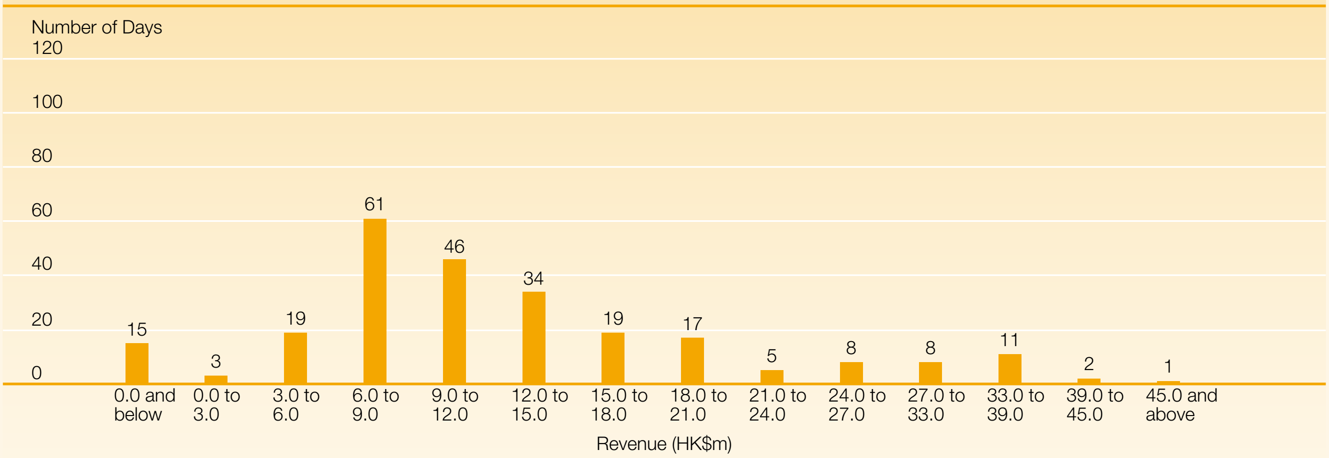
The average daily revenue earned from market risk-related treasury activities in 2010, including non-trading book net interest income and funding related to trading positions, was HK$11 million (2009: HK$12 million). The standard deviation of these daily revenues was HK$6 million, compared with HK$10 million for 2009.

An analysis of the frequency distribution of daily revenue shows that out of 249 trading days in 2010, losses were recorded on 3 days (2009: 15 days) and the maximum daily loss was HK$35 million (2009: HK$24 million). The most frequent result was a daily revenue of between HK$6 million and HK$18 million, with 191 occurrences (2009: 160 occurrences). The highest daily revenue was HK$32 million (2009: HK$62 million).

**Daily Distribution of Market Risk Revenue for 2010**




**Daily Distribution of Market Risk Revenue for 2009**



## 61. FINANCIAL RISK MANAGEMENT (continued)

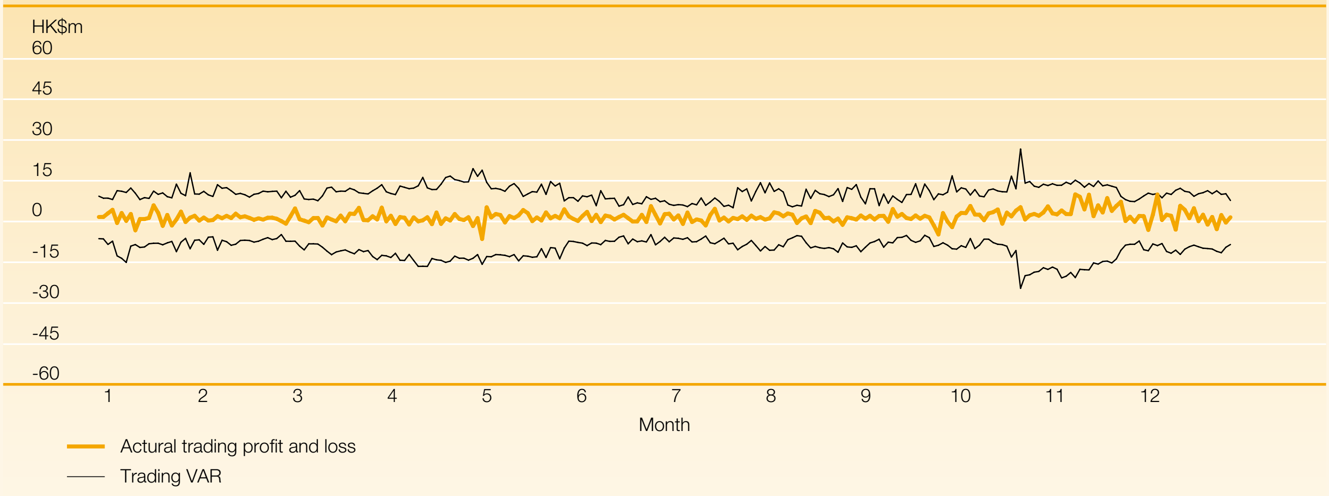
### (c) Market risk (continued)

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

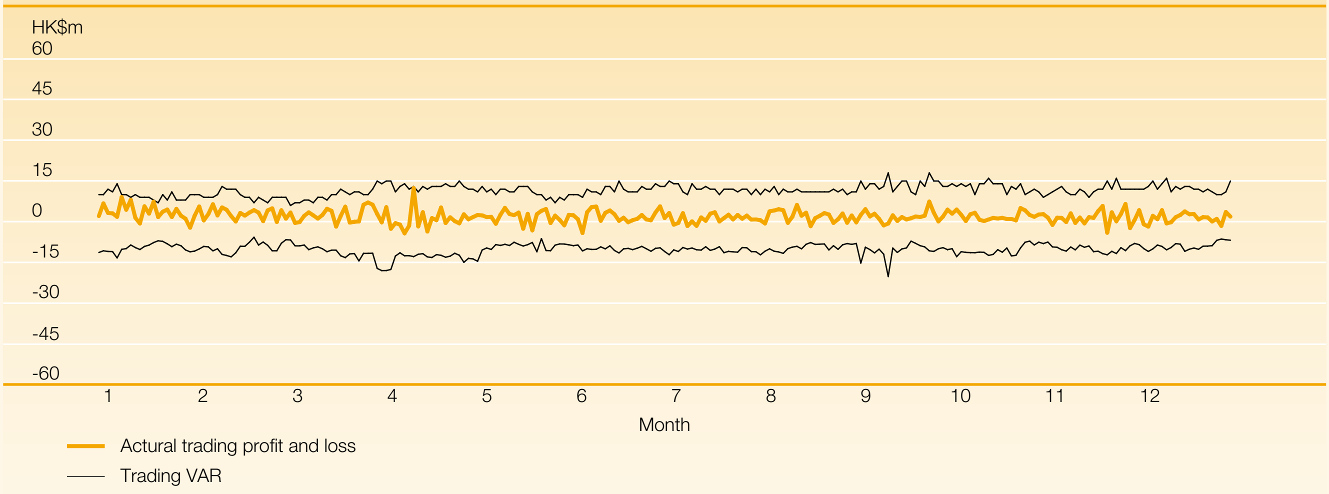
The trading VAR model back-testing with actual profit and loss involves tracking the trading VAR with the next day actual profit and loss. It will be regarded as a loss side exception if actual loss exceeds loss side trading VAR.

A comparison of the Group trading VAR with the actual profits and losses related to trading positions during 2010 and 2009 are shown in the table below.

**A Comparison of Trading VAR with Actual Trading Profit and Loss for 2010**




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



## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

#### Interest rate exposure

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

*Trading*

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

*Non-trading*

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

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

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

*Net interest income*

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

The table below sets out the impact on future net interest income of a 100 basis points parallel fall or rise in all-in yield curves at the beginning of year from 1 January 2011 and 25 basis points parallel fall or rise in all-in yield curves at the beginning of each quarter during the 12 month period from 1 January 2011.

Assuming no management actions, such a series of incremental parallel rises in all-in yield curves would increase planned net interest income for the year to 31 December 2011 by HK$1,303 million for 100 basis points case and by HK$762 million for 25 basis points case, while such a series of incremental parallel falls in all-in yield curves would decrease planned net interest income by HK$1,706 million for 100 basis points case and by HK$1,280 million for 25 basis points case. These figures incorporate the impact of any option features in the underlying exposures and takes into account the change in pricing of retail products relative to change in market interest rates.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

*Projected Net Interest Income*

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

| | 100bp parallel increase | 100bp parallel decrease | 25bp increase at the beginning of each quarter | 25bp decrease at the beginning of each quarter |
|---|---|---|---|---|
| **Change in 2011 projected net interest income** | | | | |
| – HKD | **861** | **(1,113)** | **562** | **(963)** |
| – US$ | **309** | **(447)** | **113** | **(262)** |
| – other | **133** | **(146)** | **87** | **(55)** |
| Total | **1,303** | **(1,706)** | **762** | **(1,280)** |
| Change in 2010 projected net interest income | | | | |
| – HKD | 1,737 | (1,949) | 993 | (1,426) |
| – US$ | 214 | (95) | 72 | 143 |
| – other | 235 | (116) | 123 | 29 |
| Total | 2,186 | (2,160) | 1,188 | (1,254) |

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

*Sensitivity of reserves*

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

| | At 31 December 2010 | Maximum impact | Minimum impact |
|---|---|---|---|
| + 100 basis points parallel move in all-in yield curves | **(803)** | **(1,173)** | **(803)** |
| As a percentage of shareholders' funds at 31 December 2010 (%) | **(1.1)** | **(1.7)** | **(1.1)** |
| – 100 basis points parallel move in all-in yield curves | **264** | **303** | **174** |
| As a percentage of shareholders' funds at 31 December 2010 (%) | **0.4** | **0.4** | **0.2** |

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

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

### Foreign exchange exposure

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

At 31 December 2010, the US dollar ("US$"), Chinese renminbi ("RMB"), Pound Sterling ("GBP"), Japanese Yen ("JPY"), Euro ("EUR"), Canadian dollar ("CAD"), Swiss Francs ("CHF"), Australian dollar ("AUD"), New Zealand dollar ("NZD") and Gold ("GOL") were the currencies in which the Group had non-structural foreign currency positions that were not less than 10 per cent of the total net position in all foreign currencies. The Group also had a US$ and RMB structural foreign currency position, which was not less than 10 percent of the total net structural position in all foreign currencies.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

### Foreign exchange exposure (continued)

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

**Group**

| | US$ | RMB | GBP | JPY | EUR | CAD | CHF | AUD | NZD | GOL | Other foreign currencies | Total foreign currencies |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2010** | | | | | | | | | | | | |
| **Non-structural position** | | | | | | | | | | | | |
| Spot assets | 246,638 | 93,067 | 13,026 | 8,985 | 11,068 | 13,933 | 191 | 43,643 | 9,017 | 2,169 | 974 | 442,711 |
| Spot liabilities | (155,377) | (88,666) | (15,470) | (1,912) | (12,393) | (14,882) | (549) | (41,953) | (11,658) | (3,404) | (3,034) | (349,298) |
| Forward purchases | 228,982 | 72,661 | 7,130 | 8,932 | 3,735 | 2,431 | 1,347 | 8,340 | 3,909 | 2,919 | 3,423 | 343,809 |
| Forward sales | (319,494) | (77,799) | (4,810) | (16,151) | (2,497) | (1,449) | (964) | (9,885) | (1,341) | (1,559) | (1,359) | (437,308) |
| Net options position | 133 | (41) | – | (5) | (55) | (7) | – | (71) | 60 | – | – | 14 |
| Net long/(short) non-structural position | 882 | (778) | (124) | (151) | (142) | 26 | 25 | 74 | (13) | 125 | 4 | (72) |
| **Structural position** | 206 | 20,124 | – | – | – | – | – | – | – | – | 238 | 20,568 |
| 2009 | | | | | | | | | | | | |
| **Non-structural position** | | | | | | | | | | | | |
| Spot assets | 214,379 | 41,638 | 16,344 | 48,843 | 15,423 | 14,474 | 124 | 39,757 | 7,360 | 816 | 451 | 399,609 |
| Spot liabilities | (164,511) | (41,564) | (15,527) | (1,694) | (12,292) | (14,412) | (591) | (47,508) | (14,807) | (2,387) | (826) | (316,119) |
| Forward purchases | 169,349 | 29,483 | 2,215 | 3,728 | 6,885 | 1,607 | 832 | 14,293 | 9,586 | 2,430 | 764 | 241,172 |
| Forward sales | (219,453) | (29,603) | (2,995) | (50,915) | (10,103) | (1,680) | (371) | (6,532) | (2,083) | (851) | (490) | (325,076) |
| Net options position | (4) | – | – | 1 | (1) | (4) | 2 | 7 | 2 | – | – | 3 |
| Net (short)/long non-structural position | (240) | (46) | 37 | (37) | (88) | (15) | (4) | 17 | 58 | 8 | (101) | (411) |
| **Structural position** | 285 | 14,550 | – | – | – | – | – | – | – | – | 287 | 15,122 |

**Bank**

| | US$ | RMB | GBP | JPY | EUR | CAD | CHF | AUD | NZD | GOL | Other foreign currencies | Total foreign currencies |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2010** | | | | | | | | | | | | |
| **Non-structural position** | | | | | | | | | | | | |
| Spot assets | 203,809 | 41,067 | 7,591 | 8,883 | 8,411 | 7,568 | 129 | 23,618 | 5,993 | 2,169 | 864 | 310,102 |
| Spot liabilities | (117,702) | (36,296) | (10,022) | (1,840) | (9,529) | (8,463) | (504) | (20,171) | (8,544) | (3,404) | (2,924) | (219,399) |
| Forward purchases | 205,281 | 59,923 | 7,130 | 8,695 | 3,550 | 2,377 | 1,347 | 6,433 | 3,813 | 2,919 | 3,423 | 304,891 |
| Forward sales | (292,023) | (64,330) | (4,762) | (15,805) | (2,467) | (1,449) | (948) | (9,782) | (1,341) | (1,559) | (1,359) | (395,825) |
| Net options position | 133 | (41) | – | (5) | (55) | (7) | – | (71) | 60 | – | – | 14 |
| Net (short)/long non-structural position | (502) | 323 | (63) | (72) | (90) | 26 | 24 | 27 | (19) | 125 | 4 | (217) |
| **Structural position** | 206 | 20,124 | – | – | – | – | – | – | – | – | 238 | 20,568 |
| 2009 | | | | | | | | | | | | |
| **Non-structural position** | | | | | | | | | | | | |
| Spot assets | 178,264 | 13,820 | 9,948 | 48,728 | 12,397 | 8,452 | 84 | 20,526 | 4,225 | 816 | 378 | 297,638 |
| Spot liabilities | (130,310) | (12,730) | (9,127) | (1,661) | (9,220) | (8,389) | (551) | (27,941) | (11,616) | (2,387) | (751) | (214,683) |
| Forward purchases | 165,452 | 27,274 | 2,188 | 3,640 | 6,815 | 1,607 | 832 | 13,944 | 9,530 | 2,430 | 764 | 234,476 |
| Forward sales | (215,240) | (27,146) | (2,971) | (50,738) | (10,078) | (1,680) | (371) | (6,527) | (2,083) | (851) | (490) | (318,175) |
| Net options position | (4) | – | – | 1 | (1) | (4) | 2 | 7 | 2 | – | – | 3 |
| Net (short)/long non-structural position | (1,838) | 1,218 | 38 | (30) | (87) | (14) | (4) | 9 | 58 | 8 | (99) | (741) |
| **Structural position** | 285 | 14,550 | – | – | – | – | – | – | – | – | 287 | 15,122 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (c) Market risk (continued)

#### Equities exposure

The Group's equities exposures in 2010 and 2009 are mainly in long-term equity investments which are reported as "Financial investments" set out in note 36. Equities held for trading purpose are included under "Trading assets" set out in note 32. These are subject to trading limit and risk management control procedures and other market risk regime.

### (d) Insurance risk

#### Risk management objectives and policies for management of insurance risk

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

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

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

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

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

#### Asset/liability management

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

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

### Balance sheet of insurance subsidiaries by type of contract

| | Life linked contracts[1] | Life non-linked contracts[2] | Non-life insurance[3] | Other assets[4] | Total |
|---|---|---|---|---|---|
| **2010** | | | | | |
| Financial assets: | | | | | |
| – financial assets designated at fair value | **237** | **6,586** | **–** | **142** | **6,965** |
| – derivatives | **–** | **161** | **–** | **–** | **161** |
| – financial investments | **–** | **53,591** | **–** | **3,339** | **56,930** |
| – other financial assets | **125** | **3,270** | **421** | **657** | **4,473** |
| Total financial assets | **362** | **63,608** | **421** | **4,138** | **68,529** |
| Reinsurance assets | **–** | **35** | **103** | **21** | **159** |
| Present value of in-force long-term insurance contracts | **–** | **–** | **–** | **4,593** | **4,593** |
| Other assets | **–** | **729** | **11** | **706** | **1,446** |
| Total assets | **362** | **64,372** | **535** | **9,458** | **74,727** |
| Liabilities under investment contracts designated at fair value | **136** | **321** | **–** | **–** | **457** |
| Liabilities under insurance contracts | **226** | **63,722** | **477** | **–** | **64,425** |
| Deferred tax | **–** | **–** | **–** | **733** | **733** |
| Other liabilities | **–** | **–** | **19** | **125** | **144** |
| Total liabilities | **362** | **64,043** | **496** | **858** | **65,759** |
| Shareholders' equity | **–** | **–** | **–** | **8,968** | **8,968** |
| Total liabilities and shareholders' equity | **362** | **64,043** | **496** | **9,826** | **74,727** |
| 2009 | | | | | |
| Financial assets: | | | | | |
| – financial assets designated at fair value | 217 | 4,441 | – | 616 | 5,274 |
| – derivatives | – | 78 | – | – | 78 |
| – financial investments | – | 46,791 | – | 2,329 | 49,120 |
| – other financial assets | 130 | 2,340 | 474 | 777 | 3,721 |
| Total financial assets | 347 | 53,650 | 474 | 3,722 | 58,193 |
| Reinsurance assets | – | 17 | 81 | 23 | 121 |
| Present value of in-force long-term insurance contracts | – | – | – | 3,466 | 3,466 |
| Other assets | – | 607 | 7 | 713 | 1,327 |
| Total assets | 347 | 54,274 | 562 | 7,924 | 63,107 |
| Liabilities under investment contracts designated at fair value | 121 | 332 | – | – | 453 |
| Liabilities under insurance contracts | 224 | 53,588 | 428 | – | 54,240 |
| Deferred tax | – | – | – | 533 | 533 |
| Other liabilities | – | – | – | 225 | 225 |
| Total liabilities | 345 | 53,920 | 428 | 758 | 55,451 |
| Shareholders' equity | – | – | – | 7,656 | 7,656 |
| Total liabilities and shareholders' equity | 345 | 53,920 | 428 | 8,414 | 63,107 |

1 Comprises life linked insurance contracts and linked investment contracts

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

3 Comprises non-life insurance contracts

4 Comprises shareholder assets

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

#### Underwriting strategy

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

#### Reinsurance strategy

The Group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. These reinsurance agreements transfer part of the risk and limit the exposure from each life insured. The amount of each risk retained depends on the Group's evaluation of the specific risk, subject in certain circumstances, to maximum limits based on characteristics of coverage. Under the terms of the reinsurance agreements, the reinsurer agrees to reimburse the ceded amount in the event the claim is paid. However, the Group remains liable to its policyholders with respect to ceded insurance if any reinsurer fails to meet the obligations it assumes. The Group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The Group uses non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

#### Nature of risks covered

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

*(i) Long-term insurance contracts – non-linked products*

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

*(ii) Long-term insurance contracts – linked products*

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

*(iii) Long-term investment contracts – non-linked return guaranteed products*

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

*(iv) Long-term investment contracts – linked products*

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

*(v) Non-life insurance contracts*

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

### Concentration of insurance risks

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

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

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

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

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities are therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. Details of the analysis of life insurance liabilities are disclosed in note 48. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

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

| | **2010** | 2009 |
|---|---|---|
| Accident and health | **102** | 108 |
| Fire and other damage | **126** | 110 |
| Motor | **23** | 23 |
| Liability | **45** | 58 |
| Marine, aviation and transport | **21** | 19 |
| Other (non-life) | **27** | 11 |
| | **344** | 329 |

*Financial risks*

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

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

*Financial assets held by insurance operations*

| | | | Group | | |
|---|---|---|---|---|---|
| | **Life linked contracts** | **Life non-linked contracts** | **Non-life insurance** | **Other assets** | **Total** |
| **2010** | | | | | |
| Financial assets designated at fair value: | | | | | |
| – debt securities | **–** | **4,150** | **–** | **142** | **4,292** |
| – equity securities | **237** | **2,436** | **–** | **–** | **2,673** |
| | **237** | **6,586** | **–** | **142** | **6,965** |
| Financial investments | | | | | |
| Held-to-maturity: | | | | | |
| – debt securities | **–** | **53,591** | **–** | **2,710** | **56,301** |
| | **–** | **53,591** | **–** | **2,710** | **56,301** |
| Available-for-sale: | | | | | |
| – debt securities | **–** | **–** | **–** | **616** | **616** |
| – equity securities | **–** | **–** | **–** | **13** | **13** |
| | **–** | **–** | **–** | **629** | **629** |
| Derivatives | **–** | **161** | **–** | **–** | **161** |
| Other financial assets | **125** | **3,270** | **421** | **657** | **4,473** |
| | **362** | **63,608** | **421** | **4,138** | **68,529** |

| | | | Group | | |
|---|---|---|---|---|---|
| | 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 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

The table demonstrates that for linked contracts, the Group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 0.5% of the total financial assets of the Group's insurance manufacturing subsidiaries at the end of 2010 (2009: 0.6%). The table also shows that approximately 89.3% of financial assets was invested in debt securities at 31 December 2010 (2009: 92.6%) with 3.9% (2009: 0.9%) invested in equity securities.

*Market risk*

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

*Interest rate risk*

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

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

An immediate and permanent movement in interest yield curves as at 31 December 2010 in all territories in which the Group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **Impact on profit for the year** | **Impact on net assets** | Impact on profit for the year | Impact on net assets |
| + 100 basis points shift in yield curves | **239** | **229** | 205 | 197 |
| – 100 basis points shift in yield curves | **(161)** | **(151)** | (128) | (120) |

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

*Equity risk*

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

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

| | **2010** | | 2009 | |
|---|---|---|---|---|
| | **Impact on profit for the year** | **Impact on net assets** | Impact on profit for the year | Impact on net assets |
| 10 per cent increase in equity prices | **205** | **205** | 26 | 26 |
| 10 per cent decrease in equity prices | **(205)** | **(205)** | (26) | (26) |

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

*Foreign currency risk*

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

*Credit risk*

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

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

| | Neither past due nor impaired | | | | | | |
|---|---|---|---|---|---|---|---|
| | Strong | Medium | Sub-standard | Past due not impaired | Impaired | Impairment allowances | Total |
| **2010** | | | | | | | |
| **Supporting liabilities under non-linked insurance and investment contracts** | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,148 | 2 | – | – | – | – | 4,150 |
| | 4,148 | 2 | – | – | – | – | 4,150 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 52,271 | 1,320 | – | – | – | – | 53,591 |
| | 52,271 | 1,320 | – | – | – | – | 53,591 |
| **Supporting shareholders funds** | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 142 | – | – | – | – | – | 142 |
| | 142 | – | – | – | – | – | 142 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 3,282 | 44 | – | – | – | – | 3,326 |
| | 3,282 | 44 | – | – | – | – | 3,326 |
| **Total** | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,290 | 2 | – | – | – | – | 4,292 |
| | 4,290 | 2 | – | – | – | – | 4,292 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 55,553 | 1,364 | – | – | – | – | 56,917 |
| | 55,553 | 1,364 | – | – | – | – | 56,917 |

## 61. 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 |
| 2009 | | | | | | | |
| **Supporting liabilities under non-linked insurance and investment contracts** | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,051 | 85 | – | – | – | – | 4,136 |
| | 4,051 | 85 | – | – | – | – | 4,136 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 46,239 | 552 | – | – | – | – | 46,791 |
| | 46,239 | 552 | – | – | – | – | 46,791 |
| **Supporting shareholders funds** | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 616 | – | – | – | – | – | 616 |
| | 616 | – | – | – | – | – | 616 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 2,323 | – | – | – | – | – | 2,323 |
| | 2,323 | – | – | – | – | – | 2,323 |
| **Total** | | | | | | | |
| Financial assets designated at fair value: | | | | | | | |
| – treasury and other eligible bills | – | – | – | – | – | – | – |
| – debt securities | 4,667 | 85 | – | – | – | – | 4,752 |
| | 4,667 | 85 | – | – | – | – | 4,752 |
| Financial investments: | | | | | | | |
| – treasury and other similar bills | – | – | – | – | – | – | – |
| – debt securities | 48,562 | 552 | – | – | – | – | 49,114 |
| | 48,562 | 552 | – | – | – | – | 49,114 |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

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

Reinsurers' share of liabilities under insurance contracts

| | Neither past due nor impaired | | | | | | |
|---|---|---|---|---|---|---|---|
| | Strong | Medium | Sub-standard | Past due not impaired | Impaired | Impairment allowances | Total |
| **2010** | | | | | | | |
| Linked insurance contracts | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| Non-linked insurance contracts | **108** | **30** | **–** | **–** | **–** | **–** | **138** |
| Total | **108** | **30** | **–** | **–** | **–** | **–** | **138** |
| Reinsurance Debtors | **7** | **3** | **–** | **11** | **–** | **–** | **21** |
| 2009 | | | | | | | |
| Linked insurance contracts | – | – | – | – | – | – | – |
| Non-linked insurance contracts | 82 | 16 | – | – | – | – | 98 |
| Total | 82 | 16 | – | – | – | – | 98 |
| Reinsurance Debtors | 7 | 2 | – | 13 | – | – | 22 |

*Liquidity risk*

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

The following table shows the expected maturity of insurance contract liabilities at balance sheet dates:

Expected maturity of insurance contract liabilities

| | Expected cash flows (undiscounted) | | | | |
|---|---|---|---|---|---|
| | Within 1 year | Over 1 year but within 5 years | Over 5 years but within 15 years | Over 15 years | Total |
| **2010** | | | | | |
| Non-life insurance | **266** | **187** | **43** | **–** | **496** |
| Life insurance (non-linked) | **5,281** | **29,418** | **61,674** | **35,696** | **132,069** |
| Life insurance (linked) | **27** | **177** | **149** | **892** | **1,245** |
| | **5,574** | **29,782** | **61,866** | **36,588** | **133,810** |
| 2009 | | | | | |
| Non-life insurance | 249 | 160 | 33 | – | 442 |
| Life insurance (non-linked) | 3,985 | 26,231 | 56,760 | 32,549 | 119,525 |
| Life insurance (linked) | 28 | 183 | 158 | 973 | 1,342 |
| | 4,262 | 26,574 | 56,951 | 33,522 | 121,309 |

## 61. 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 |
| **2010** | | | | |
| Remaining contractual maturity: | | | | |
| – due within 1 year | **2** | **–** | **–** | **2** |
| – due over 1 year but within 5 years | **–** | **–** | **–** | **–** |
| – due over 5 years but within 10 years | **–** | **–** | **–** | **–** |
| – due over 10 years | **–** | **–** | **–** | **–** |
| – undated | **134** | **321** | **–** | **455** |
| | **136** | **321** | **–** | **457** |
| 2009 | | | | |
| Remaining contractual maturity: | | | | |
| – due within 1 year | 2 | – | – | 2 |
| – due over 1 year but within 5 years | – | – | – | – |
| – due over 5 years but within 10 years | – | – | – | – |
| – due over 10 years | – | – | – | – |
| – undated | 119 | 332 | – | 451 |
| | 121 | 332 | – | 453 |

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

The Group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2010 was HK$4,593 million (2009: HK$3,466 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at balance sheet dates can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF at balance sheet dates of reasonably possible changes in the main economic and business assumptions:

| | 2010 | 2009 |
|---|---|---|
| + 100 basis points shift in risk-free rate | **635** | 548 |
| – 100 basis points shift in risk-free rate | **(494)** | (375) |
| + 100 basis points shift in risk discount rate | **(196)** | (181) |
| – 100 basis points shift in risk discount rate | **220** | 204 |
| + 100 basis points shift in expenses inflation | **(18)** | (15) |
| – 100 basis points shift in expenses inflation | **16** | 13 |
| + 100 basis points shift in lapse rate | **824** | 853 |
| – 100 basis points shift in lapse rate | **(769)** | (817) |

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (d) Insurance risk (continued)

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

Non-economic assumptions

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

| | **Impact on 2010 results** | | Impact on 2009 results | |
|---|---|---|---|---|
| | **Profit for the year** | **Net assets** | Profit for the year | Net assets |
| 20 per cent increase in claims costs | **(12)** | **(12)** | (24) | (24) |
| 20 per cent decrease in claims costs | **12** | **12** | 24 | 24 |
| 10 per cent increase in mortality and/or morbidity rates | **(27)** | **(27)** | (22) | (22) |
| 10 per cent decrease in mortality and/or morbidity rates | **27** | **27** | 21 | 21 |
| 50 per cent increase in lapse rates | **520** | **520** | 535 | 535 |
| 50 per cent decrease in lapse rates | **(531)** | **(531)** | (549) | (549) |
| 10 per cent increase in expense rates | **(40)** | **(40)** | (36) | (36) |
| 10 per cent decrease in expense rates | **40** | **40** | 36 | 36 |

### (e) Operational risk

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

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

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

- operational risk management responsibility is assigned to senior management within the business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;
- assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;
- operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the Group’s Audit Committee; and
- risk mitigation, including insurance is considered where this is cost-effective.

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (e) Operational risk (continued)

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

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

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

### (f) Capital management

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

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

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

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

#### Externally imposed capital requirements:

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

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

## 61. FINANCIAL RISK MANAGEMENT (continued)

### (f) Capital management (continued)

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

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

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

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

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

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

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

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS

### (a) Determination of fair value

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

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

### Control framework

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

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

### Determination of fair value of financial instruments carried at fair value

*Fair value are determined according to the following hierarchy:*

(i) Level 1: Quoted market price

Financial instruments with quoted prices for identical instruments in active markets.

(ii) Level 2: Valuation technique using observable inputs

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

(iii) Level 3: Valuation technique with significant non-observable inputs

Financial instruments valued using models where one or more significant inputs are not observable.

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

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

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

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

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

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

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

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

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

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

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

– Debt securities, Treasury and eligible bills, and Equities

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

– Derivatives

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

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

– Private equity

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

#### Analysis of fair value determination

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

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | Valuation techniques | | | | | |
| | quoted market price | using observable inputs | with significant non-observable inputs | Third party total | Amounts with HSBC entities* | Total |
| **2010** | | | | | | |
| **Assets** | | | | | | |
| Trading assets | **24,840** | **1,215** | **–** | **26,055** | **–** | **26,055** |
| Financial assets designated at fair value | **818** | **2,245** | **510** | **3,573** | **3,541** | **7,114** |
| Derivative financial instruments | **721** | **4,161** | **106** | **4,988** | **605** | **5,593** |
| Available-for-sale financial investments | **25,207** | **117,568** | **283** | **143,058** | **–** | **143,058** |
| **Liabilities** | | | | | | |
| Trading liabilities | **18,991** | **23,037** | **553** | **42,581** | **–** | **42,581** |
| Financial liabilities designated at fair value | **–** | **457** | **–** | **457** | **–** | **457** |
| Derivative financial instruments | **96** | **4,034** | **–** | **4,130** | **553** | **4,683** |
| 2009 | | | | | | |
| **Assets** | | | | | | |
| Trading assets | 64,476 | 2,121 | – | 66,597 | – | 66,597 |
| Financial assets designated at fair value | 216 | 1,192 | 696 | 2,104 | 3,346 | 5,450 |
| Derivative financial instruments | 511 | 4,156 | – | 4,667 | 383 | 5,050 |
| Available-for-sale financial investments | 59,895 | 132,490 | 448 | 192,833 | – | 192,833 |
| **Liabilities** | | | | | | |
| Trading liabilities | 12,932 | 24,703 | 756 | 38,391 | – | 38,391 |
| Financial liabilities designated at fair value | – | 1,456 | – | 1,456 | – | 1,456 |
| Derivative financial instruments | 92 | 2,845 | – | 2,937 | 1,314 | 4,251 |

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

| | Bank | | | | | |
|---|---|---|---|---|---|---|
| | Valuation techniques | | | | | |
| | quoted market price | using observable inputs | with significant non-observable inputs | Third party total | Amounts with HSBC entities* | Total |
| **2010** | | | | | | |
| **Assets** | | | | | | |
| Trading assets | **24,840** | **392** | **–** | **25,232** | **–** | **25,232** |
| Financial assets designated at fair value | **–** | **148** | **–** | **148** | **–** | **148** |
| Derivative financial instruments | **717** | **3,784** | **–** | **4,501** | **525** | **5,026** |
| Available-for-sale financial investments | **24,176** | **78,894** | **36** | **103,106** | **–** | **103,106** |
| **Liabilities** | | | | | | |
| Trading liabilities | **18,991** | **10,831** | **284** | **30,106** | **–** | **30,106** |
| Financial liabilities designated at fair value | **–** | **–** | **–** | **–** | **–** | **–** |
| Derivative financial instruments | **95** | **3,742** | **–** | **3,837** | **691** | **4,528** |
| 2009 | | | | | | |
| **Assets** | | | | | | |
| Trading assets | 64,476 | 812 | – | 65,288 | – | 65,288 |
| Financial assets designated at fair value | – | 174 | – | 174 | – | 174 |
| Derivative financial instruments | 510 | 4,115 | – | 4,625 | 291 | 4,916 |
| Available-for-sale financial investments | 55,446 | 101,236 | 33 | 156,715 | – | 156,715 |
| **Liabilities** | | | | | | |
| Trading liabilities | 12,932 | 21,537 | 602 | 35,071 | – | 35,071 |
| Financial liabilities designated at fair value | – | 1,003 | – | 1,003 | – | 1,003 |
| Derivative financial instruments | 92 | 2,765 | – | 2,857 | 1,323 | 4,180 |

* Included structured instrument and derivative contracts transacted with HSBC entities which were mainly classified within level 2 of the valuation hierarchy.

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

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

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

| | Group | | | | | | |
|---|---|---|---|---|---|---|---|
| | Assets | | | | Liabilities | | |
| | Available-for-sale | Held for trading | Designated at fair value through profit or loss | Derivatives | Held for trading | Designated at fair value through profit or loss | Derivatives |
| At 1 January 2010 | 448 | – | 696 | – | 756 | – | – |
| Total gains or losses recognised in profit and loss | (1) | – | 47 | 14 | 14 | – | – |
| Total gains or losses recognised in other comprehensive income | 12 | – | – | – | – | – | – |
| Purchases | 20 | – | 165 | – | – | – | – |
| Issues/deposits taking | – | – | – | – | 1,528 | – | – |
| Sales | – | – | (21) | – | – | – | – |
| Settlements | (9) | – | (80) | 92 | (2,110) | – | – |
| Transfers out | (397) | – | (425) | – | (685) | – | – |
| Transfers in | 210 | – | 128 | – | 1,044 | – | – |
| Exchange adjustments | – | – | – | – | 6 | – | – |
| At 31 December 2010 | 283 | – | 510 | 106 | 553 | – | – |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date | 16 | – | 52 | 13 | 8 | – | – |

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

| | Bank | | | | | | |
|---|---|---|---|---|---|---|---|
| | Assets | | | | Liabilities | | |
| | Available-for-sale | Held for trading | Designated at fair value through profit or loss | Derivatives | Held for trading | Designated at fair value through profit or loss | Derivatives |
| At 1 January 2010 | 33 | – | – | – | 602 | – | – |
| Total gains or losses recognised in profit and loss | – | – | – | – | 11 | – | – |
| Total gains or losses recognised in other comprehensive income | 3 | – | – | – | – | – | – |
| Purchases | – | – | – | – | – | – | – |
| Issues/deposits taking | – | – | – | – | 1,018 | – | – |
| Sales | – | – | – | – | – | – | – |
| Settlements | – | – | – | – | (1,662) | – | – |
| Transfers out | – | – | – | – | (685) | – | – |
| Transfers in | – | – | – | – | 1,000 | – | – |
| Exchange adjustments | – | – | – | – | – | – | – |
| At 31 December 2010 | 36 | – | – | – | 284 | – | – |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the balance sheet date | 5 | – | – | – | 9 | – | – |

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

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

For available-for-sale securities and financial assets designated at fair value, the transfers into and out of Level 3 were due to change in valuation observability of certain debt securities during the year.

For held-for-trading liabilities, transfers into and out of Level 3 were primarily due to change in valuation observability of equity correlation during the year.

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

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

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

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

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

| | Group | | | |
|---|---|---|---|---|
| | Reflected in profit/(loss) | | Reflected in equity | |
| | favourable changes | unfavourable changes | favourable changes | unfavourable changes |
| **2010** | | | | |
| Derivatives/trading assets/trading liabilities | **1** | **(1)** | **–** | **–** |
| Financial assets/liabilities designated at fair value | **51** | **(51)** | **–** | **–** |
| Available-for-sale financial investments | **–** | **–** | **28** | **(28)** |
| 2009 | | | | |
| Derivatives/trading assets/trading liabilities | – | – | – | – |
| Financial assets/liabilities designated at fair value | 70 | (70) | – | – |
| Available-for-sale financial investments | – | – | 45 | (45) |

| | Bank | | | |
|---|---|---|---|---|
| | Reflected in profit/(loss) | | Reflected in equity | |
| | favourable changes | unfavourable changes | favourable changes | unfavourable changes |
| **2010** | | | | |
| Derivatives/trading assets/trading liabilities | **–** | **–** | **–** | **–** |
| Financial assets/liabilities designated at fair value | **–** | **–** | **–** | **–** |
| Available-for-sale financial investments | **–** | **–** | **4** | **(4)** |
| 2009 | | | | |
| Derivatives/trading assets/trading liabilities | – | – | – | – |
| Financial assets/liabilities designated at fair value | – | – | – | – |
| Available-for-sale financial investments | – | – | 3 | (3) |

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

### Changes in fair value recorded in the income statement

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

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

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

| | Group | | Bank | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Recorded profit: | | | | |
| Derivatives/trading assets/trading liabilities | **28** | 310 | **11** | 309 |
| Financial assets/liabilities designated at fair value | **47** | 14 | **–** | – |

### Fair value of financial instruments not carried at fair value

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

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

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

(i) Loans and advances to customers

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

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (a) Determination of fair value (continued)

(ii) Financial investments

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

(iii) Deposits and customer accounts

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

(iv) Debt securities in issue and subordinated liabilities

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

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

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

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

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

**Assets**

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

**Liabilities**

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

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

## 62. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)

### (b) Fair value

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

| | Group | | | |
|---|---|---|---|---|
| | **2010** | | 2009 | |
| | **Carrying amount** | **Fair value** | Carrying amount | Fair value |
| **Financial Assets** | | | | |
| Placings with and advances to banks and other financial institutions | **110,564** | **110,570** | 104,551 | 104,551 |
| Advances to customers | **472,637** | **474,045** | 344,621 | 346,459 |
| Held-to-maturity debt securities | **56,301** | **58,327** | 48,669 | 49,805 |
| **Financial Liabilities** | | | | |
| Current, savings and other deposit accounts | **683,628** | **683,732** | 636,369 | 636,435 |
| Deposits from banks | **15,586** | **15,586** | 4,870 | 4,870 |
| Certificates of deposit and other debt securities in issue | **3,095** | **3,104** | 1,826 | 1,859 |
| Subordinated liabilities | **11,848** | **12,761** | 9,320 | 9,041 |

| | Bank | | | |
|---|---|---|---|---|
| | **2010** | | 2009 | |
| | **Carrying amount** | **Fair value** | Carrying amount | Fair value |
| **Financial Assets** | | | | |
| Placings with and advances to banks and other financial institutions | **52,131** | **52,136** | 65,624 | 65,624 |
| Advances to customers | **423,074** | **424,514** | 299,179 | 301,054 |
| **Financial Liabilities** | | | | |
| Current, savings and other deposit accounts | **649,144** | **649,249** | 612,014 | 612,080 |
| Deposits from banks | **15,585** | **15,585** | 4,469 | 4,469 |
| Certificates of deposit and other debt securities in issue | **3,095** | **3,104** | 1,826 | 1,859 |
| Subordinated liabilities | **11,848** | **12,761** | 9,320 | 9,041 |

## 63. COMPARATIVE FIGURES

As a result of the adoption of the amendments to HKAS 17 "Leases", certain comparative figures have been adjusted to conform with the current year's presentation and to provide comparative amounts in respect of items disclosed for the first time in 2010.

## 64. IMMEDIATE AND ULTIMATE HOLDING COMPANIES

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

## 65. APPROVAL OF FINANCIAL STATEMENTS

The financial statements were approved and authorised for issue by the Board of Directors on 28 February 2011.