The Hongkong and Shanghai Banking Corporation Limited

Annual Report and Accounts 2009

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Annual Report and Accounts 2009

Contents

A Chinese translation of the *Annual Report and Accounts* is available upon request from: Group Communications (Asia), Level 32, HSBC Main Building, 1 Queen's Road Central, Hong Kong. The report is also available, in English and Chinese, on the Bank's web site at www.hsbc.com.hk.

本《*年報及賬目*》備有中譯本，如欲查閱可向下址索取：香港皇后大道中 1 號滙豐總行大廈 32 樓集團企業傳訊部（亞太區）。本年報之中英文本亦載於本行之網址 www.hsbc.com.hk。

Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'.

Financial Highlights: The Hongkong and Shanghai Banking Corporation Limited and Subsidiaries

	2009	2008
For the year	**HK$m**	HK$m
Net operating income before loan impairment charges	**118,250**	124,264
Profit before tax	**62,563**	67,690
Profit attributable to shareholders	**45,808**	50,306
At the year-end		
Shareholders' equity	**245,788**	193,612
Total equity	**270,727**	216,486
Total capital base	**220,582**	190,598
Customer accounts	**2,944,539**	2,576,084
Total assets	**4,341,703**	4,260,356
Ratios	**%**	%
Return on average shareholders' equity	**21.2**	24.3
Post-tax return on average total assets	**1.15**	1.31
Cost efficiency ratio	**44.1**	42.1
Net interest margin	**1.92**	2.36
Capital adequacy ratios		
– capital adequacy	**16.1**	13.4
– core capital	**12.2**	10.3

Established in Hong Kong and Shanghai in 1865, The Hongkong and Shanghai Banking Corporation Limited is the founding member of the HSBC Group – one of the world's largest banking and financial services organisations – and its flagship in the Asia-Pacific region. It is the largest bank incorporated in the Hong Kong Special Administrative Region and one of the SAR's three note-issuing banks.

Serving the financial and wealth management needs of an international customer base, the Bank and its subsidiaries provide a complete range of personal, commercial and corporate banking and related financial services through some 1,040 branches and offices in 19 countries and territories in Asia-Pacific – the largest network of any international financial institution in the region – and 20 branches and offices in six other countries around the world. Employing some 68,700 people, of whom 39,300 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2009 of HK$4,342 billion.

The Hongkong and Shanghai Banking Corporation Limited is a wholly owned subsidiary of HSBC Holdings plc, the holding company of the HSBC Group, which has some 8,000 offices in 88 countries and territories and assets of US$2,364 billion.

The Hongkong and Shanghai Banking Corporation Limited
Incorporated in the Hong Kong SAR with limited liability
Registered Office and Head Office: HSBC Main Building, 1 Queen's Road Central, Hong Kong
Telephone: (852) 2822 1111 Facsimile: (852) 2810 1112 Web: www.hsbc.com.hk Telex:73201 HKBG HX

Report of the Directors

Board of Directors

Michael F Geoghegan, CBE, *Chairman*
Dr William Fung Kwok Lun, SBS, OBE, *Deputy Chairman*
Laura Cha May Lung, GBS, *Deputy Chairman*
Peter Wong Tung Shun, *Chief Executive*
Dr Raymond Ch'ien Kuo Fung, GBS, CBE
Alexander A Flockhart, CBE
Stephen K Green
Stuart T Gulliver
Margaret Leung Ko May Yee (appointed on 1 April 2009)
Victor Li Tzar Kuoi
Dr Lo Ka Shui, GBS
Zia Mody
Christopher D Pratt
Andreas Sohmen-Pao
T Brian Stevenson, SBS
Dr Patrick Wang Shui Chung
David Wei Zhe
Dr Rosanna Wong Yick-ming, DBE
Marjorie Yang Mun Tak

Principal Activities

The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary and associated companies ('the group') provide a comprehensive range of domestic and international banking and related financial services, principally in the Asia-Pacific region.

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 27 to 205.

Reserves

Profits attributable to shareholders, before dividends, of HK$45,808 million have been transferred to reserves. During the year, a surplus of HK$470 million, net of the related deferred taxation effect, arising from professional valuations of premises and held by the Bank and the group was credited to reserves. Details of the movements in reserves, including appropriations therefrom, are set out in the Consolidated Statement of Changes in Equity and note 39 to the financial statements. The Directors do not recommend the payment of a final dividend.

Share Capital

The capital has been increased during the year by US$1,050 million (HK$8,138 million) by the issue of 1,050 million Cumulative Redeemable Preference Shares of US$1.00 each. The shares were issued in order to finance the acquisition of HSBC Bank Malaysia Berhad and to support business growth. In accordance with Hong Kong Accounting Standard 32 'Financial Instruments: Presentation', these Preference Shares are presented as liabilities in the Consolidated Statement of Financial Position and the Statement of Financial Position of the Bank. Details of the movements in share capital of the Bank during the year are set out in notes 37 and 38 to the financial statements.

Directors

The names of the Directors serving during the year and up to the date of this report are set out above, apart from R C F Or and V H C Cheng, who resigned from the Board on 6 May 2009 and 1 February 2010 respectively.

Directors' Interests in Contracts

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

Directors' Rights to Acquire Shares or Debentures

Certain Directors of the Bank have been granted options and conditional awards over HSBC Holdings plc ordinary shares by that company (being the ultimate holding company) pursuant to the HSBC Holdings Savings-Related Share Option Plan and The HSBC Share Plan. During the year, V H C Cheng, A A Flockhart, M F Geoghegan, S K Green, S T Gulliver and P T S Wong acquired shares in HSBC Holdings plc under the terms of The HSBC Share Plan.

Apart from these arrangements, at no time during the year was the Bank, its holding companies, its subsidiary companies or any fellow subsidiary company a party to any arrangements to enable the Directors of the Bank to acquire benefits by means of the acquisition of shares in or debentures of the Bank or any other body corporate.

Executive Committee

An Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board. The current members of the Committee are Peter Wong Tung Shun (Chairman of the Committee), Louisa Cheang Wai Wan (Regional Director, Personal Financial Services, Asia-Pacific), J E Coverdale (Group General Manager, Global Co-Head Commercial Banking), R H Cox (Chief Risk Officer), N P Fretwell (Head of Human Resources, Asia-Pacific and Global Head of Human Resources of Commercial Banking), D L Fried (Group General Manager, Regional Head of Insurance), Anita Fung Yuen Mei (Group General Manager, Head of Global Banking and Markets, Asia-Pacific), P E Leech (Head of International), I J Mackay (Chief Financial Officer), M S McCombe (Group General Manager, Chief Executive Officer Hong Kong), E I Sinyak (Chief Technology and Services Officer) and F Slevin (Head of Global Banking, Asia-Pacific).

Audit Committee

An Audit Committee, comprising three non-executive Directors of the Bank, meets regularly with the group's senior management and the internal and external auditors to consider and review the group's financial statements, the nature and scope of audit reviews and the effectiveness of the systems of internal control and compliance. The members of the Audit Committee are T B Stevenson (Chairman of the Committee), Dr Lo Ka Shui and Dr Patrick Wang Shui Chung.

Donations

Donations made by the Bank and its subsidiary companies during the year amounted to HK$88 million.

Compliance with the Banking (Disclosure) Rules and Hong Kong Monetary Authority Supervisory Policy Manual on Corporate Governance

The Directors are of the view that the Accounts and Supplementary Notes, which will be published separately, for the year ended 31 December 2009 fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance and the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'.

Auditors

The Accounts have been audited by KPMG. A resolution to reappoint KPMG as auditors of the Bank will be proposed at the forthcoming Annual General Meeting.

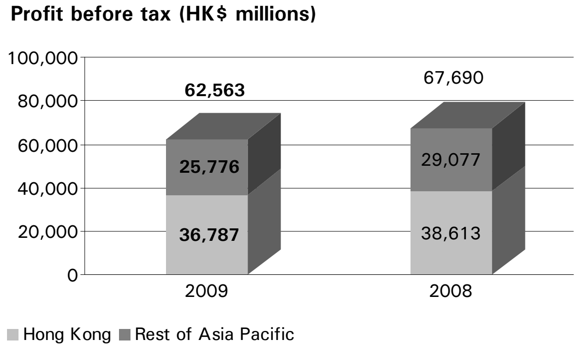
On behalf of the Board
Michael F Geoghegan, *Chairman*
Hong Kong, 1 March 2010

Financial Review

Summary of Financial Performance

Group Profit

Profit attributable to shareholders for 2009 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary and associated companies ('the group') decreased by HK$4,498 million, or 8.9 per cent, to HK$45,808 million in 2009. Profit before taxation decreased by HK$5,127 million, or 7.6 per cent, to HK$62,563 million.



Geographical Regions

The group's operating segments are organised into two geographical regions, Hong Kong and Rest of Asia-Pacific. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by retail businesses and global businesses. Although the chief operating decision-maker reviews information on a number of bases, capital resources are allocated and performance assessed primarily by geographical region and the segmental analysis is presented on that basis. In addition, the economic conditions of each geographical region are highly influential in determining performance across the different types of business activity carried out in the region. Therefore, provision of segment performance on a geographical basis provides the most meaningful information with which to understand the performance of the business.

Geographical information is classified by the location of the principal operations of the subsidiary or, in the case of the Bank, by the location of the branch responsible for reporting the results or advancing the funds.

Information provided to the chief operating decision maker of the group to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with Hong Kong Financial Reporting Standards ('HKFRSs'). Due to the nature of the group's structure, the analysis of profits shown below includes intra-segment items between geographical regions with the elimination shown in a separate column. Such transactions are conducted on an arm's length basis. Shared costs are included in segments on the basis of actual recharges made.

Products and services

The group provides a comprehensive range of banking and related financial services to its customers in its two geographical regions. The products and services offered to customers are organised by customer groups and global businesses.

- Personal Financial Services offers a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance, wealth management and local and international payment services.
- Commercial Banking product offerings include the provision of financial services, payments and cash management, international trade finance, treasury and capital markets, commercial cards, insurance, wealth management and investment banking services.
- Global Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients worldwide. The client-focused business lines deliver a full range of banking capabilities including investment banking and financing solutions; a markets business that provides services in credit, rates, foreign exchange, money markets and securities services; global asset management services and principal investment activities.
- Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

Geographical Regions *(continued)*

(HK$ millions)

	Hong Kong	Rest of Asia-Pacific	Intra-segment elimination	Total
2009				
Net interest income	**30,935**	**27,484**	**13**	**58,432**
Net fee income	**19,119**	**11,159**	**–**	**30,278**
Net trading income	**8,427**	**12,112**	**(13)**	**20,526**
Net income from financial instruments designated at fair value	**6,391**	**868**	**–**	**7,259**
Gains less losses from financial investments	**117**	**(248)**	**–**	**(131)**
Dividend income	**245**	**119**	**–**	**364**
Net earned insurance premiums	**28,566**	**2,829**	**–**	**31,395**
Other operating income	**9,791**	**1,746**	**(4,279)**	**7,258**
Total operating income	**103,591**	**56,069**	**(4,279)**	**155,381**
Net insurance claims incurred and movement in policyholders' liabilities	**(34,070)**	**(3,061)**	**–**	**(37,131)**
Net operating income before loan impairment charges and other credit risk provisions	**69,521**	**53,008**	**(4,279)**	**118,250**
Loan impairment charges and other credit risk provisions	**(3,875)**	**(7,360)**	**–**	**(11,235)**
Net operating income	**65,646**	**45,648**	**(4,279)**	**107,015**
Operating expenses	**(28,918)**	**(27,554)**	**4,279**	**(52,193)**
Operating profit	**36,728**	**18,094**	**–**	**54,822**
Share of profit in associates and joint venture	**59**	**7,682**	**–**	**7,741**
Profit before tax	**36,787**	**25,776**	**–**	**62,563**

(HK$ millions)

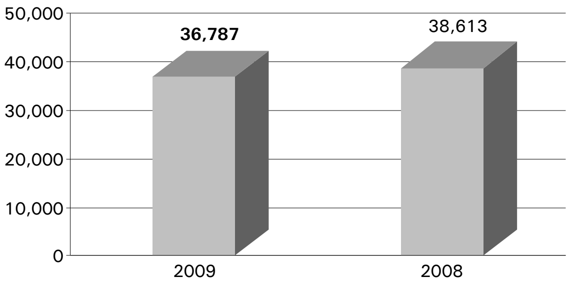
	Hong Kong	Rest of Asia-Pacific	Intra-segment elimination	Total
2008				
Net interest income/(expense)	42,679	26,374	(8)	69,045
Net fee income	18,458	12,309	–	30,767
Net trading income	7,201	14,154	8	21,363
Net loss from financial instruments designated at fair value	(9,607)	(1,375)	–	(10,982)
Gains less losses from financial investments	(2,848)	(128)	–	(2,976)
Dividend income	363	489	–	852
Net earned insurance premiums	25,351	1,535	–	26,886
Other operating income	6,525	1,222	(3,671)	4,076
Total operating income	88,122	54,580	(3,671)	139,031
Net insurance claims incurred and movement in policyholders' liabilities	(14,981)	214	–	(14,767)
Net operating income before loan impairment charges and other credit risk provisions	73,141	54,794	(3,671)	124,264
Loan impairment charges and other credit risk provisions	(5,837)	(6,163)	–	(12,000)
Net operating income	67,304	48,631	(3,671)	112,264
Operating expenses	(28,811)	(27,123)	3,671	(52,263)
Operating profit	38,493	21,508	–	60,001
Share of profit in associates and joint venture	120	7,569	–	7,689
Profit before tax	38,613	29,077	–	67,690

Financial Review (continued)

Geographical Regions *(continued)*

Hong Kong

Profit before tax (HK$ millions)



Hong Kong reported profit before tax of HK$36,787 million, a decrease of 4.7 per cent over 2008 primarily due to the fall in net interest income which was partly offset by increased trading income and lower loan impairment charges.

Net interest income decreased by HK$11,744 million, or 27.5 per cent, compared with 2008 as falling interest rates in the second half of 2008 impacted all business lines throughout 2009. In Personal Financial Services and Commercial Banking the relatively lower funding cost of the asset book and the increase in customer deposits of 14.4 per cent was more than offset by the year-on-year narrowing of interest rate spreads which impacted the overall margin.

In Personal Financial Services the mortgage book continued to perform strongly, with HSBC maintaining the number one position in Hong Kong for new business in 2009. The average loan-to-value ratio was 58.3 per cent in respect of new business. In Commercial Banking customer loans and advances fell by 6.9 per cent as market demand reduced and trade fell. However, there was an increase in trade volumes and lending activities in the second half of the year. Despite the challenging environment, HSBC continued to support local businesses. The group provided access to funds and launched a HK$4 billion SME fund in December 2008. This was increased a number of times during 2009 and now stands at HK$20 billion. The take-up of the fund was 100 per cent at 31 December, benefiting some 8,600 customers. HSBC also launched Green Financing, the first product in Hong Kong to specifically target the financing of capital investments which have a positive environmental impact, offering an interest rebate and principal repayment flexibility.

Global Banking and Markets net interest income decreased as falling interest rates impacted the Payments and Cash Management business. This was partly offset by improved spread in the Credit and Lending businesses.

Net fee income increased by HK$661 million, or 3.6 per cent, over 2008 as the improvement in the equity markets in the second half of 2009 was reflected in increased demand for services and confidence in wealth management products strengthened. Income from retail brokerage was significantly higher than 2008 with increased IPO activity in the second half of 2009 reflecting improved sentiment and a market rally. In addition, income in the primary debt markets was very strong and HSBC was ranked number one in Asia's local currency markets and in total issuance in Asia-Pacific excluding Japan. A decline in trade-related fee income reflected lower volumes in response to the challenging global environment. However, there was a recovery in trade activity in the second half of the year.

Net trading income increased by HK$1,226 million, or 17.0 per cent compared to 2008 as a result of increased volatility and risk adversity in the first half of 2009. This led to better margins on market-making activities across all asset classes primarily Rates and Credit. In addition, the non-recurrence of the write-down of a monoline exposure in 2008 contributed to the year-on-year improvement. However, in 2009 there was a reduction in foreign exchange trading contribution compared to a record high in 2008 and a change in the fair value movement in own credit spread.

Gains less losses from financial investments increased by HK$2,965 million mainly due to the non-recurrence of impairments against available-for-sale equity investments in 2008 following declines in market valuations.

Income from insurance business *(included within 'Net interest income', 'Net fee income', 'Net income from financial instruments designated at fair value', 'Net earned insurance premiums', the change in present value of in-force business within 'Other operating income', and after deducting 'Net insurance claims incurred and movement in policyholders' liabilities')* increased by 98.1 per cent compared with 2008. The increase was largely driven by strong new business growth and positive investment returns. Active management of the investment portfolio, shifted the mix from equities into bonds (excluding unit-linked) and resulted in higher net interest income and more stable returns in 2009. The positive movement in fair value which was primarily driven by equity market-related gains in unit-linked insurance products was largely offset by a corresponding increase in *'Net insurance claims incurred and movement policyholders' liabilities'* to reflect the extent to which unit-linked policyholders participate in the investment performance experienced on the linked investment portfolio.

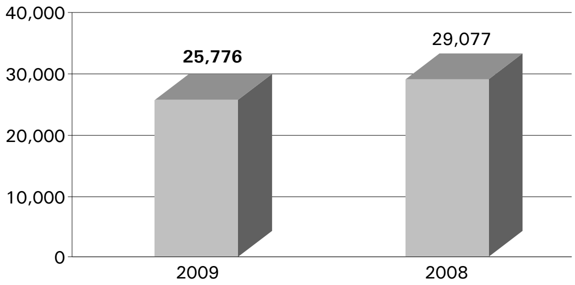
Insurance premiums increased by 12.7 per cent due to strong sales of regular premium insurance products, notably annuity based retirement products and unit-linked products, together with the launch of a high net worth life insurance product. In Hong Kong, the group (including Hang Seng Bank) became market leaders with a 30.8 per cent market share at the end of the third quarter of 2009 (up from 23.8 per cent in 2008) in the individual life new business (regular premiums).

Loan impairment charges and other credit risk provisions decreased by HK$1,962 million during the year as a result of an improved credit environment following a significant downturn in the second half of 2008. The levels of corporate default experienced in 2008 were not repeated in 2009, contributing to improvement in loan impairment charges and credit risk provisions in both Global Banking and Markets and Commercial Banking. There was also a reduction of impairment charges against available-for-sale debt securities. In Personal Financial Services, loan impairment charges increased by HK$531 million, due to an increase in the collective impairment charges on the credit card portfolio. The mortgage book is well secured with a loan to value ratio of 38.4 per cent which has resulted in very low impairment charges.

Operating expenses were HK$107 million, or 0.4 per cent higher than 2008 as a result of a marginal increase in staff costs within Global Banking and Markets due to an increase in performance-related pay reflecting improved performance. In Personal Financial Services and Commercial Banking, staff costs were lower as a result of a reduction in staff numbers and reduced performance-related pay. Non-staff costs fell as marketing expenditure was reduced, although this started to rise in the second half of the year. The group's move towards increased online transactions also contributed to sales generation at a lower cost which is reflected in the reduced expenses.

Rest of Asia-Pacific

Profit before tax (HK$ millions)



Rest of Asia-Pacific reported profit before tax of HK$25,776 million which was 11.4 per cent lower than 2008. This was primarily as a result of a fall in net fee income and net trading income and an increase in loan impairment charges.

Net interest income increased by HK$1,110 million, or 4.2 per cent. Excluding HSBC Bank Malaysia Berhad which was transferred into the group in January, and PT Bank Ekonomi Raharja Tbk ('Bank Ekonomi') which was acquired in May, net interest income fell by HK$2,161 million, or 8.2 per cent.

Most countries within Asia-Pacific saw a fall in net interest income compared to last year but this was offset by increases in Australia and South Korea as a result of improvements in local market positions. There were significant decreases in India, Taiwan, mainland China and Singapore as the low interest rate environment affected all customer groups.

Despite the challenging economic environment, HSBC continued to expand in the region positioning itself for a change in the external market conditions. In mainland China, 19 HSBC outlets, eight Rural bank outlets and four Hang Seng outlets were opened during the year, resulting in 98 HSBC branded outlets, 11 Rural bank outlets and 38 Hang Seng Bank outlets. In Indonesia, the acquisition of Bank Ekonomi increased our branch presence to over 200 outlets in 27 cities.

Customer deposits remained strong. Personal Financial Services was successful in attracting deposits and the acquisition of Premier customers within the region was notable, with a 35 per cent increase in customer numbers to over 580,000 in total. In Commercial Banking, customer deposit balances grew following the acquisitions of Bank Ekonomi in Indonesia and the transfer of HSBC Bank Malaysia Berhad into the group in the first half of the year.

Financial Review (continued)

Geographical Regions *(continued)*

Net fee income was HK$1,150 million, or 9.3 per cent, lower than 2008 reflecting a reduction in fees earned by Securities Services and Asset Management, a result of a drop in assets under custody and administration, notably in Singapore. However, this was partly offset by increases within Personal Financial Services and Commercial Banking. In Personal Financial Services, the increased sales focus on wealth management products and improved sentiment in equity markets in the second half of the year contributed to the 5.0 per cent rise in fee income. Commercial Banking net fee income was comparable to last year due to an increase in trade services in Malaysia (due to the transfer in of HSBC Bank Malaysia Berhad), Singapore and Bangladesh; cash management in Vietnam and Indonesia; and returning confidence in wealth management products towards the end of the year. In addition, Commercial Banking took various steps to capture cross-border business and continued to benefit from HSBC's international business reach and Amanah branches in Asia. Significant referral growth was seen in Greater China where cross border referral numbers doubled compared to the previous year.

Net trading income decreased by HK$2,042 million, or 14.4 per cent, as a result of a fall in net interest income on trading activities. In addition, income trends within the region diverged. In mainland China, trading income fell as expectation of an improvement in the economy impacted long-term bond yields. However, in South Korea trading income increased as opportunities arose from market-making and client hedging activities. Foreign exchange and Rates revenues declined across most of the region, reflecting low market volatility, though Credit trading performance was strong, particularly in mainland China, Japan and Singapore.

Net insurance income increased by 54.7 per cent primarily as a result of increased insurance premiums. Sales growth was particularly strong in Singapore following the launch of new products, including a high net worth life insurance product and a single premium guaranteed saver product.

Loan impairment charges increased by HK$1,197 million, or 19.4 per cent, compared to 2008 as the credit conditions continued to deteriorate in parts of the region, notably in India.

In Personal Financial Services, loan impairment charges rose by 9.8 per cent to HK$5,028 million primarily in India and Indonesia where the unsecured portfolios continued to incur high delinquencies. However, through a number of risk management initiatives, the loan impairment charges related to the unsecured portfolios in India reduced in the second half of the year. With the exception of India and Indonesia, loan impairment charges in the region remained relatively low indicating that the early credit risk measures taken in 2008 were effective.

In Commercial Banking the increase in loan impairment charges of HK$1,125 million reflected a rise in corporate default as the economic downturn took effect. While significant deterioration was experienced in India in the first half of the year, the charge in the second half of the year was much lower. Overall credit quality in the region is relatively stable as a result of the governments' economic stimulus packages feeding through into the real economy, together with liquidity improvements and actions taken by customers to adapt to the difficult circumstances.

Operating expenses have increased slightly by HK$431 million. The increase includes additional costs as a result of including HSBC Bank Malaysia Berhad and Bank Ekonomi for the first time. However, cautious cost management has resulted in lower administrative costs and marketing expenditure. These were broadly offset by investment to support the ongoing development of infrastructure in the region including branch expansion in mainland China, Vietnam and Malaysia, the integration of Bank Ekonomi and a full year's cost associated with The Chinese Bank in Taiwan and HSBC InvestDirect in India.

In an effort to improve operational efficiencies and reduce costs, the number of transactions completed through direct channels, including internet banking, telephone services and self-service machines is now more than 55 per cent.

Geographical Customer Groups

Hong Kong

(HK$ millions)

	Personal Financial Services	Commercial Banking	Global Banking and Markets	Private Banking	Other	Intra-segment elimination	Hong Kong Total
2009							
Net interest income/(expense)	**20,039**	**7,274**	**8,912**	**–**	**(4,367)**	**(923)**	**30,935**
Net fee income	**10,933**	**4,106**	**3,760**	**–**	**320**	**–**	**19,119**
Net trading income/ (expense)	**1,091**	**718**	**6,226**	**–**	**(529)**	**921**	**8,427**
Net income/(loss) from financial instruments designated at fair value	**5,650**	**(359)**	**1,072**	**–**	**26**	**2**	**6,391**
Gains less losses from financial investments	**623**	**136**	**(661)**	**–**	**19**	**–**	**117**
Dividend income	**5**	**11**	**71**	**–**	**158**	**–**	**245**
Net earned insurance premiums	**24,512**	**3,926**	**128**	**–**	**–**	**–**	**28,566**
Other operating income	**2,680**	**498**	**439**	**–**	**8,042**	**(1,868)**	**9,791**
Total operating income	**65,533**	**16,310**	**19,947**	**–**	**3,669**	**(1,868)**	**103,591**
Net insurance claims incurred and movement in policyholders' liabilities	**(30,840)**	**(3,142)**	**(88)**	**–**	**–**	**–**	**(34,070)**
Net operating income before loan impairment charges and other credit risk provisions	**34,693**	**13,168**	**19,859**	**–**	**3,669**	**(1,868)**	**69,521**
Loan impairment charges and other credit risk provisions	**(1,575)**	**(1,301)**	**(1,004)**	**–**	**5**	**–**	**(3,875)**
Net operating income	**33,118**	**11,867**	**18,855**	**–**	**3,674**	**(1,868)**	**65,646**
Operating expenses	**(12,138)**	**(4,469)**	**(7,361)**	**–**	**(6,818)**	**1,868**	**(28,918)**
Operating profit/(loss)	**20,980**	**7,398**	**11,494**	**–**	**(3,144)**	**–**	**36,728**
Share of profit/(loss) in associates and joint ventures	**40**	**10**	**11**	**–**	**(2)**	**–**	**59**
Profit/(loss) before tax	**21,020**	**7,408**	**11,505**	**–**	**(3,146)**	**–**	**36,787**

Financial Review (continued)

Geographical Customer Groups *(continued)*

Hong Kong

(HK$ millions)

	Personal Financial Services	Commercial Banking	Global Banking and Markets	Private Banking	Other	Intra-segment elimination	Hong Kong Total
2008							
Net interest income/(expense)	26,326	11,664	11,853	2	(6,657)	(509)	42,679
Net fee income	11,225	4,271	2,837	–	125	–	18,458
Net trading income/(expense)	1,193	620	4,868	–	87	433	7,201
Net (loss)/income from financial instruments designated at fair value	(10,051)	(79)	300	–	147	76	(9,607)
Gains less losses from financial investments	1,220	250	(605)	–	(3,713)	–	(2,848)
Dividend income	27	17	169	–	150	–	363
Net earned insurance premiums	23,719	1,456	159	–	17	–	25,351
Other operating income	1,030	297	348	–	7,095	(2,245)	6,525
Total operating income/(expense)	54,689	18,496	19,929	2	(2,749)	(2,245)	88,122
Net insurance claims incurred and movement in policyholders' liabilities	(13,792)	(1,070)	(107)	–	(12)	–	(14,981)
Net operating income/(expense) before loan impairment charges and other credit risk provisions	40,897	17,426	19,822	2	(2,761)	(2,245)	73,141
Loan impairment charges and other credit risk provisions	(1,044)	(2,605)	(2,198)	–	10	–	(5,837)
Net operating income/(expense)	39,853	14,821	17,624	2	(2,751)	(2,245)	67,304
Operating expenses	(13,131)	(4,578)	(7,062)	-	(6,285)	2,245	(28,811)
Operating profit/(loss)	26,722	10,243	10,562	2	(9,036)	–	38,493
Share of profit in associates and joint ventures	34	5	6	–	75	–	120
Profit/(loss) before tax	26,756	10,248	10,568	2	(8,961)	–	38,613

Geographical Customer Groups *(continued)*

Rest of Asia-Pacific

(HK$ millions)

	Personal Financial Services	Commercial Banking	Global Banking and Markets	Private Banking	Other	Intra-segment elimination	Rest of Asia-Pacific Total
2009							
Net interest income/(expense)	**11,568**	**6,248**	**10,213**	**121**	**71**	**(837)**	**27,484**
Net fee income/(expense)	**4,296**	**2,569**	**4,388**	**51**	**(145)**	**–**	**11,159**
Net trading income/ (expense)	**613**	**1,040**	**9,412**	**98**	**112**	**837**	**12,112**
Net income/(loss) from financial instruments designated at fair value	**851**	**8**	**(13)**	**–**	**22**	**–**	**868**
Gains less losses from financial investments	**41**	**18**	**(111)**	**–**	**(196)**	**–**	**(248)**
Dividend income	**1**	**–**	**1**	**–**	**117**	**–**	**119**
Net earned insurance premiums	**2,613**	**216**	**–**	**–**	**–**	**–**	**2,829**
Other operating income	**519**	**514**	**254**	**16**	**682**	**(239)**	**1,746**
Total operating income	**20,502**	**10,613**	**24,144**	**286**	**763**	**(239)**	**56,069**
Net insurance claims incurred and movement in policyholders' liabilities	**(2,947)**	**(114)**	**–**	**–**	**–**	**–**	**(3,061)**
Net operating income before loan impairment charges and other credit risk provisions	**17,555**	**10,499**	**24,144**	**286**	**763**	**(239)**	**53,008**
Loan impairment charges and other credit risk provisions	**(5,028)**	**(2,150)**	**(173)**	**–**	**(9)**	**–**	**(7,360)**
Net operating income	**12,527**	**8,349**	**23,971**	**286**	**754**	**(239)**	**45,648**
Operating expenses	**(14,260)**	**(4,934)**	**(7,334)**	**(358)**	**(907)**	**239**	**(27,554)**
Operating profit/(loss)	**(1,733)**	**3,415**	**16,637**	**(72)**	**(153)**	**–**	**18,094**
Share of profit in associates and joint ventures	**1,106**	**4,393**	**2,181**	**–**	**2**	**–**	**7,682**
Profit/(loss) before tax	**(627)**	**7,808**	**18,818**	**(72)**	**(151)**	**–**	**25,776**

Financial Review (continued)

Geographical Customer Groups *(continued)*

Rest of Asia-Pacific

(HK$ millions)

	Personal Financial Services	Commercial Banking	Global Banking and Markets	Private Banking	Other	Intra-segment elimination	Rest of Asia-Pacific Total
2008							
Net interest income/(expense)	11,376	6,294	11,222	41	1,160	(3,693)	26,374
Net fee income	4,092	2,519	5,482	83	133	–	12,309
Net trading income/(expense)	377	783	9,499	165	(389)	3,719	14,154
Net (loss)/income from financial instruments designated at fair value	(1,343)	2	(34)	–	–	–	(1,375)
Gains less losses from financial investments	8	–	34	–	(170)	–	(128)
Dividend income	–	–	4	–	485	–	489
Net earned insurance premiums	1,342	193	–	–	–	–	1,535
Other operating income	376	544	234	22	296	(250)	1,222
Total operating income	16,228	10,335	26,441	311	1,515	(250)	54,580
Net insurance claims incurred and movement in policyholders' liabilities	322	(108)	–	–	–	–	214
Net operating income before loan impairment charges and other credit risk provisions	16,550	10,227	26,441	311	1,515	(250)	54,794
Loan impairment charges and other credit risk provisions	(4,581)	(1,025)	(556)	–	(1)	–	(6,163)
Net operating income	11,969	9,202	25,885	311	1,514	(250)	48,631
Operating expenses	(14,111)	(4,653)	(7,175)	(326)	(1,108)	250	(27,123)
Operating profit/(loss)	(2,142)	4,549	18,710	(15)	406	–	21,508
Share of profit in associates and joint ventures	934	4,362	2,207	–	66	–	7,569
Profit/(loss) before tax	(1,208)	8,911	20,917	(15)	472	–	29,077

Net Interest Income

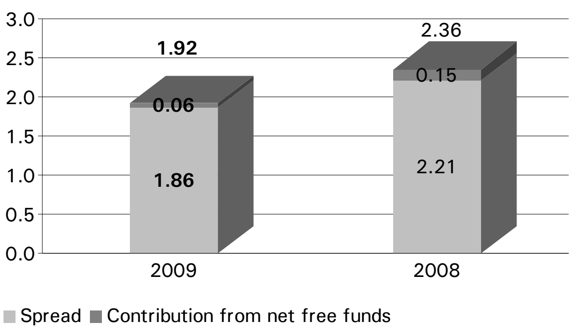
Net interest income declined by HK$10,613 million or 15.4 per cent compared to 2008 primarily as a result of a decline in interest rates. Net interest income was affected by the continuous compression of deposit spreads, repricing of assets at lower rates and a change in asset mix with deployment of funds to high quality but lower yielding assets.

Average interest-earning assets increased by HK$121,238 million or 4.1 per cent compared to 2008. Excluding HSBC Bank Malaysia Berhad which was transferred into the group at the start of 2009 and the acquisition of Bank Ekonomi in the first half of 2009, interest earning assets increased by HK$2,546 million. Financial investments increased as the commercial surplus was redeployed from interbank placements to lower risk treasury bills, government bonds and debt securities.

(HK$ millions)	2009	2008
Average interest-earning assets	**3,047,570**	2,926,332

Net interest margin decreased to 1.92 per cent, a reduction of 44 basis points when compared to 2008. The decline in interest margin was in line with the overall fall in interest rates, which resulted in the repricing of assets off lower yield curves. Net interest spread declined by 35 basis points to 1.86 per cent, while the contribution of net free funds decreased by nine basis points to six basis points.

Net interest margin (%)



In Hong Kong, the Bank recorded a drop in net interest margin of 75 basis points to 1.52 per cent. Net interest spread decreased by 77 basis points to 1.53 per cent on the back of declining HIBOR and LIBOR resulting in a further compression of deposit spreads. The adverse impact was moderated by a growth in customer accounts, an increase in residential mortgages on the back of a strong property market and improved lending spreads from lower cost of funds and repricing of portfolios.

At Hang Seng Bank, the net interest margin declined by 48 basis points to 2.11 per cent while the net interest spread declined by 28 basis points to 2.06 per cent. Net interest spread declined due to narrowing deposit spreads and the repricing of assets as interest rates fell. While average interest-earning assets increased, funds were deployed to high quality but low yield liquid assets to reduce risk. The benefit of net free funds decreased by 20 basis points to 0.05 per cent as a consequence of a low interest rate environment.

Net interest margin (%)

	2009	2008
Hong Kong:		
The Bank	**1.52**	2.27
Hang Seng Bank	**2.11**	2.59
Rest of Asia-Pacific	**2.19**	2.09

In the **Rest of Asia-Pacific**, net interest margin was 2.19 per cent, 10 basis points higher than 2008. Net interest spread widened by 21 basis points to 1.99 per cent. Excluding HSBC Bank Malaysia Berhad and Bank Ekonomi, net interest margin increased by three basis points. In Australia, net interest margin increased benefiting from a rising interest rate environment, repricing initiatives and growth in banking book assets, in particular residential mortgages. South Korea also reported a higher margin primarily due to lower cost of funds.

Financial Review (continued)

Net Fee Income

Net fee income was HK$489 million or 1.6 per cent lower than in 2008.

Unit trusts income declined 27.6 per cent, as cautious investment sentiment in 2009 led to lower demand for wealth management products. Falling sales in new unit trusts and investment funds, particularly in Hong Kong, resulted in a drop in subscription fees and commissions, although this moderated in the second half of the year.

Income from funds under management decreased 16.2 per cent as a result of lower sales in new funds and declining returns amidst market volatility during 2009, notably in Hong Kong. As a result, a reduction in the value of assets under management held by the group led to lower fees received.

Similarly, securities and stockbroking income fell as lower income was generated from securities services due to unfavourable conditions in 2009, particularly in Hong Kong, Japan, South Korea and Taiwan. However, the stockbroking business reported higher commissions from increased trading in Hong Kong, along with increased IPO opportunities in the second half of 2009.

(HK$ millions)	2009	2008
Account services	**2,181**	2,027
Credit facilities	**2,025**	1,767
Import/export	**3,744**	3,970
Remittances	**2,059**	1,900
Securities/stockbroking	**8,628**	9,734
Cards	**5,673**	5,308
Insurance	**478**	617
Unit trusts	**1,719**	2,374
Funds under management	**3,327**	3,969
Other	**5,749**	6,085
Fee income	**35,583**	37,751
Fee expense	**(5,305)**	(6,984)
Net fee income	**30,278**	30,767

Net Trading Income

Net trading income decreased HK$837 million or 3.9 per cent in 2009.

Interest on trading assets and liabilities declined 46.6 per cent from reduced holdings of trading debt securities, notably in Hong Kong and Australia. The reduction also reflected the low interest rate environment experienced throughout 2009.

Dealing profits increased 20.9 per cent, partially due to the non-recurrance of a write-down recognised last year and a revaluation gain on certain held-for-trading equity investments in 2009. Excluding these, improved market positions and trading opportunities led to higher trading revenues in Hong Kong especially on bonds, partially offset by lower foreign exchange trading income. In the Rest of Asia-Pacific, lower profits in India mainly reflected fewer trading opportunities as market volatility subsided in the latter part of 2009, coupled with a decline in client trading volume. Mainland China was affected by rising bond yields as the market anticipated a fast economic recovery and future inflation which led to higher revaluation losses on renminbi trading bonds.

(HK$ millions)	2009	2008
Dealing profits	**16,275**	13,462
Loss from hedging activities	**(23)**	(73)
Net interest income	**3,853**	7,215
Dividend income from trading securities	**421**	759
Net trading income	**20,526**	21,363

Gains Less Losses from Financial Investments

Impairment of available-for-sale equity investments decreased HK$3,461 million in 2009, which was attributable to the non-recurrence of the write-downs of strategic investments in 2008 and improving market conditions more generally.

During the year, the group realised gains on the disposal of certain investments including Visa shares. However, this was less than the gain recognised in 2008, which included income on the sale of MasterCard shares.

(HK$ millions)	2009	2008
Gains on disposal of available-for-sale securities	**1,191**	1,807
Impairment of available-for-sale equity investments	**(1,322)**	(4,783)
Gains less losses from financial investments	**(131)**	(2,976)

Other Operating Income

The movement in the present value of in-force insurance business increased substantially in 2009, primarily due to a growth in new business, including the launch of a new high net worth product and higher projected fee income on unit-linked funds.

'Other' mainly consisted of recoveries of IT and other operating costs that were incurred on behalf of fellow HSBC Group companies. It also included gains on acquired loans from The Chinese Bank and Bank Ekonomi.

The profit on disposal of property, plant and equipment mainly represented a gain realised from the sale of property in Hong Kong in late 2009.

(HK$ millions)	2009	2008
Rental income from investment properties	**169**	153
Movement in present value of in-force insurance business	**2,888**	823
Gains on investment properties	**262**	11
Profit/(loss) on disposal of property, plant and equipment, and assets held for sale	**696**	(63)
Loss on disposal of subsidiaries, associates and business portfolios	**(6)**	(96)
(Deficit)/surplus arising on property revaluation	**(143)**	60
Other	**3,392**	3,188
Other operating income	**7,258**	4,076

Insurance Income

Net interest income increased 39.2 per cent as a result of a change in the portfolio mix towards bond investments and a growth in funds under management. Net fee income declined 33.7 per cent due to increased fee expenses through higher commissions paid in respect of higher sales in life and non-life insurance products during the year, together with higher investment management fees as funds size increased.

Gains less losses from financial investments in the insurance business included a non-recurring significant write-down of a strategic investment in 2008. Changes in the fair value of assets supporting linked insurance contracts are reported in 'Net income from financial instruments designated at fair value', but with offsetting movements in the value of those contracts in 'Net insurance claims incurred and movement in policyholders' liabilities'.

Net earned insurance premiums rose 16.8 per cent, reflecting growing demand for deferred annuity and unit-linked products, combined with the launch of new high net worth products in 2009. Non-life premiums also increased through improved sales on medical, accident and health, and general liability products.

Movement in present value of in-force business increased as a result of higher new business production and growth in projected fee income on unit-linked funds.

(HK$ millions)	2009	2008
Net interest income	**4,691**	3,369
Net fee income	**768**	1,159
Net trading loss	**(8)**	(126)
Net income/(loss) from financial instruments designated at fair value	**6,150**	(11,471)
Gains less losses from financial investments	**(7)**	(1,468)
Dividend income	**29**	1
Net earned insurance premiums	**31,395**	26,886
Movement in present value of in-force business	**2,888**	823
Other operating income	**29**	307
	45,935	19,480
Net insurance claims incurred and movement in policyholder liabilities	**(37,131)**	(14,767)
Net operating income	**8,804**	4,713

Loan Impairment Charges and Other Credit Risk Provisions

The net charge for loan impairment and other credit risk provisions decreased by HK$765 million, or 6.4 per cent comparing to 2008.

Included in the net charge for other credit risk provisions was an impairment charge of HK$365 million against available-for-sale debt securities in 2009 (2008: HK$2,006 million). There were no impairment losses or provisions against held-to-maturity investments.

The charge for individually assessed allowances increased HK$630 million, with higher impairment charges from the Private Equity business, India and Bahrain, where corporate customers were adversely affected by deteriorating economic conditions. Hong Kong reported lower impairment charges and higher releases in 2009, mainly driven by a gradual improvement in the credit environment.

The net charge for collectively assessed impairment allowances declined marginally (HK$44 million), through lower provision charges against commercial customers and higher allowance releases, offset by rising impairment against credit cards and other unsecured lending. In Hong Kong, lower provisions were a result of a gradual improvement in local credit conditions, supported by ongoing recovery efforts throughout the year. Conversely, India experienced increases in loss rates in both personal and commercial portfolios, with some improvements in the latter part of 2009.

Net charge for impairment provisions by region

HK$ millions	**2009**	2008
Hong Kong	**3,487**	4,210
Rest of Asia-Pacific	**7,192**	5,883
Total	**10,679**	10,093

Net charge/(release) for impairment and other credit risk provisions

HK$ millions	**2009**	2008
Net charge for impairment of customer advances		
– Individually assessed impairment allowances:		
New allowances	**5,504**	4,243
Releases	**(1,135)**	(523)
Recoveries	**(188)**	(169)
	4,181	3,551
– Net charge for collectively assessed impairment allowances	**6,498**	6,542
	10,679	10,093
Net charge for other credit risk provisions	**556**	1,907
Net charge for loan impairment and other credit risk provisions	**11,235**	12,000

Financial Review (continued)

Operating Expenses

Employee compensation and benefits are slightly increased as compared with 2008, up HK$453 million, or 1.6 per cent.

Wages, salaries and other costs increased HK$250 million due to higher staff numbers acquired through acquisition and organic investment across the region. 2009 included the first full year for IL&FS Investsmart (now HSBC InvestDirect India) which was acquired in late 2008, HSBC Malaysia Berhad which transferred into the group at the start of 2009 and Bank Ekonomi which was acquired in the first half of 2009. In addition, mainland China continued to hire new staff to support ongoing branch expansion. However, staff numbers in a number of countries and territories reduced in 2009.

Performance-related pay rose marginally by HK$21 million, reflecting a favourable business performance by Global Banking and Markets especially in Hong Kong, partially offset by lower performance-related pay in Personal Finance Services and Commercial Banking in 2009.

Staff numbers by region*

	2009	2008
Hong Kong:		
The bank and wholly owned subsidiaries	**18,358**	19,499
Hang Seng Bank Hong Kong	**7,834**	8,256
Total Hong Kong	**26,192**	27,755
Rest of Asia-Pacific		
Australia	**1,599**	1,653
Mainland China	**7,204**	7,300
Malaysia	**5,024**	185
India	**8,337**	9,292
Indonesia	**5,042**	2,893
Singapore	**2,784**	2,857
Taiwan	**2,866**	3,030
Sri Lanka	**1,517**	1,646
Others	**8,209**	8,960
Total rest of Asia-Pacific	**42,582**	37,816
Total	**68,774**	65,571

* *Full time equivalent*

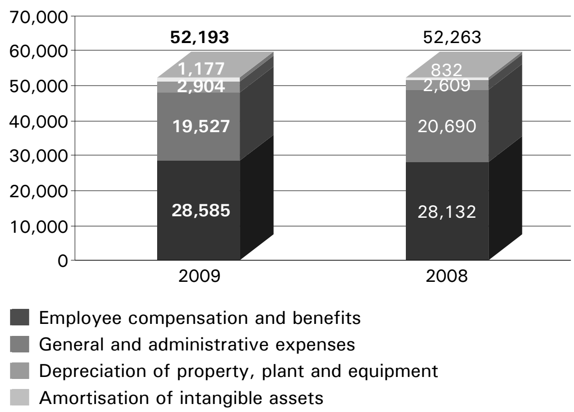
General and administrative expenses decreased year on year by HK$1,163 million, or 5.6 per cent.

Charges in respect of premises and equipment rose by HK$438 million, particularly in Hong Kong due to tenancy agreements being renewed at higher rates, more refurbishment projects and higher technology costs. Costs in mainland China also increased to support an expanding branch network.

Other administrative expenses declined HK$760 million, reflecting ongoing controls on overhead costs across the region, notably in Hong Kong and India. Marketing and advertising expenses decreased by HK$411 million primarily as a result of fewer promotional campaigns in 2009, although marketing activities increased in late 2009 as market sentiment improved. Litigation expenses reduced by HK$430 million due to lower charges in Australia and Singapore, together with a provision release in Hong Kong during 2009.

	2009	2008
Cost efficiency ratio (%)	**44.1**	42.1

Operating expenses (HK$ millions)



Share of Profit in Associates and Joint Ventures

Share of profit in associates and joint ventures principally included the group's share of post-tax profits from Bank of Communications and Industrial Bank, and amortisation of intangible assets arising on acquisition.

(HK$ millions)	**2009**	2008
Share of profit in associates and joint ventures	**7,741**	7,689

Tax Expense

The effective rate of tax for 2009 was 19.1 per cent compared with 18.8 per cent in 2008.

	2009	2008
Effective rate of tax (%)	**19.1**	18.8

Assets

Total assets increased by HK$81 billion, or 1.9 per cent, since 31 December 2008.

Cash and short-term funds increased by HK$295 billion, or 49.3 per cent, reflecting an increase in the commercial surplus and the redeployment of funds from the trading book into inter-bank placements.

Trading assets decreased by HK$171 billion, or 34.6 per cent, as a result of transferring the available surplus to financial investments and inter-bank placements as the market became less volatile for short-term profit taking.

Net advances to customers increased by HK$64 billion, or 5.0 per cent, since the end of 2008.

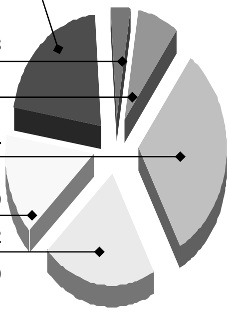
Net advances in Hong Kong decreased by HK$3.2 billion, or 0.4 per cent, since the end of 2008. The decline was largely attributable to a drop in Corporate and Commercial lending (down HK$21.2 billion), with decreases noted in commercial, industrial and international trade and commercial real estate sectors. The decrease was partly offset by an increase in advances to personal customers, which increased by HK$17.4 billion, or 5.3 per cent, largely attributable to an increase in residential mortgages as the property market became more active in 2009.

In the Rest of Asia-Pacific, net advances to customers increased by HK$67.7 billion, or 12.6 per cent, mainly due to the inclusion of HSBC Bank Malaysia Berhad and the acquisition of Bank Ekonomi in Indonesia. Excluding these new subsidiaries, net advances to customers dropped by HK$4.4 billion, or 0.8 per cent. Decreases were noted in Corporate and Commercial lending (down HK$9.3 billion), lending to financials institutions (down HK$12.2 billion), and other personal lending (down HK$8.9 billion), partly offset by an increase in residential mortgages (up HK$27.5 billion), notably in Australia (with strong underlying growth, coupled with appreciation in underlying currency) and Singapore.

Financial investments rose by HK$297 billion, or 50.6 per cent. The increase was as a result of the switch from the trading book to available-for-sale corporate securities, with an increase in the holding of debt securities of HK$246 billion. In addition, the value of our equity investments started to improve as the market recovered.

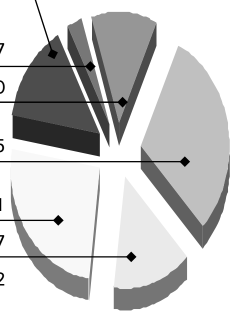
Assets 2009*

	%	*HK$ millions*
Cash and short-term funds	**21.2**	**892,175**
Placings with banks maturing after one month and certificates of deposit	**3.4**	**144,458**
Trading assets	**7.7**	**322,731**
Advances to customers	**32.1**	**1,350,644**
Financial investments	**21.0**	**882,689**
Other	**14.6**	**613,592**
Total	**100.0**	**4,206,289**



Assets 2008*

	%	*HK$ millions*
Cash and short-term funds	14.4	597,572
Placings with banks maturing after one month and certificates of deposit	2.7	112,647
Trading assets	11.9	493,670
Advances to customers	31.1	1,286,145
Financial investments	14.2	586,161
Other	25.7	1,065,137
Total	100.0	4,141,332



* *Excluding Hong Kong SAR Government certificates of indebtedness*

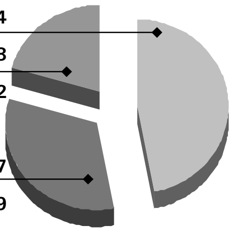
Financial Review (continued)

Customer Accounts

Customer accounts increased by HK$368.5 billion, or 14.3 per cent, compared with the end of 2008.

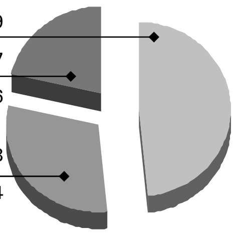
Customer accounts 2009 by region

	%	HK$ millions
Hong Kong excluding Hang Seng Bank	**46.8**	**1,378,254**
Hang Seng Bank	**20.6**	**606,618**
Total Hong Kong	**67.4**	**1,984,872**
Rest of Asia-Pacific	**32.6**	**959,667**
Total	**100.0**	**2,944,539**



Customer accounts 2008 by region

	%	HK$ millions
Hong Kong excluding Hang Seng Bank	48.2	1,242,079
Hang Seng Bank	21.3	548,977
Total Hong Kong	69.5	1,791,056
Rest of Asia-Pacific	30.5	785,028
Total	100.0	2,576,084



In Hong Kong, customer accounts increased by HK$193.8 billion, or 10.8 per cent, through growth in current accounts, partially offset by lower savings and deposit accounts. Despite the low interest rate environment, customer accounts continued to grow, reflecting a preference for holding liquid deposits for future investment opportunities.

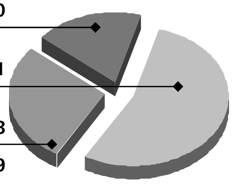
In the Rest of Asia-Pacific, customer accounts were HK$177.1 billion (22.6 per cent) higher, with increased balances in all customer groups. Excluding HSBC Bank Malaysia Berhad and Bank Ekonomi, customer accounts increased 7.8 per cent. In India, the increase was attributable to rising current account balances from foreign institutional investors and higher foreign currency deposits. Meanwhile, ongoing branch expansion in mainland China contributed to growing deposits.

The group's advances-to-deposits ratio decreased to 45.9 per cent at 31 December 2009, from 49.9 per cent at 31 December 2008.

	2009	2008
Advances: deposits ratio (%)	**45.9**	49.9

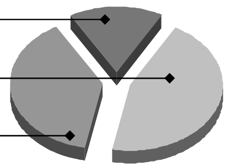
Customer accounts 2009

	%	HK$ millions
Current accounts	**18.2**	**536,350**
Savings accounts	**54.0**	**1,591,351**
Other deposit accounts	**27.8**	**816,838**
Total	**100.0**	**2,944,539**



Customer accounts 2008

	%	HK$ millions
Current accounts	15.9	408,891
Savings accounts	45.5	1,172,406
Other deposit accounts	38.6	994,787
Total	100.0	2,576,084



Equity

Equity increased by HK$54 billion, or 25.1 per cent, to HK$271 billion. The increase was principally due to the movement in the available-for-sale securities reserve, which largely comprised the improvement in the value of the group's investments in Ping An Insurance and the group's other strategic investments. There was also an increase in retained earnings.

Capital Adequacy

The following table shows the capital adequacy ratio and the components of the capital base contained in the 'Capital Adequacy Ratio' return required to be submitted to the Hong Kong Monetary Authority ('HKMA') by The Hongkong and Shanghai Banking Corporation Limited on a consolidated basis that is specified by the HKMA under the requirement of section 98(2) of the Banking Ordinance.

Effective 1 January 2008, the group adopted the foundation internal ratings-based approach and internal ratings-based (securitisation) approach to determine credit risk. It also used the standardised (operational risk) approach and standardised (market risk) approach to calculate its operational risk and market risk respectively. An internal models approach was adopted for calculating general market risk, while a separate model is used for calculating the market risk relating to equity options.

From 1 January 2009, The Hongkong and Shanghai Banking Corporation Limited migrated to the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. As a result of the change in approach used to determine credit risk for non-securitisation exposures, the numbers for 2008 are not strictly comparable. From 30 March 2009, the group adopted an internal models approach to calculate its market risk in respect of specific risk for the interest rate risk category. Apart from these, there is no change in the approaches used to calculate credit risk for securitisation exposures, operational risk and market risk for other risk categories.

There is no relevant capital shortfall in any of the group's subsidiaries that is not included in its consolidation group for regulatory purposes.

Financial Review (continued)

Capital Adequacy *(continued)*

Figures in HK$m	**2009**	2008
Composition of capital		
Core Capital:		
Paid-up ordinary share capital	**21,040**	21,040
Paid-up irredeemable non-cumulative preference shares	**51,590**	51,561
Published reserves	**113,618**	84,262
Profit and loss account	**16,852**	19,953
Minority interests*	**18,902**	16,087
Less: Deduction from core capital	**(19,682)**	(14,457)
Less: 50% of total amount of deductible items (@50%)**	**(35,099)**	(32,212)
Total core capital	**167,221**	146,234
Supplementary Capital:		
Property revaluation reserves***	**6,742**	6,655
Available-for-sale investments revaluation reserves****	**3,961**	2,881
Unrealised fair value gains from financial instruments designated at fair value through profit or loss	**34**	1
Regulatory reserve*****	**937**	723
Collective provisions*****	**858**	908
Surplus provisions******	**2,686**	2,904
Perpetual subordinated debt	**9,393**	9,410
Paid-up irredeemable cumulative preference shares	**16,517**	16,508
Term subordinated debt	**14,406**	11,786
Paid-up term preference shares	**32,956**	24,800
Less: 50% of total amount of deductible items (@ 50%)**	**(35,099)**	(32,212)
Total supplementary capital	**53,391**	44,364
Capital base	**220,612**	190,598
Total deductible items**	**70,198**	64,424

* *After deduction of minority interests in unconsolidated subsidiary companies.*

** *Total deductible items are deducted from institution's core capital and supplementary capital.*

*** *Includes the revaluation surplus on investment properties which is reported as part of retained profits.*

**** *Includes adjustments made in accordance with guidelines issued by the HKMA.*

***** *Total regulatory reserve and collective provisions are apportioned between the standardised approach and internal ratings-based approach in accordance with guidelines issued by the HKMA. Those apportioned to the standardised approach are included in the supplementary capital. Those apportioned to the internal ratings-based approach are excluded from the supplementary capital.*

****** *Surplus provisions represent the excess of the total eligible provisions over the total expected loss amount. Surplus provisions are applicable to non-securitisation exposures calculated by using internal ratings-based approach.*

The capital ratios on a consolidated basis calculated in accordance with the Capital Rules are as follows:

	2009	2008
Capital adequacy ratio	**16.1%**	13.4%
Core capital ratio	**12.2%**	10.3%

Non-bank mainland exposures

The analysis of non-bank mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the HKMA under the Banking (Disclosure) Rules with reference to the HKMA return for non-bank mainland exposures, which includes the mainland exposures extended by the Bank and its banking subsidiary in mainland China as at 31 December 2009 and as at 31 December 2008.

At 31 December 2009

	On-balance sheet exposure	Off-balance sheet exposure	Total exposures	Specific provisions
	HK$m	HK$m	HK$m	HK$m
Mainland entities	20,155	11,344	31,499	1
Companies and individuals outside the Mainland where the credit is granted for use in the Mainland	36,844	36,997	73,841	810
Other counterparties the exposures to whom are considered by the Bank to be non-bank Mainland exposures	155	3,207	3,362	–
	57,154	51,548	108,702	811
Mainland exposures of wholly owned Mainland subsidiaries:				
Loans and advances	76,607	2,689	79,296	47
Debt securities and other	51,080	9,763	60,843	–
	127,687	12,452	140,139	47
	184,841	64,000	248,841	858

At 31 December 2008

	On-balance sheet exposure	Off-balance sheet exposure	Total exposures	Specific provisions
	HK$m	HK$m	HK$m	HK$m
Mainland entities	18,541	14,842	33,383	–
Companies and individuals outside the Mainland where the credit is granted for use in the Mainland	42,692	40,044	82,736	685
Other counterparties the exposures to whom are considered by the Bank to be non-bank Mainland exposures	509	3,086	3,595	–
	61,742	57,972	119,714	685
Mainland exposures of wholly owned Mainland subsidiaries:				
Loans and advances	60,709	1,344	62,053	60
Debt securities and other	34,430	12,164	46,594	–
	95,139	13,508	108,647	60
	156,881	71,480	228,361	745

Financial Review (continued)

Overdue and rescheduled advances

Over due and rescheduled advances are shown in Notes 18d and 18e on the Financial Statements respectively on pages 91 to 94.

Analysis of advances to customers by geographical areas according to the location of counterparties, after recognised risk transfer

HK$ millions

	Hong Kong	Rest of Asia-Pacific/ Other	Total
At 31 December 2009			
Gross advances to customers	**683,553**	**681,371**	**1,364,924**
At 31 December 2008			
Gross advances to customers	681,961	615,142	1,297,103

Cross-Border Exposure

The country risk exposures in the tables below are prepared in accordance with the HKMA Return of External Positions Part II: Cross-Border Claims (MA(BS)9) guidelines.

Cross-border claims are on-balance sheet exposures to counterparties based on the location of the counterparties after taking into account the transfer of risk.

The tables show claims on individual countries and territories or areas, after recognised risk transfer, amounting to 10 per cent or more of the aggregate cross-border claims.

Cross-border risk is controlled centrally through a well-developed system of country limits and is frequently reviewed to avoid concentration of transfer, economic or political risk.

As at 31 December 2009

	Banks and Other Financial Institutions	Public Sector Entities	Others	Total
(HK$ millions)				
Americas				
United States	**124,438**	**89,352**	**48,777**	**262,567**
Others	**20,249**	**10,595**	**45,805**	**76,649**
	144,687	**99,947**	**94,582**	**339,216**
Europe				
United Kingdom	**228,935**	**854**	**13,247**	**243,036**
Others	**182,577**	**50,833**	**19,040**	**252,450**
	411,512	**51,687**	**32,287**	**495,486**
Asia-Pacific excluding Hong Kong	**197,633**	**92,634**	**178,339**	**468,606**

As at 31 December 2008

	Banks and Other Financial Institutions	Public Sector Entities	Others	Total
(HK$ millions)				
Americas				
United States	96,870	122,594	48,225	267,689
Others	24,459	4,171	82,817	111,447
	121,329	126,765	131,042	379,136
Europe				
United Kingdom	349,284	575	28,651	378,510
Others	221,598	8,571	62,754	292,923
	570,882	9,146	91,405	671,433
Asia-Pacific excluding Hong Kong	158,481	168,458	167,597	494,536

All the group's activities involve the analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The principal types of risk faced by the group are credit risk (which includes country and cross-border risk), liquidity risk, market risk, insurance risk, operational risk and reputational risk.

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group worldwide. The group's risk management policies and procedures are subject to a high degree of oversight and guidance to ensure that all types of risk are systematically identified, measured, analysed and actively managed.

Credit risk, liquidity risk, market risk, operational risk, insurance risk and capital management are discussed in detail in Note 52 to the Financial Statements on pages 166 to 199.

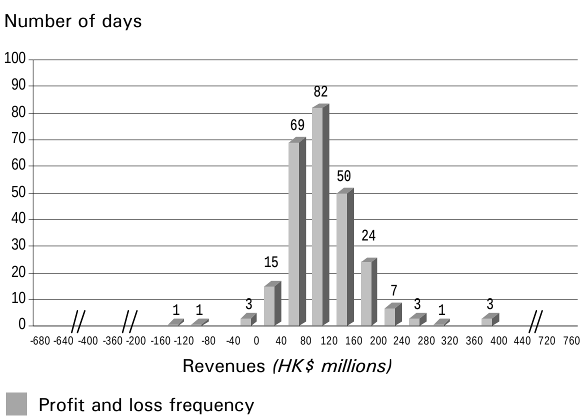
Market Risk Management

The nature of market risk and the principal tool used to monitor and limit market risk exposure (value at risk) are discussed in Note 52 on the Financial Statements on pages 181 to 185.

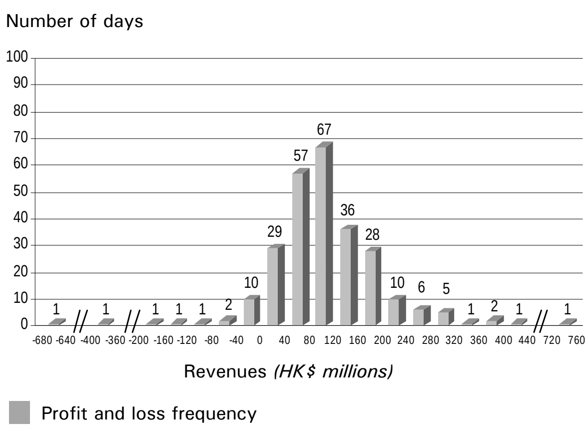
The average daily revenue earned from market risk-related treasury activities in 2009, including accrual book net interest income and funding related to dealing positions, was HK$106 million compared with HK$105 million in 2008. The standard deviation of these daily revenues was HK$62 million (HK$113 million for 2008).

An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 5 days in 2009. The most frequent result was a daily revenue of between HK$80 million and HK$120 million with 82 occurrences. The highest daily revenue was HK$393 million. The most frequent result in 2008 was a daily revenue of between HK$80 million and HK$120 million with 67 occurrences. The highest daily revenue in 2008 was HK$724 million.

Daily distribution of market risk revenues 2009



Daily distribution of market risk revenues 2008



Financial Review (continued)

Operational Risk Management

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

The group manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken 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 learnt from publicised operational failures within the financial services industry.

The HSBC 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 it is cost-effective.

The group maintains and tests contingency facilities to support operations in the event of disasters. Additional reviews and tests are conducted in the event that any HSBC office is affected by a business disruption event, to incorporate lessons learnt 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, for instance, a flu pandemic occur.

Reputational Risk Management

Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events.

Reputational risks are considered and assessed by senior management. Standards on all major aspects of business are set by the HSBC Group Head Office. These policies, which form an integral part of the internal control systems, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies set out operational procedures in all areas of reputational risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations.

Internal controls are an integral part of how the group conducts its business. HSBC's manuals and statements of policy are the foundation of these internal controls. There is a strong process in place to ensure controls operate effectively. Any significant failings are reported through the control mechanisms, internal audit and compliance functions to the Group's Audit Committee and senior management. In addition, all businesses and major functions are required to review their control procedures and to make regular reports about any losses arising from operational risks.

Management in all operating entities is required to establish a strong internal control structure to minimise the risk of operational and financial failure, and to ensure that a full appraisal of reputational implications is made before strategic decisions are taken. The HSBC Group's internal audit function monitors compliance with policies and standards.

Consolidated Income Statement for the year ended 31 December 2009

	Note	**2009 HK$m**	2008 HK$m
Interest income	*5a*	**82,550**	125,864
Interest expense	*5b*	**(24,118)**	(56,819)
Net interest income		**58,432**	69,045
Fee income		**35,583**	37,751
Fee expense		**(5,305)**	(6,984)
Net fee income	*5c*	**30,278**	30,767
Net trading income	*5d*	**20,526**	21,363
Net income/(loss) from financial instruments designated at fair value	*5e*	**7,259**	(10,982)
Gains less losses from financial investments	*5f*	**(131)**	(2,976)
Dividend income	*5g*	**364**	852
Net earned insurance premiums	*5h*	**31,395**	26,886
Other operating income	*5i*	**7,258**	4,076
Total operating income		**155,381**	139,031
Net insurance claims incurred and movement in policyholders' liabilities	*5j*	**(37,131)**	(14,767)
Net operating income before loan impairment charges and other credit risk provisions		**118,250**	124,264
Loan impairment charges and other credit risk provisions	*5k*	**(11,235)**	(12,000)
Net operating income		**107,015**	112,264
Employee compensation and benefits	*5l*	**(28,585)**	(28,132)
General and administrative expenses	*5m*	**(19,527)**	(20,690)
Depreciation of property, plant and equipment	*25*	**(2,904)**	(2,609)
Amortisation of intangible assets	*24c*	**(1,177)**	(832)
Total operating expenses		**(52,193)**	(52,263)
Operating profit		**54,822**	60,001
Share of profit in associates and joint ventures		**7,741**	7,689
Profit before tax		**62,563**	67,690
Tax expense	*6*	**(11,919)**	(12,710)
Profit for the year		**50,644**	54,980
Profit attributable to shareholders		**45,808**	50,306
Profit attributable to minority interests		**4,836**	4,674

Consolidated Statement of Comprehensive Income for the year ended 31 December 2009

	2009	2008
	HK$m	HK$m
Profit for the year	**50,644**	54,980
Other comprehensive income		
Available-for-sale investments:		
– fair value changes taken to equity	**31,250**	(46,506)
– fair value changes transferred to the income statement on disposal	**(1,174)**	(1,709)
– fair value changes transferred to the income statement on impairment	**472**	2,682
– fair value changes transferred to the income statement on hedged items due to hedged risk	**483**	(1,973)
– income taxes	**(1,241)**	587
Cash flow hedges:		
– fair value changes taken to equity	**1,650**	4,182
– fair value changes transferred to the income statement	**(3,026)**	(2,652)
– income taxes	**204**	(210)
Property revaluation:		
– fair value changes taken to equity	**808**	1,946
– income taxes	**(59)**	(214)
Share of changes in equity of associates and joint ventures	**212**	97
Exchange differences	**5,344**	(6,996)
Actuarial gains/(losses) on post-employment benefits		
– before income taxes	**3,606**	(6,194)
– income taxes	**(559)**	953
Other comprehensive for the year, net of tax	**37,970**	(56,007)
Total comprehensive income for the year, net of tax	**88,614**	(1,027)
Total comprehensive income for the year attributable to:		
– shareholders	**81,588**	(1,968)
– minority interests	**7,026**	941
	88,614	(1,027)

Consolidated Statement of Financial Position at 31 December 2009

	Note	2009 HK$m	2008 HK$m
ASSETS			
Cash and short-term funds	*10*	**892,175**	597,572
Items in the course of collection from other banks		**15,528**	13,949
Placings with banks maturing after one month	*11*	**107,070**	55,569
Certificates of deposit	*12*	**37,388**	57,078
Hong Kong SAR Government certificates of indebtedness	*13*	**135,414**	119,024
Trading assets	*14*	**322,731**	493,670
Financial assets designated at fair value	*15*	**48,087**	40,553
Derivatives	*16*	**235,171**	453,923
Advances to customers	*17*	**1,350,644**	1,286,145
Financial investments	*20*	**882,689**	586,161
Amounts due from Group companies		**134,511**	378,662
Investments in associates and joint ventures	*23*	**53,683**	48,270
Goodwill and intangible assets	*24*	**25,069**	16,181
Property, plant and equipment	*25*	**36,327**	35,885
Deferred tax assets	*34*	**2,668**	1,699
Retirement benefit assets	*51*	**292**	84
Other assets	*27*	**62,256**	75,931
Total assets		**4,341,703**	4,260,356
LIABILITIES			
Hong Kong SAR currency notes in circulation	*13*	**135,414**	119,024
Items in the course of transmission to other banks		**22,960**	31,334
Deposits by banks		**111,206**	196,674
Customer accounts	*28*	**2,944,539**	2,576,084
Trading liabilities	*29*	**154,366**	210,587
Financial liabilities designated at fair value	*30*	**36,709**	39,926
Derivatives	*16*	**232,846**	466,204
Debt securities in issue	*31*	**43,396**	48,800
Retirement benefit liabilities	*51*	**3,922**	7,486
Amounts due to Group companies		**50,842**	51,244
Other liabilities and provisions	*32*	**55,982**	63,319
Liabilities under insurance contracts issued	*33*	**144,928**	113,431
Current tax liabilities	*6*	**4,119**	3,270
Deferred tax liabilities	*34*	**7,358**	4,433
Subordinated liabilities	*36*	**21,181**	19,184
Preference shares	*37*	**101,208**	92,870
Total liabilities		**4,070,976**	4,043,870
EQUITY			
Share capital	*38*	**22,494**	22,494
Other reserves		**75,213**	36,863
Retained profits		**139,231**	123,085
Proposed fourth interim dividend	*8*	**8,850**	11,170
Total shareholders' equity		**245,788**	193,612
Minority interests		**24,939**	22,874
Total equity		**270,727**	216,486
Total equity and liabilities		**4,341,703**	4,260,356

Directors
Michael F Geoghegan
Alexander A Flockhart
Peter T S Wong

Secretary
M W Scales

Statement of Financial Position at 31 December 2009

	Note	2009 HK$m	2008 HK$m
ASSETS			
Cash and short-term funds	*10*	**657,765**	481,702
Items in the course of collection from other banks		**11,151**	9,908
Placings with banks maturing after one month	*11*	**67,299**	33,754
Certificates of deposit	*12*	**20,492**	36,980
Hong Kong SAR Government certificates of indebtedness	*13*	**135,414**	119,024
Trading assets	*14*	**216,480**	329,123
Financial assets designated at fair value	*15*	**1,801**	1,728
Derivatives	*16*	**230,998**	452,209
Advances to customers	*17*	**752,574**	817,996
Financial investments	*20*	**564,738**	340,800
Amounts due from group companies		**161,755**	397,961
Investments in subsidiary companies	*22*	**39,606**	16,956
Investments in associates and joint ventures	*23*	**21,132**	21,132
Goodwill and intangible assets	*24*	**6,754**	6,368
Property, plant and equipment	*25*	**20,182**	21,384
Deferred tax assets	*34*	**1,436**	819
Retirement benefit assets	*51*	**176**	52
Other assets	*27*	**37,891**	50,012
Total assets		**2,947,644**	3,137,908
LIABILITIES			
Hong Kong SAR currency notes in circulation	*13*	**135,414**	119,024
Items in the course of transmission to other banks		**15,796**	26,581
Deposits by banks		**94,861**	174,532
Customer accounts	*28*	**1,902,571**	1,767,001
Trading liabilities	*29*	**103,456**	151,089
Financial liabilities designated at fair value	*30*	**1,857**	7,086
Derivatives	*16*	**230,143**	457,732
Debt securities in issue	*31*	**28,250**	34,855
Retirement benefit liabilities	*51*	**1,986**	3,550
Amounts due to group companies		**123,202**	117,681
Other liabilities and provisions	*32*	**38,029**	47,897
Current tax liabilities	*6*	**3,456**	2,580
Deferred tax liabilities	*34*	**3,318**	2,107
Subordinated liabilities	*36*	**9,925**	10,602
Preference shares	*37*	**101,063**	92,870
Total liabilities		**2,793,327**	3,015,187
EQUITY			
Share capital	*38*	**22,494**	22,494
Other reserves	*39*	**42,986**	19,633
Retained profits	*39*	**79,987**	69,424
Proposed fourth interim dividend	*8*	**8,850**	11,170
Total equity		**154,317**	122,721
Total equity and liabilities		**2,947,644**	3,137,908

Directors
Michael F Geoghegan
Alexander A Flockhart
Peter T S Wong

Secretary
M W Scales

Consolidated Statement of Changes in Equity for the Year Ended 31 December 2009

Group

			Other reserves							
	Share capital	*Retained profits*	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total share-holders' equity*	*Minority interests*	*Total equity*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January 2009	**22,494**	**123,085**	**8,578**	**15,103**	**1,833**	**1,666**	**9,683**	**182,442**	**22,874**	**205,316**
Profit for the year	**–**	**45,808**	**–**	**–**	**–**	**–**	**–**	**45,808**	**4,836**	**50,644**
Other comprehensive income (net of tax)	**–**	**5,140**	**573**	**28,220**	**(992)**	**2,659**	**180**	**35,780**	**2,190**	**37,970**
Available-for-sale investments	**–**	**–**	**–**	**28,174**	**–**	**–**	**–**	**28,174**	**1,616**	**29,790**
Cash flow hedges	**–**	**–**	**–**	**–**	**(1,025)**	**–**	**–**	**(1,025)**	**(147)**	**(1,172)**
Property revaluation	**–**	**(62)**	**573**	**–**	**–**	**–**	**–**	**511**	**238**	**749**
Actuarial gains on defined benefit plans	**–**	**2,451**	**–**	**–**	**–**	**–**	**–**	**2,451**	**596**	**3,047**
Share of other comprehensive income of associates and joint ventures	**–**	**4**	**–**	**53**	**–**	**–**	**155**	**212**	**–**	**212**
Exchange differences	**–**	**2,747**	**–**	**(7)**	**33**	**2,659**	**25**	**5,457**	**(113)**	**5,344**
Total comprehensive income for the year	**–**	**50,948**	**573**	**28,220**	**(992)**	**2,659**	**180**	**81,588**	**7,026**	**88,614**
Dividends	**–**	**(26,520)**	**–**	**–**	**–**	**–**	**–**	**(26,520)**	**(4,830)**	**(31,350)**
Movement in respect of share-based payment arrangements	**–**	**–**	**–**	**–**	**–**	**–**	**586**	**586**	**37**	**623**
Other movements	**–**	**257**	**(16)**	**(11)**	**–**	**–**	**(1,388)**	**(1,158)**	**(168)**	**(1,326)**
Transfers	**–**	**(8,539)**	**(542)**	**73**	**7**	**2,673**	**6,328**	**–**	**–**	**–**
At 31 December 2009	**22,494**	**139,231**	**8,593**	**43,385**	**848**	**6,998**	**15,389**	**236,938**	**24,939**	**261,877**

Consolidated Statement of Changes in Equity for the Year Ended 31 December 2008

Group

			Other reserves							
	Share capital	*Retained profits*	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total share-holders' equity*	*Minority interests*	*Total equity*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January 2008	22,494	107,908	6,995	58,757	677	8,887	8,636	214,354	25,080	239,434
Profit for the year	–	50,306	–	–	–	–	–	50,306	4,674	54,980
Other comprehensive income (net of tax)	–	(3,674)	2,013	(43,525)	1,166	(8,500)	246	(52,274)	(3,733)	(56,007)
Available-for-sale investments	–	–	–	(43,686)	–	–	–	(43,686)	(3,233)	(46,919)
Cash flow hedges	–	–	–	–	1,161	–	–	1,161	159	1,320
Property revaluation	–	(53)	1,713	–	–	–	–	1,660	72	1,732
Actuarial losses on defined benefit plans	–	(4,282)	–	–	–	–	–	(4,282)	(959)	(5,241)
Share of other comprehensive income of associates and joint ventures	–	8	276	(11)	–	–	(176)	97	–	97
Exchange differences	–	653	24	172	5	(8,500)	422	(7,224)	228	(6,996)
Total comprehensive income for the year	–	46,632	2,013	(43,525)	1,166	(8,500)	246	(1,968)	941	(1,027)
Dividends	–	(31,170)	–	–	–	–	–	(31,170)	(4,664)	(35,834)
Movement in respect of share-based payment arrangements	–	–	–	–	–	–	629	629	40	669
Other movements	–	17	–	29	–	–	551	597	1,477	2,074
Transfers	–	(302)	(430)	(158)	(10)	1,279	(379)	–	–	–
At 31 December 2008	22,494	123,085	8,578	15,103	1,833	1,666	9,683	182,442	22,874	205,316

Consolidated Cash Flow Statement for the Year Ended 31 December 2009

	Note	**2009 HK$m**	2008 HK$m
Operating activities			
Cash generated from/(used in) operations	*42*	**123,789**	(75,489)
Interest received on financial investments		**15,420**	17,548
Dividends received on financial investments		**306**	697
Dividends received from associates		**2,565**	3,005
Taxation paid		**(10,239)**	(14,586)
Net cash inflow/(outflow) from operating activities		**131,841**	(68,825)
Investing activities			
Purchase of financial investments		**(533,217)**	(632,954)
Proceeds from sale or redemption of financial investments		**423,421**	570,372
Purchase of property, plant and equipment		**(1,984)**	(3,269)
Proceeds from sale of property, plant and equipment and assets held for sale		**1,848**	218
Purchase of other intangible assets		**(1,271)**	(1,757)
Net cash inflow/(outflow) in respect of the acquisition of and increased shareholding in subsidiary companies	*43c*	**15,271**	(1,240)
Net cash inflow in respect of the purchase of interests in business portfolios	*43e*	**–**	13,992
Net cash outflow in respect of the purchase of interests in associates and joint ventures		**(43)**	(2,643)
Net cash inflow/(outflow) from the sale of interests in business portfolios	*43d*	**251**	(33)
Proceeds from the sale of interests in associates		**20**	–
Net cash outflow from investing activities		**(95,704)**	(57,314)
Net cash inflow/(outflow) before financing		**36,137**	(126,139)
Financing			
Issue of preference share capital		**8,282**	3,113
Change in minority interests		**(160)**	1,893
Repayment of subordinated liabilities		**(659)**	–
Issue of subordinated liabilities		**–**	296
Ordinary dividends paid	*8*	**(28,840)**	(26,500)
Dividends paid to minority interests		**(4,830)**	(4,664)
Interest paid on preference shares		**(4,034)**	(5,752)
Interest paid on subordinated liabilities		**(741)**	(1,039)
Net cash outflow from financing		**(30,982)**	(32,653)
Increase/(Decrease) in cash and cash equivalents	*43a*	**5,155**	(158,792)

Notes on the Financial Statements

1 Basis of preparation

a The consolidated financial statements comprise the accounts of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiary companies ('the group') as of 31 December 2009.

The consolidated financial statements have been prepared in accordance with all Hong Kong Financial Reporting Standards ('HKFRSs'), the provisions of the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong. HKFRSs is a collective term which includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ('HKASs') and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ('HKICPA').

The consolidated financial statements have been prepared under the historical cost convention as modified by the revaluation of certain financial assets and liabilities and premises.

b The consolidated financial statements include the attributable share of the results and reserves of associates and joint ventures based on accounts made up to dates not earlier than three months prior to 31 December 2009.

c During the year the group adopted the following HKFRSs and amendments to HKFRSs:

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

HKFRS 8 'Operating Segments' ('HKFRS 8'), which replaced HKAS 14 'Operating Segments'. HKFRS 8 requires an entity to disclose information about its segments which enables users to evaluate the nature and financial effects of its business activities and the economic environments in which it operates. The group's operating segments are organised into two geographical regions, Hong Kong and Rest of Asia-Pacific. Due to the nature of the group its chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group and by retail businesses and global businesses. The group's HKFRS 8 operating segments were determined to be primarily geographical segments because the chief operating decision-maker uses information on geographical segments in order to make decisions about allocating resources and assessing performance. The group's chief operating decision-maker was determined to be the Executive Committee.

HKFRS 8 requires segment financial information to be reported using the same measures reported to the chief operating decision-maker for the purpose of making decisions about allocating resources to the operating segments and assessing their performance. Information provided to the chief operating decision-maker of the group to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with HKFRSs.

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

- the presentation of all items of income and expenditure in two financial statements, the 'Consolidated income statement' and the 'Consolidated statement of comprehensive income'; and
- the presentation of the 'Consolidated statement of changes in equity' as a financial statement, which replaces the 'Reserves' note on the financial statements.

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

- Amendments to HKFRS 1 'First-time Adoption of International Financial Reporting Standards' and HKAS 27 'Consolidated and Separate Financial Statements' – 'Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate';

1 Basis of preparation *(continued)*

- Amendments to HKFRS 2 'Share-based Payment' – 'Vesting Conditions and Cancellations';
- HKAS 23 (Revised 2007) 'Borrowing Costs';
- Amendments to HKAS 32 'Financial Instruments: Presentation' and HKAS 1 'Presentation of Financial Statements' – 'Puttable Financial Instruments and Obligations Arising on Liquidation';
- Hong Kong (IFRIC) Interpretation 9 and HKAS 39 – 'Embedded Derivatives';
- Improvements to HKFRSs (2008);
- Hong Kong (IFRIC) Interpretation 13 'Customer Loyalty Programmes';
- Hong Kong (IFRIC) Interpretation 15 'Agreements for the Construction of Real Estate';
- Hong Kong (IFRIC) Interpretation 16 ' Hedges of a Net Investment in a Foreign Operation'.

2 Critical accounting estimates and judgements in applying accounting policies

The preparation of financial statements requires the group to make certain estimates and to form judgements about the application of its accounting policies. The most significant areas where estimates and judgements have been made are set out below.

Disclosures under HKFRS4 and HKFRS7 relating to the nature and extent of risks have been included in note 52 'Risk management'.

Disclosures relating to 'Impact of market turmoil' are included in note 53.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is included in note 4h and is discussed further within note 16 'Derivatives' and note 51 '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 derivative models.

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

Notes on the Financial Statements (continued)

2 Critical accounting estimates and judgements in applying accounting policies *(continued)*

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 removed from equity and recognised in the income statement, reducing the group's operating profit.

Loan impairment

Application of the group's methodology for assessing loan impairment, as set out in note 4d, involves considerable judgement and estimation.

For individually significant loans, judgement is required in determining first, whether there are indications that an impairment loss may have already been incurred, and then estimating the amount and timing of expected cash flows, which form the basis of the impairment loss that is recorded.

For collectively assessed loans, judgement is involved in selecting and applying the criteria for grouping together loans with similar credit characteristics, as well as in selecting and applying the statistical and other models used to estimate the losses incurred for each group of loans in the reporting period. The benchmarking of loss rates, the assessment of the extent to which historical losses are representative of current conditions and the ongoing refinement of modelling methodologies provide a means of identifying changes that may be required, but the process is inherently one of estimation.

Special purpose entities

In the normal course of business, the group participates, in a variety of ways, in financial structures involving special purpose entities. Judgement is required in determining whether the rights and obligations taken on result in the group having control of the special purpose entity and whether it should be included in the consolidated financial statements as a subsidiary.

Impairment of available-for-sale financial investments

Judgment is required in determining whether or not a decline in fair value of an available-for-sale financial investment below its original cost is of such a nature as to constitute impairment, and thus whether an impairment loss needs to be recognised under HKAS 39 'Financial Instruments: Recognition and Measurement' (HKAS 39).

Liabilities under investment contracts

Estimating the liabilities for long term investment contracts where the group has guaranteed a minimum return involves the use of statistical techniques. The selection of these techniques and the assumptions used about future interest rates and rates of return on equity, as well as behavioural and other future events, have a significant impact on the amount recognised as a liability.

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 assurance business ('PVIF')

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in note 24b. 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.

2 Critical accounting estimates and judgements in applying accounting policies *(continued)*

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 52.

Income taxes

The group is subject to income taxes in many jurisdictions and significant judgement is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some time later. The group recognises liabilities for taxation based on estimates of whether additional taxes will be payable. The estimation process includes seeking expert advice where appropriate.

Where the final liability for taxation is different from the amounts that were initially recorded, these differences will affect the income tax and deferred tax provisions in the period in which the estimate is revised or the final liability is established.

Held-to-maturity securities

As indicated in note 4g, certain debt instruments within the 'Financial investments' category are classified as held-to-maturity investments. In order to be able to use this classification, the group needs to exercise judgement upon initial recognition of the investments as to whether it has the positive intention and ability to hold them until maturity. A failure to hold these investments to maturity, in all but a limited number of circumstances, would result in the entire held-to-maturity category being reclassified as 'available-for-sale'. They would then be measured at fair value. The carrying amount and the fair value of held-to-maturity securities at 31 December 2009 are disclosed in note 51.

3 Comparative figures

Certain comparative figures have been restated to reflect changes in presentation in the current year disclosure.

4 Principal accounting policies

a *Interest income and expense*

Interest income and expense for all interest-bearing financial instruments except those classified as held for trading or designated at fair value are recognised in 'Interest income' and 'Interest expense' 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 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.

Interest on impaired financial assets is recognised at the original effective interest rate of the financial asset applied to the impaired carrying amount. The accounting policy for recognising impairment of loans and advances is set out in note 4d below.

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);

4 Principal accounting policies *(continued)*

- 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 recorded in 'Interest income' (see note 4a).

(ii) Dividend income

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

(iii) 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 (net of accrued coupon) of such financial assets and financial liabilities, together with interest income and expense and dividend income attributable to those financial instruments.

(iv) Net trading income

Net trading income comprises interest income and expense and dividend income attributable to trading financial assets and liabilities, together with all gains and losses from changes in fair value of trading assets and liabilities. Income and expenses arising from economic hedging activities which do not qualify for hedge accounting under HKAS 39, as well as from the ineffective portion of qualifying hedges, are also included in 'Net trading income'.

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c *Advances to customers and placings with banks*

Loans and advances to banks and customers include loans and advances originated by the group which are not classified as either held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either borrowers repay their obligations, or the loans are sold or written off, or substantially all the risk and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where loans and advances are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

For certain leveraged finance and syndicated lending activities, the group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit or loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit or loss. Where it is not the group's intention to trade the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception of the loan, the hold portion is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. However, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write-down is charged to the income statement. The write-down will be recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write-down is recorded as a reduction to other operating income.

4 Principal accounting policies *(continued)*

d *Loan impairment*

It is the group's policy to make provisions for impaired loans and advances promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred.

Impairment losses are assessed for all credit exposures. Loans that are individually significant are assessed and where impairment is identified, impairment losses are recognised. Loans that have been subject to individual assessment, but for which no impairment has been identified are then assessed collectively to estimate the amount of impairment at the reporting date, which has not been specifically identified. Loans which are not individually significant, but which can be aggregated into groups of exposures sharing similar characteristics, are then assessed collectively to identify and calculate impairment losses which have occurred by the reporting date. This methodology is explained in greater detail below.

Impairment losses are only recognised when there is evidence that they have been incurred prior to the reporting date. Losses which may be expected as a result of future events, no matter how likely, are not recognised.

(i) Individually significant 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.

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

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and capability to trade successfully out of financial difficulties and generate sufficient 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, HSBC and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain and make payments in the relevant foreign currency if loans are not in local currency; and
- where available, the secondary market price for the debt.

The impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged to the income statement. The carrying amount of impaired loans is reduced through the use of an allowance account.

4 Principal accounting policies *(continued)*

(ii) Collectively assessed loans

Impairment losses are calculated on a collective basis in two different scenarios:

- in respect of losses which have been incurred but have not yet been identified on loans subject to individual assessment for impairment (see section (i) above); 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 impairment has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment allowance. The impairment calculated by this method represents impairments that have occurred at the balance sheet date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account:

- historical loss experience in portfolios of similar risk characteristics (for example, by industry and geographical sectors, loan grade or product);
- the estimated period between a loss occurring and the establishment of an allowance against the loss on an individual loan; and
- management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined by management for each identified portfolio.

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis.

- When appropriate empirical information is available, the group utilises a roll rate methodology. This methodology utilises a statistical analysis of historical trends of the probability of default and amount of consequential loss, assessed for each time period during which the customer's contractual payments are overdue. The amount of loss is based on the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio. Other historical data and an evaluation of current economic conditions are also considered to calculate the appropriate level of impairment allowance based on inherent loss.
- In other cases, when the portfolio size is small or when information is insufficient or not sufficiently reliable to adopt a roll rate methodology, the group adopts a formulaic approach which allocates rolling average loss rates over the outstanding receivable amount. Loss rates are based on the discounted expected future cash flows from a portfolio.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

(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.

4 Principal accounting policies *(continued)*

(iv) Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reduced accordingly. The reduction of an impairment loss under these circumstances is recognised in the income statement in the period in which it occurs.

(v) Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. 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 within 'Other operating income' 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 as a gain in 'Other operating income' in the income statement.

Debt securities or equities acquired in debt-to-debt/equity swaps are included in 'Financial investments' and are classified as available-for-sale.

(vi) Renegotiated loans

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

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e *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, loans and advances to and from banks, debt securities, structured deposits, equity shares, own debt issued and short positions in securities 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. This designation, once made, is irrevocable in respect of the financial instruments to which it is made. Such financial assets or financial liabilities are recognised initially at fair value, with transaction costs taken to the income statement, and are subsequently remeasured at fair value. All subsequent gains and losses from changes in the fair value of these assets and liabilities, together with related interest income and expense and dividends, are recognised in the income statement within 'Net trading income' as they arise. Financial assets and financial liabilities are recognised using trade date accounting.

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f *Financial instruments designated at fair value*

A financial instrument, other than one held for trading, is classified in this category if it meets the criteria set out below, and is so designated by management.

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. Financial assets and financial liabilities are recognised using trade date accounting.

Gains and losses from changes in the fair value of such assets and liabilities are recognised in the income statement as they arise, together with related interest income and expense and dividends, within 'Net income from financial instruments designated at fair value' (except as noted below).

Gains and losses arising from the changes in fair value of derivatives that are managed in conjunction with financial assets or financial liabilities designated at fair value are included in 'Net income from financial instruments designated at fair value' (except as noted below).

4 Principal accounting policies *(continued)*

Where issued debt has been designated at fair value and there is a related derivative, then the interest components of the debt and the derivative are recognised in 'Interest expense'.

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; examples include unit-linked investment contracts, and certain portfolios of securities and debt issuances that are managed in conjunction with financial assets or liabilities measured on a fair value basis;
- 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; examples include financial assets held to back certain insurance contracts, and certain asset-backed securities; or
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, and which would otherwise be required to be accounted for separately; examples include certain debt issuances and debt securities held.

g *Financial investments*

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

Available-for-sale

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 equity in the 'Available-for-sale fair value reserve' until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale debt securities using the effective interest rate, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

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 financial 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 and 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 removed from equity and recognised in the income statement.

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

4 Principal accounting policies *(continued)*

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if there is objective evidence of impairment. 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 impacted that can be reliably measured. Where there is no objective evidence of impairment, the decline in the fair value of the financial asset is recognised directly 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;
- 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 directly in equity. Impairment losses recognised on an 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.

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 losses.

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h *Determination of fair value*

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

For certain investments, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

A number of factors such as bid-offer spread, credit profile, servicing costs of portfolios and model uncertainty are taken into account, as appropriate, when values are calculated using valuation techniques.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset, or it is extinguished.

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i *Sale and repurchase agreements (including stock lending and borrowing)*

Where securities are sold subject to a commitment to repurchase them at a predetermined price (‘repos’), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to re-sell (‘reverse repos’) are not recognised on the balance sheet and the consideration paid is recorded in ‘Advances to customers’ or ‘Placings with banks’ as appropriate. 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)*

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Net trading income'.

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j *Derivative financial instruments and hedge accounting*

Derivatives are initially recognised at fair value from the date a derivative contract is entered into and are subsequently re-measured at their fair value at each reporting date.

Fair values are obtained from quoted market prices in active markets, or by using valuation techniques, including recent market transactions, where an active market does not exist. Valuation techniques include discounted cash flow models and option pricing models as appropriate. All derivatives are classified as assets when their fair value is positive, or as liabilities when their 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 in the income statement either: 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 derivative are the same as those of a stand-alone derivative, and the combined contract is not designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

Derivative assets and liabilities from 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 either simultaneously or 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. 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 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

Where derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedge'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedge'); or (iii) hedges of net investments in a foreign operation ('net investment hedge'). Hedge accounting is applied for derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

4 Principal accounting policies *(continued)*

Hedge accounting

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

Fair value hedge

Changes in the fair value of derivatives (net of interest accrual) that are designated and qualify as fair value hedging instruments are recorded as 'Net trading income' in the income statement, together with changes in the fair value of the asset or liability attributable to the hedged risk.

If the hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of a hedged item for which the effective interest rate method is used is amortised to the income statement over the residual period to maturity in 'Net interest income'. Where the adjustment relates to the carrying amount of a hedged available-for-sale equity security, this remains in equity until the disposal of the equity security.

Cash flow hedge

The effective portion of changes in the fair value of derivatives (net of interest accrual) that are designated and qualify as cash flow hedges are recognised in shareholders' equity. Any gain or loss relating to an ineffective portion is recognised immediately in the income statement within 'Net trading income' along with accrued interest.

Amounts accumulated in shareholders' equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from shareholders' equity and included in the initial measurement of the cost of the asset or liability.

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

Net investment hedge

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in shareholders' equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement within 'Net trading income'. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of.

Hedge effectiveness testing

To qualify for hedge accounting, HKAS 39 requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.

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

For fair value hedge relationships, the cumulative dollar offset method or regression analysis are used to test hedge effectiveness. For cash flow hedge relationships, effectiveness is tested by applying the change in variable cash flow method or the cumulative dollar offset method using the hypothetical derivative approach.

Notes on the Financial Statements (continued)

4 Principal accounting policies *(continued)*

For prospective effectiveness, the hedging instrument must be 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 changes in fair value or cash flows, at each reporting date or based on recent history, must offset each other. The group considers that a hedge is highly effective when the offset is within the range of 80 per cent to 125 per cent.

k *Derecognition of financial assets and liabilities*

Financial assets are derecognised when the rights to receive cash flows from the assets have expired; or where the group has transferred its contractual rights to receive the cash flows of the financial assets and has transferred substantially all the risks and rewards of ownership; or where both control and substantially all the risks and rewards are not retained.

Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged or cancelled or expires.

l *Offsetting financial assets and financial liabilities*

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 the group intends to settle on a net basis, or realise the asset and settle the liability simultaneously.

m *Subsidiaries, associates and joint ventures*

The group

Subsidiaries are entities which the group, directly or indirectly, controls. Subsidiaries are controlled if the group has the power to govern their financial and operating policies so as to obtain benefits from their activities. Control exists where the group holds more than half of the issued share capital, controls more than half the voting power, controls the composition of the board of directors, or equivalent body, or where control is provided by virtue of contractual arrangements. Subsidiaries are consolidated in the group's financial statements from the date on which the group obtains control until control ceases.

Balances and transactions between entities that comprise the group, together with unrealised gains and losses thereon, are eliminated in the consolidated financial statements. Minority interests represent the portion of the profit or loss and net assets of subsidiaries attributable to equity interests in those subsidiaries that are not held by the group.

Associates are entities over which the group has significant influence but not control or joint control. Joint ventures involve contractual arrangements whereby the group undertakes an economic activity with one or more parties and that economic activity is subject to joint control. Investments in associates and joint ventures in the consolidated balance sheet are stated at the group's attributable share of the net assets of the associates and joint ventures using the equity method of accounting. Share of profit in associates and joint ventures is stated in the income statement net of tax.

The Bank

The Bank's investments in subsidiaries, associates and joint ventures are stated at cost less impairment losses, if any.

n *Goodwill and intangible assets*

(i) Goodwill arises on business combinations, including the acquisition of subsidiaries and interests in joint ventures 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. If the group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

4 Principal accounting policies *(continued)*

Goodwill is allocated to cash-generating units ('CGUs') for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the CGU may be impaired, by comparing the recoverable amount from a CGU with the carrying amount 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 CGU. If the recoverable amount from the CGU is less than the carrying value, an impairment loss is charged to the income statement. Any write-off in excess of the carrying value of goodwill is limited to the fair value of the individual assets and liabilities of the CGU.

Goodwill is stated at cost less accumulated impairment losses, if any.

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 present value of in-force long-term assurance business, operating rights, computer software, trade names, customer relationships and core deposit relationships. Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually.

Intangible assets that have a finite useful life, except for the value of in-force long-term assurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected economic life.

Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

The accounting policy on the value of the in-force long-term assurance business is set out in note 4v.

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o *Property, plant and equipment*

(i) Premises

Premises held for own use, comprising freehold land and buildings, and leasehold land and buildings where the 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, are stated at valuation less accumulated depreciation and impairment losses.

Such premises are revalued by professional qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value. 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 premises, and are thereafter taken to the 'Property revaluation reserve'. Deficits arising on revaluation are first set off against any previous revaluation surpluses included in the 'Property revaluation reserve' in respect of the same premises, and are thereafter recognised in the income statement.

Buildings held for own use which are situated on leasehold land where it is possible to reliably separate the value of the building from the value of the leasehold land at inception of the lease are revalued by professional qualified valuers, on a depreciated replacement cost basis or surrender value, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value.

Depreciation on premises is calculated to write off the assets over their estimated useful lives as follows:

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

4 Principal accounting policies *(continued)*

(ii) Other plant and equipment

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses. Depreciation is calculated on a straight-line basis to write-off the assets over their useful lives, which are generally between 5 and 20 years.

(iii) Investment properties

The group holds certain properties as investments to earn rentals, or for capital appreciation, or both. Investment properties are stated at fair value with changes in fair value being recognised in 'Other operating income'. Fair values are determined by independent professional valuers, primarily on the basis of capitalisation of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation or, both, are classified and accounted for as investment property on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 4p).

(iv) Leasehold land and land use rights

The Government of the Hong Kong SAR owns all the land in Hong Kong and permits its use under leasehold arrangements. Where the cost of land is known or can be reliably determined at the inception of the lease, the Group records its interest in leasehold land and land use rights separately as operating leases. These leases are recorded at original cost and amortised over the term 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 premises, as discussed above.

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

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p *Finance and operating leases*

(i) Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. Where the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Advances to customers' as appropriate. Finance income receivable is recognised over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

(ii) Where the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. The finance lease and corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised over the periods of the leases based on the interest rates implicit in the leases so as to give a constant rate of interest on the remaining balance of the liability.

(iii) All other leases are classified as operating leases. Where the group is the lessor, the assets subject to the operating leases are included in 'Property, plant and equipment' and accounted for accordingly. Impairment losses are recognised to the extent that the carrying value of equipment is impaired through residual values not being fully recoverable. Where the group is the lessee, the leased assets are not recognised on the balance sheet.

(iv) Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the period of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

(v) There are no freehold interests in land in Hong Kong. Accordingly all such land is considered to be held under operating leases. Unless it qualifies for inclusion in 'Property, plant and equipment' (as described in note 4o above), such land is included under 'Other assets' in the balance sheet and is stated at cost less amortisation and impairment losses. Amortisation is calculated to write off the cost of the land on a straight-line basis over the terms of the leases, which are generally between 20 and 999 years.

4 Principal accounting policies *(continued)*

q *Income tax*

(i) Income tax for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in the statement of comprehensive income, in which case it is recognised in the statement of comprehensive income.

(ii) Current tax is the expected tax payable on the taxable income for the year, calculated using tax rates enacted or substantively enacted at the period end date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to set off exists.

(iii) Deferred tax is recognised on temporary differences between the carrying amount of assets and liabilities in the statement of financial position and the amount attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates that have been enacted or substantively enacted at the period end date and are expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group, relate to income taxes levied by the same taxation authority, and a legal right to set off exists in the entity.

Deferred tax relating to actuarial gains and losses arising from post-employment benefit plans which are recognised in the statement of comprehensive income is also credited or charged to the statement of comprehensive income.

Deferred tax relating to changes in the fair value of available-for-sale investments and cash flow hedges, which are charged or credited directly to the statement of comprehensive income, is also credited or charged directly to the statement of comprehensive income and is recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

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r *Pension and other post-retirement benefits*

The group operates a number of pension plans which include both defined benefit and defined contribution plans.

Payments to defined contribution plans and state-managed retirement benefit plans, where the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The costs recognised for funding defined benefit plans are determined using the projected unit credit method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the statement of comprehensive income in the period they arise. Past service costs are recognised immediately to the extent the benefits are vested, and are otherwise recognised on a straight-line basis over the average period until the benefits are vested. The current service costs and any past service costs together with the expected return on plan assets less the unwinding of the discount on the plan liabilities are charged to 'Employee compensation and benefits'.

The net defined benefit asset or liability recognised in the balance sheet represents the difference between the fair value of plan assets and the present value of the defined benefit obligations adjusted for unrecognised past service costs. In the case of a defined benefit asset, it is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

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s *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 'Other reserves'. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

4 Principal accounting policies *(continued)*

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

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

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

t *Foreign currencies*

(i) Items included in each of the group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The group's financial statements are presented in Hong Kong dollars which is the Bank's functional and presentation currency.

(ii) Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined.

(iii) The results of branches, subsidiaries and associates not reporting in Hong Kong dollars are translated into Hong Kong dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period-end are accounted for in a separate foreign exchange reserve in the consolidated financial statements. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary financial statements. In the consolidated financial statements, these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

u *Provisions*

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

v *Financial guarantee contracts*

Liabilities under financial guarantee contracts which are not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

4 Principal accounting policies *(continued)*

w *Insurance contracts*

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

Insurance contracts are accounted for as follows:

Premiums

Gross insurance premiums for general insurance business are reported as income over the term of the insurance contract attributable to the risks borne during the accounting period. The unearned premium or the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date is calculated on a daily or monthly pro-rata basis.

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

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance to which they relate.

Claims and reinsurance recoveries

Gross insurance claims for general insurance business include paid claims and movements in outstanding claims reserves. The outstanding claims reserves are based on the estimated ultimate cost of all claims that have occurred but not settled at the balance sheet date, whether reported or not, together with related claim handling costs and a reduction for the expected value of salvage and other recoveries. Reserves for claims incurred but not reported ('IBNR') are made on an estimated basis, using appropriate statistical techniques.

Gross insurance claims for life assurance reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. The reserves for non-linked liabilities (long-term business provision) are calculated by each life assurance operation based on local actuarial principles. The reserves for linked liabilities are at least the element of any surrender or transfer value which is calculated by reference to the relevant fund, funds or index. Some insurance contracts may contain discretionary participation features whereby the policyholder is entitled to additional payments whose amount and/or timing is at the discretion of the issuer. The discretionary element of these contracts is included in 'Liabilities under insurance contracts issued'.

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

Present value of in-force long-term assurance business

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

The present value of in-force long-term assurance business is determined by discounting future earnings expected to emerge from business currently in force, using appropriate assumptions in assessing factors such as recent experience and general economic conditions. Movements in the present value of in-force long-term assurance business are included in 'Other operating income' gross of tax.

4 Principal accounting policies *(continued)*

x *Investment contracts*

Customer liabilities under unit-linked investment contracts, along with the linked financial assets, are designated as held 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 fees receivable are recognised in the income statement over the period of the provision of the investment management services.

y *Dividends*

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

z *Debt securities in issue and subordinated liabilities*

Debt securities issued for trading purposes or designated at fair value are reported under the appropriate balance sheet captions. Other 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'.

aa *Cash and cash equivalents*

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments comprise cash and balances with banks maturing within one month, and treasury bills and certificates of deposit with less than three months' maturity from the date of acquisition.

ab *Share capital*

Shares are classified as equity when the group has the unconditional right to avoid transferring cash or other financial assets.

5 Operating profit

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

a *Interest income*

	2009	2008
	HK$m	HK$m
Interest income on listed securities	**8,094**	8,374
Interest income on unlisted securities	**16,849**	23,993
Other interest income	**64,382**	106,771
	89,325	139,138
Less: interest income classified as 'Net trading income' (note 5d)	**(6,701)**	(13,168)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 5e)	**(74)**	(106)
	82,550	125,864

Included in the above is interest income accrued on impaired financial assets of HK$480 million (*2008:HK$341 million*), including unwinding of discounts on loan impairment losses of HK$297 million *(2008:HK$280 million).*

5 Operating profit *(continued)*

b *Interest expense*

	2009	2008
	HK$m	HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**964**	1,375
Interest expense on preference shares	**3,937**	4,946
Other interest expense	**22,097**	56,493
	26,998	62,814
Less: interest expense classified as 'Net trading income' (note 5d)	**(2,848)**	(5,953)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 5e)	**(32)**	(42)
	24,118	56,819

c *Net fee income*

	2009	2008
	HK$m	HK$m
Net fee income includes the following:		
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 or designated at fair value		
– fee income	**11,844**	11,196
– fee expense	**(1,225)**	(1,115)
	10,619	10,081
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**6,711**	7,294
– fee expense	**(761)**	(819)
	5,950	6,475

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

d *Net trading income*

	2009 HK$m	2008 HK$m
Dealing profits		
– Foreign exchange	**12,613**	12,696
– Interest rate derivatives	**1,591**	2,999
– Debt securities	**999**	673
– Equities and other trading	**1,072**	(2,906)
	16,275	13,462
Loss from hedging activities		
Fair value hedges		
– Net (loss)/gain on hedged items attributable to the hedged risk	**(413)**	2,000
– Net gain/(loss) on hedging instruments	**375**	(2,023)
Cash flow hedges		
– Net hedging gain/(loss)	**15**	(50)
	(23)	(73)
Interest on trading assets and liabilities		
– Interest income (note 5a)	**6,701**	13,168
– Interest expense (note 5b)	**(2,848)**	(5,953)
	3,853	7,215
Dividend income from trading securities		
– Listed investments	**421**	759
	20,526	21,363

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

	2009 HK$m	2008 HK$m
Income/(expense) on assets designated at fair value which back insurance and investment contracts	**9,100**	(15,714)
Change in fair value of liabilities to customers under investment contracts	**(2,854)**	3,596
	6,246	(12,118)
Net change in fair value of other financial assets/liabilities designated at fair value [1]	**971**	1,072
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 5a)	**74**	106
– Interest expense (note 5b)	**(32)**	(42)
	42	64
	7,259	(10,982)

1 *Gains and losses from changes in the fair value of the group's issued debt securities may arise from changes in the group's own credit risk. In 2009 the group recognised a HK$35 million loss on changes in the fair value of these instruments arising from changes in own credit risk (2008:HK$66 million gain).*

5 Operating profit *(continued)*

f *Gains less losses from financial investments*

	2009	2008
	HK$m	HK$m
Gains on disposal of available-for-sale securities	**1,191**	1,807
Impairment of available-for-sale equity investments	**(1,322)**	(4,783)
	(131)	(2,976)

There are no gains or losses on the disposal of held-to-maturity investments in the year *(2008: nil)*.

g *Dividend income*

	2009	2008
	HK$m	HK$m
Listed investments	**228**	694
Unlisted investments	**136**	158
	364	852

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

h *Net earned insurance premiums*

2009	*Non-life insurance* **HK$m**	*Life insurance (non-linked)* **HK$m**	*Life insurance (linked)* **HK$m**	*Investment contracts with discretionary participation features* **HK$m**	*Total* **HK$m**
Gross written premiums	**2,754**	**27,391**	**1,933**	**–**	**32,078**
Movement in unearned premiums	**(116)**	**–**	**–**	**–**	**(116)**
Gross earned premiums	**2,638**	**27,391**	**1,933**	**–**	**31,962**
Gross written premiums ceded to reinsurers	**(394)**	**(197)**	**(9)**	**–**	**(600)**
Reinsurers' share of movement in unearned premiums	**33**	**–**	**–**	**–**	**33**
Reinsurers' share of gross earned premiums	**(361)**	**(197)**	**(9)**	**–**	**(567)**
Net earned premiums	**2,277**	**27,194**	**1,924**	**–**	**31,395**

2008	*Non-life insurance* HK$m	*Life insurance (non-linked)* HK$m	*Life insurance (linked)* HK$m	*Investment contracts with discretionary participation features* HK$m	*Total* HK$m
Gross written premiums	2,581	23,736	5,570	24	31,911
Movement in unearned premiums	(139)	–	–	–	(139)
Gross earned premiums	2,442	23,736	5,570	24	31,772
Gross written premiums ceded to reinsurers	(351)	(182)	(4,357)	–	(4,890)
Reinsurers' share of movement in unearned premiums	4	–	–	–	4
Reinsurers' share of gross earned premiums	(347)	(182)	(4,357)	–	(4,886)
Net earned premiums	2,095	23,554	1,213	24	26,886

5 Operating profit *(continued)*

i *Other operating income*

	2009 HK$m	2008 HK$m
Rental income from investment properties	**169**	153
Movement in present value of in-force insurance business	**2,888**	823
Gains on investment properties	**262**	11
Profit/(loss) on disposal of property, plant and equipment, and assets held for sale	**696**	(63)
Loss on disposal of subsidiaries, associates and business portfolios	**(6)**	(96)
(Deficit)/surplus arising on property revaluation	**(143)**	60
Other	**3,392**	3,188
	7,258	4,076

Gains on investment properties comprise of unrealised revaluation gains.

Included within 'Other' is a gain of HK$664 million on the disposal of loans and receivables *(2008: HK$554 million)*. There are no gains or losses on disposal of financial liabilities measured at amortised cost during the year *(2008: nil)*.

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

j *Net insurance claims incurred and movement in policyholders' liabilities*

2009	*Non-life insurance* **HK$m**	*Life insurance (non-linked)* **HK$m**	*Life insurance (linked)* **HK$m**	*Investment contracts with discretionary participation features* **HK$m**	*Total* **HK$m**
Claims, benefits and surrenders paid	**1,227**	**3,001**	**884**	**2**	**5,114**
Movement in provision	**(143)**	**25,293**	**5,706**	**–**	**30,856**
Gross claims incurred and movement in policyholders' liabilities	**1,084**	**28,294**	**6,590**	**2**	**35,970**
Reinsurers' share of claims, benefits and surrenders paid	**(110)**	**(149)**	**(95)**	**–**	**(354)**
Reinsurers' share of movement in provision	**18**	**92**	**1,405**	**–**	**1,515**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(92)**	**(57)**	**1,310**	**–**	**1,161**
Net insurance claims incurred and movement in policyholders' liabilities	**992**	**28,237**	**7,900**	**2**	**37,131**

2008	*Non-life insurance* HK$m	*Life Insurance (non-linked)* HK$m	*Life insurance (linked)* HK$m	*Investment contracts with discretionary participation features* HK$m	*Total* HK$m
Claims, benefits and surrenders paid	1,184	2,644	1,796	3	5,627
Movement in provision	(82)	19,954	884	(12)	20,744
Gross claims incurred and movement in policyholders' liabilities	1,102	22,598	2,680	(9)	26,371
Reinsurers' share of claims, benefits and surrenders paid	(121)	(58)	(234)	–	(413)
Reinsurers' share of movement in provision	75	(75)	(11,191)	–	(11,191)
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(46)	(133)	(11,425)	–	(11,604)
Net insurance claims incurred and movement in policyholders' liabilities	1,056	22,465	(8,745)	(9)	14,767

5 Operating profit *(continued)*

k *Loan impairment charges and other credit risk provisions*

	2009	2008
Net charge for impairment of customer advances	**HK$m**	HK$m
– Individually assessed impairment allowances:		
New allowances	**5,504**	4,243
Releases	**(1,135)**	(523)
Recoveries	**(188)**	(169)
	4,181	3,551
– Net charge for collectively assessed impairment allowances	**6,498**	6,542
Net charge for other credit risk provisions	**556**	1,907
Net charge for loan impairment and other credit risk provisions	**11,235**	12,000

Included in the net charge for other credit risk provisions is an impairment charge of HK$365 million against available-for-sale debt securities (*2008: HK$2,006 million*). There are no impairment losses or provisions relating to held-to-maturity investments *(2008: nil)*.

l *Employee compensation and benefits*

	2009	2008
	HK$m	HK$m
Wages, salaries and other costs	**20,367**	20,117
Performance-related pay	**6,147**	6,126
Social security costs	**698**	549
Retirement benefit costs		
– Defined contribution plans	**811**	779
– Defined benefit plans	**562**	561
	28,585	28,132

Retirement benefit pension plans

The group operates 69 *(2008: 69)* retirement benefit plans, with a total cost of HK$1,373 million *(2008: HK$1,340 million)*, of which HK$532 million *(2008: HK$539 million)* relates to overseas plans and HK$35 million *(2008:HK$66 million)* are sponsored by HSBC Asia Holdings BV.

Progressively the group has been moving to defined contribution plans for all new employees.

The group's defined benefit plans, which cover 39 per cent *(2008: 43 per cent)* of the group's employees, are predominantly funded plans with assets which, in the case of the larger plans, are held either under insurance policies or in trust funds separate from the group. The cost relating to the funded plans was HK$533 million *(2008: HK$537 million)* which was assessed in accordance with the advice of qualified actuaries; the plans are reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the projected benefit obligations of the group's retirement benefits plans vary according to the economic conditions of the countries in which they are situated.

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

(i) Defined benefit plan principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the major defined benefit pension plans were:

	2009	2008
	% p.a.	% p.a.
Discount rate	**2.58**	1.19
Expected rate of return on plan assets		
– equities	**8.5**	8.3
– bonds	**3.6**	4.2
– other	**0.9**	2.1
Rate of pay increase		
– long term	**5.0**	5.0
Mortality table	HKLT2001*	HKLT2001*

* *HKLT2001 – Hong Kong Life Tables 2001*

The overall expected long-term rate of return on assets as at 31 December 2009 is 5.8 per cent *(2008: 6.7 per cent)*. The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based on historical market returns adjusted for additional factors such as the current rate of inflation and interest rates.

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of The Hongkong and Shanghai Banking Corporation Limited and certain other employees of the HSBC Group. The latest actuarial valuation of the defined benefit plan was made at 31 December 2008, and was performed by Estella Chiu, Fellow of the Society of Actuaries of the United States of America, of HSBC Insurance (Asia) Limited, a subsidiary of HSBC Holdings. At the valuation date, the market value of the defined benefit scheme's assets was HK$8,309 million. On an ongoing basis, the actuarial value of the scheme's assets represented 103 per cent of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK$264 million. On a wind-up basis, the scheme's assets represented 104 per cent of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$341 million. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 6 per cent per annum and long-term salary increases of 5 per cent per annum.

5 Operating profit *(continued)*

(ii) Value recognised in the balance sheet

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Equities	**2,285**	1,990	**996**	926
Bonds	**9,995**	9,090	**6,855**	6,630
Other	**2,038**	2,508	**1,776**	1,823
Fair value of plan assets	**14,318**	13,588	**9,627**	9,379
Present value of funded obligations	**17,823**	20,824	**11,366**	12,719
Present value of unfunded obligations	**125**	130	**71**	122
Defined benefit obligations	**17,948**	20,954	**11,437**	12,841
Effect of limit on plan surpluses	**–**	36	**–**	36
Net defined benefit liability	**(3,630)**	(7,402)	**(1,810)**	(3,498)
Reported as ‘Assets’	**292**	84	**176**	52
Reported as ‘Liabilities’	**(3,922)**	(7,486)	**(1,986)**	(3,550)
Net defined benefit liability	**(3,630)**	(7,402)	**(1,810)**	(3,498)

(iii) Changes in the present value of the defined benefit obligations

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**20,954**	17,966	**12,841**	11,310
Current service cost	**1,153**	1,069	**721**	706
Interest cost	**307**	639	**207**	413
Contributions by employees	**2**	2	**–**	–
Actuarial (gains)/losses	**(3,200)**	2,583	**(1,472)**	1,430
Benefits paid	**(1,299)**	(1,152)	**(842)**	(847)
Past service cost – vested immediately	**–**	3	**–**	3
Reduction in liabilities resulting from curtailments	**(48)**	–	**(48)**	–
Exchange and other movements	**79**	(156)	**30**	(174)
At 31 December	**17,948**	20,954	**11,437**	12,841

(iv) Changes in the fair value of plan assets

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**13,588**	16,572	**9,379**	10,506
Expected return	**891**	1,150	**639**	716
Contributions by the group	**736**	687	**484**	505
Contributions by employees	**2**	2	**–**	–
Actuarial gains/(losses)	**368**	(3,591)	**(47)**	(1,400)
Benefits paid	**(1,261)**	(1,114)	**(822)**	(816)
Assets distributed on curtailments	**(33)**	–	**(33)**	–
Exchange and other movements	**27**	(118)	**27**	(132)
At 31 December	**14,318**	13,588	**9,627**	9,379

5 Operating profit *(continued)*

The plan assets above included assets issued by entities within HSBC Group:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Equities	**418**	357	**369**	312
Others	**103**	93	**62**	42
	521	450	**431**	354

The group's actual gain on plan assets for the year ended 31 December 2009 was HK$1,259 million *(2008: HK$2,441 million loss)*. The Bank's actual gain on plan assets for the year ended 31 December 2009 was HK$592 million *(2008: HK$684 million loss)*.

The group expects to make HK$706 million of contributions to defined benefit pension plans during the following year *(2008: HK$989 million)*. Contributions to be made by the Bank are expected to be HK$453 million *(2008: HK$546 million)*.

(v) Total expense recognised in the income statement in 'Defined benefit plans'

	Group	
	2009	2008
	HK$m	HK$m
Current service cost	**1,153**	1,069
Interest cost	**307**	639
Expected return on plan assets	**(891)**	(1,150)
Past service costs	**–**	3
Gains on curtailments	**(7)**	–
Total net expense	**562**	561

Total net actuarial gains recognised in the group's total equity during 2009 in respect of defined benefit pension plans was HK$3,606 million *(2008: HK$6,194 million loss).* After deduction of minority interests, a gain of HK$2,893 million *(2008: HK$5,051 million loss)* was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date was HK$5,972 million *(2008: HK$9,578 million)*. After deduction of minority interests, the total net actuarial losses recognised in total shareholders' equity to date was HK$5,107 million *(2008: HK$8,000 million).*

Total net actuarial gains recognised in the Bank's retained profits during 2009 in respect of defined benefit pension plans were HK$1,463 million *(2008: HK$2,850 million loss)*. Total net actuarial losses recognised outside of the income statement to date were HK$3,489 million *(2008: HK$4,952 million).*

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2009 was a HK$38 million reduction, excluding exchange differences of HK$2 million *(2008: HK$20 million addition, excluding exchange difference of HK$4 million).*

Expenses recognised in the income statement in respect of defined benefit schemes sponsored by the Bank's immediate holding company, HSBC Asia Holdings BV ("HABV") were not included in the tables above as these are reported as Defined Contribution Plans.

HABV recharges contributions to participating members of the HSBC International Staff Retirement Benefits Scheme, a funded defined benefit scheme, in accordance with schedules determined by the Trustees following consultation with qualified actuaries. There is no contractual agreement or stated policy for charging the net defined benefit cost to the group.

5 Operating profit *(continued)*

The scheme is denominated in Sterling with the following details:

Assumptions as at 31 December	**2009**	2008
	% p.a.	% p.a.
Inflation	**3.70**	2.90
Salary increases	**5.45**	4.65
Pension increases	**3.70**	2.90
Discount rate	**5.70**	6.50
Expected return on assets	**5.51**	4.12
Mortality table	**PNA00YOB***	PNA00YOB*

* *The "PNA00 Year of Birth" tables are based on the 2000 series of tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries. The mortality rates (that is, the probability of death in a given year) in these tables have been reduced by a factor of 80%. An allowance for future improvements in mortality after 2000 has been made in line with those underlying the medium cohort improvements applicable to the series, subject to a minimum improvement of 1% per annum.*

The International Staff Scheme

Funded status at 31 December	**2009**	2008
	£m	£m
Plan assets	**604**	545
Defined benefit obligations	**(693)**	(523)
Net defined benefit (liability)/asset	**(89)**	22

Categories of assets at 31 December	**2009**	2008
	£m	£m
Bonds	**428**	345
Property	**18**	35
Other	**158**	165
Fair value of plan assets	**604**	545

Reconciliation of defined benefit obligations at 31 December	**2009**	2008
	£m	£m
At 1 January	**523**	619
Current service cost	**11**	15
Interest cost	**34**	35
Contributions by employees	**1**	1
Actuarial gains/(losses)	**154**	(114)
Benefits paid	**(30)**	(33)
At 31 December	**693**	523

Notes on the Financial Statements (continued)

5 Operating profit *(continued)*

Reconciliation of the fair value of plan assets at 31 December	**2009**	2008
	£m	£m
At 1 January	**545**	525
Expected return	**24**	34
Actuarial (losses)/gains	**(45)**	5
Contributions by the group	**109**	13
Contributions by employees	**1**	1
Benefits paid	**(30)**	(33)
At 31 December	**604**	545

Estimated contributions in the following year	**2009**	2008
	£m	£m
Estimated company contributions in the financial year	**12**	14
Estimated employee contributions in the financial year	**1**	1
Estimated total contributions in the financial year	**13**	15

(vi) Amounts for the current and previous years

	Group					*Bank*				
	2009	2008	2007	2006	2005	**2009**	2008	2007	2006	2005
	HK$m	HK$m	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m	HK$m	HK$m
Defined benefit obligations	**17,948**	20,954	17,966	13,134	11,950	**11,437**	12,841	11,310	8,674	7,726
Plan assets	**14,318**	13,588	16,572	14,860	13,344	**9,627**	9,379	10,506	9,500	8,599
Net (deficit)/surplus	**(3,630)**	(7,366)	(1,394)	1,726	1,394	**(1,810)**	(3,462)	(804)	826	873
Experience (gains)/ losses on plan liabilities	**(408)**	132	790	420	84	**(60)**	363	585	384	71
Experience gains/ (losses) on plan assets	**368**	(3,591)	948	953	67	**(47)**	(1,400)	487	499	(5)

m *General and administrative expenses*

	2009	2008
	HK$m	HK$m
Premises and equipment		
– Rental expenses	**2,747**	2,432
– Amortisation of prepaid operating lease payments	**58**	59
– Other premises and equipment	**3,192**	3,068
	5,997	5,559
Marketing and advertising expenses	**3,168**	3,579
Other administrative expenses	**10,368**	11,128
Litigation and other provisions	**(6)**	424
	19,527	20,690

Included in operating expenses are direct operating expenses of HK$21 million *(2008: HK$18 million)* arising from investment properties that generated rental income during the year. Direct operating expenses arising from investment properties that did not generate rental income amounted to HK$1 million *(2008: HK$1 million)*.

Included in operating expenses are minimum lease payments under operating leases of HK$2,806 million *(2008: HK$2,443 million)*.

5 Operating profit *(continued)*

n *Auditors' remuneration*

Auditors' remuneration amounted to HK$72 million *(2008: HK$68 million)*, of which HK$29 million *(2008: HK$30 million)* related to the Bank.

o *Directors' emoluments*

Key management compensation includes the aggregate emoluments of the directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance of HK$129 million *(2008: HK$107 million)*. This comprises fees of HK$6 million *(2008: HK$6 million)* and other emoluments of HK$123 million *(2008: HK$101 million)* which includes pension benefits of HK$5 million *(2008: HK$5 million)*. In addition, HK$8.5 million was paid as compensation for loss of office.

6 Tax expense

a The Bank and its subsidiary companies in Hong Kong have provided for Hong Kong profits tax at the rate of 16.5% *(2008: 16.5%)* on the profits for the year assessable in Hong Kong. Overseas branches and subsidiary companies have similarly provided for tax in the countries in which they operate at the appropriate rates of tax ruling in 2009. Deferred taxation is provided for in accordance with the group's accounting policy in note 4q.

The charge for taxation in the income statement comprises:

	2009	2008
	HK$m	HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**6,010**	6,592
– Hong Kong profits tax – adjustments in respect of prior years	**(171)**	(348)
– Overseas taxation – on current year profit	**6,397**	6,601
– Overseas taxation – adjustments in respect of prior years	**(222)**	(407)
	12,014	12,438
Deferred tax (note 34)		
– Origination and reversal of temporary differences	**(352)**	182
– Adjustments in respect of prior years	**257**	90
	(95)	272
	11,919	12,710

b *Provisions for taxation*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong profits tax	**722**	475	**368**	319
Overseas taxation	**3,397**	2,795	**3,088**	2,261
Current tax liabilities	**4,119**	3,270	**3,456**	2,580
Deferred tax liabilities (note 34)	**7,358**	4,433	**3,318**	2,107
	11,477	7,703	**6,774**	4,687

Notes on the Financial Statements (continued)

6 Tax expense *(continued)*

c *Reconciliation between taxation charge and accounting profit at applicable tax rates:*

	2009 **HK$m**	2008 HK$m
Profit before tax	**62,563**	67,690
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**11,807**	12,930
Tax effect of non-taxable revenue (net of non-deductible expenses)	**(161)**	(330)
Tax effect of prior year's tax losses utilised this year (net of unused tax losses not recognised)	**(30)**	(3)
Over provision in prior years	**(136)**	(665)
Others	**439**	778
	11,919	12,710

7 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$35,343 million *(2008: HK$44,734 million)* which has been dealt with in the accounts of the Bank.

8 Dividends

	2009		2008	
	HK$ per share	**HK$m**	HK$ per share	HK$m
Ordinary dividends				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	**1.24**	**11,170**	0.72	6,500
– first interim dividend paid	**0.65**	**5,890**	0.67	6,000
– second interim dividend paid	**0.65**	**5,890**	0.72	6,500
– third interim dividend paid	**0.65**	**5,890**	0.83	7,500
	3.19	**28,840**	2.94	26,500

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2009 of HK$8,850 million (HK$0.98 per ordinary share).

9 Financial Assets and Liabilities

Group

	At 31 December 2009								
	Held for trading	*Designated at fair value*	*Held-to-maturity securities*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
ASSETS									
Cash and short-term funds	–	–	–	**441,862**	**359,538**	**90,775**	–	–	**892,175**
Items in the course of collection from other banks	–	–	–	–	–	**15,528**	–	–	**15,528**
Placings with banks maturing after one month	–	–	–	**107,070**	–	–	–	–	**107,070**
Certificates of deposit	–	–	**4,458**	–	**32,930**	–	–	–	**37,388**
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	**135,414**	–	–	**135,414**
Trading assets	**322,731**	–	–	–	–	–	–	–	**322,731**
Financial assets designated at fair value	–	**48,087**	–	–	–	–	–	–	**48,087**
Derivatives	**233,046**	–	–	–	–	–	**148**	**1,977**	**235,171**
Advances to customers	–	–	–	**1,350,644**	–	–	–	–	**1,350,644**
Financial investments	–	–	**106,263**	–	**776,426**	–	–	–	**882,689**
Amounts due from group companies	**41,463**	**5,230**	–	–	–	**87,818**	–	–	**134,511**
Other assets	–	–	–	–	–	**54,744**	–	–	**54,744**
Total financial assets	**597,240**	**53,317**	**110,721**	**1,899,576**	**1,168,894**	**384,279**	**148**	**1,977**	**4,216,152**
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	**135,414**	–	–	**135,414**
Items in the course of transmission to other banks	–	–	–	–	–	**22,960**	–	–	**22,960**
Deposits by banks	–	–	–	–	–	**111,206**	–	–	**111,206**
Customer accounts	–	–	–	–	–	**2,944,539**	–	–	**2,944,539**
Trading liabilities	**154,366**	–	–	–	–	–	–	–	**154,366**
Financial liabilities designated at fair value	–	**36,709**	–	–	–	–	–	–	**36,709**
Derivatives	**230,084**	–	–	–	–	–	**2,533**	**229**	**232,846**
Debt securities in issue	–	–	–	–	–	**43,396**	–	–	**43,396**
Amounts due to group companies	**10,811**	**1**	–	–	–	**40,030**	–	–	**50,842**
Other liabilities	–	–	–	–	–	**52,887**	–	–	**52,887**
Subordinated liabilities	–	–	–	–	–	**21,181**	–	–	**21,181**
Preference shares	–	–	–	–	–	**101,208**	–	–	**101,208**
Total financial liabilities	**395,261**	**36,710**	–	–	–	**3,472,821**	**2,533**	**229**	**3,907,554**

9 Financial Assets and Liabilities *(continued)*

Group

	At 31 December 2008								
	Held for trading HK$m	*Designated at fair value* HK$m	*Held-to-maturity securities* HK$m	*Loans and receivables* HK$m	*Available-for-sale securities* HK$m	*Financial assets and liabilities at amortised cost* HK$m	*Derivatives designated as fair value hedging instruments* HK$m	*Derivatives designated as cash flow hedging instruments* HK$m	*Total* HK$m
ASSETS									
Cash and short-term funds	–	–	–	336,731	131,651	129,190	–	–	597,572
Items in the course of collection from other banks	–	–	–	–	–	13,949	–	–	13,949
Placings with banks maturing after one month	–	–	–	55,569	–	–	–	–	55,569
Certificates of deposit	–	–	4,472	–	52,606	–	–	–	57,078
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	119,024	–	–	119,024
Trading assets	493,670	–	–	–	–	–	–	–	493,670
Financial assets designated at fair value	–	40,553	–	–	–	–	–	–	40,553
Derivatives	447,645	–	–	–	–	–	140	6,138	453,923
Advances to customers	–	–	–	1,286,145	–	–	–	–	1,286,145
Financial investments	–	–	77,502	–	508,659	–	–	–	586,161
Amounts due from group companies	53,375	429	–	–	–	324,858	–	–	378,662
Other assets	–	–	–	–	–	66,139	–	–	66,139
Total financial assets	994,690	40,982	81,974	1,678,445	692,916	653,160	140	6,138	4,148,445
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	119,024	–	–	119,024
Items in the course of transmission to other banks	–	–	–	–	–	31,334	–	–	31,334
Deposits by banks	–	–	–	–	–	196,674	–	–	196,674
Customer accounts	–	–	–	–	–	2,576,084	–	–	2,576,084
Trading liabilities	210,587	–	–	–	–	–	–	–	210,587
Financial liabilities designated at fair value	–	39,926	–	–	–	–	–	–	39,926
Derivatives	463,488	–	–	–	–	–	2,332	384	466,204
Debt securities in issue	–	–	–	–	–	48,800	–	–	48,800
Amounts due to group companies	19,479	–	–	–	–	31,765	–	–	51,244
Other liabilities	–	–	–	–	–	59,685	–	–	59,685
Subordinated liabilities	–	–	–	–	–	19,184	–	–	19,184
Preference shares	–	–	–	–	–	92,870	–	–	92,870
Total financial liabilities	693,554	39,926	–	–	–	3,175,420	2,332	384	3,911,616

9 Financial Assets and Liabilities *(continued)*

Bank

	At 31 December 2009								
	Held for trading	*Designated at fair value*	*Held-to-maturity securities*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
ASSETS									
Cash and short-term funds	–	–	–	**275,538**	**296,406**	**85,821**	–	–	**657,765**
Items in the course of collection from other banks	–	–	–	–	–	**11,151**	–	–	**11,151**
Placings with banks maturing after one month	–	–	–	**67,299**	–	–	–	–	**67,299**
Certificates of deposit	–	–	–	–	**20,492**	–	–	–	**20,492**
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	**135,414**	–	–	**135,414**
Trading assets	**216,480**	–	–	–	–	–	–	–	**216,480**
Financial assets designated at fair value	–	**1,801**	–	–	–	–	–	–	**1,801**
Derivatives	**229,352**	–	–	–	–	–	**101**	**1,545**	**230,998**
Advances to customers	–	–	–	**752,574**	–	–	–	–	**752,574**
Financial investments	–	–	–	–	**564,738**	–	–	–	**564,738**
Amounts due from group companies	**47,562**	–	–	–	–	**114,193**	–	–	**161,755**
Other assets	–	–	–	–	–	**32,469**	–	–	**32,469**
Total financial assets	**493,394**	**1,801**	–	**1,095,411**	**881,636**	**379,048**	**101**	**1,545**	**2,852,936**
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	**135,414**	–	–	**135,414**
Items in the course of transmission to other banks	–	–	–	–	–	**15,796**	–	–	**15,796**
Deposits by banks	–	–	–	–	–	**94,861**	–	–	**94,861**
Customer accounts	–	–	–	–	–	**1,902,571**	–	–	**1,902,571**
Trading liabilities	**103,456**	–	–	–	–	–	–	–	**103,456**
Financial liabilities designated at fair value	–	**1,857**	–	–	–	–	–	–	**1,857**
Derivatives	**228,223**	–	–	–	–	–	**1,864**	**56**	**230,143**
Debt securities in issue	–	–	–	–	–	**28,250**	–	–	**28,250**
Amounts due to group companies	**26,691**	–	–	–	–	**96,511**	–	–	**123,202**
Other liabilities	–	–	–	–	–	**36,266**	–	–	**36,266**
Subordinated liabilities	–	–	–	–	–	**9,925**	–	–	**9,925**
Preference shares	–	–	–	–	–	**101,063**	–	–	**101,063**
Total financial liabilities	**358,370**	**1,857**	–	–	–	**2,420,657**	**1,864**	**56**	**2,782,804**

Notes on the Financial Statements (continued)

9 Financial Assets and Liabilities *(continued)*

Bank

	At 31 December 2008								
	Held for trading HK$m	*Designated at fair value* HK$m	*Held-to-maturity securities* HK$m	*Loans and receivables* HK$m	*Available-for-sale securities* HK$m	*Financial assets and liabilities at amortised cost* HK$m	*Derivatives designated as fair value hedging instruments* HK$m	*Derivatives designated as cash flow hedging instruments* HK$m	*Total* HK$m
ASSETS									
Cash and short-term funds	–	–	–	238,540	117,998	125,164	–	–	481,702
Items in the course of collection from other banks	–	–	–	–	–	9,908	–	–	9,908
Placings with banks maturing after one month	–	–	–	33,754	–	–	–	–	33,754
Certificates of deposit	–	–	–	–	36,980	–	–	–	36,980
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	119,024	–	–	119,024
Trading assets	329,123	–	–	–	–	–	–	–	329,123
Financial assets designated at fair value	–	1,728	–	–	–	–	–	–	1,728
Derivatives	447,586	–	–	–	–	–	140	4,483	452,209
Advances to customers	–	–	–	817,996	–	–	–	–	817,996
Financial investments	–	–	–	–	340,800	–	–	–	340,800
Amounts due from group companies	56,979	–	–	–	–	340,982	–	–	397,961
Other assets	–	–	–	–	–	42,455	–	–	42,455
Total financial assets	833,688	1,728	–	1,090,290	495,778	637,533	140	4,483	3,063,640
LIABILITIES									
Hong Kong SAR currency notes in circulation	–	–	–	–	–	119,024	–	–	119,024
Items in the course of transmission to other banks	–	–	–	–	–	26,581	–	–	26,581
Deposits by banks	–	–	–	–	–	174,532	–	–	174,532
Customer accounts	–	–	–	–	–	1,767,001	–	–	1,767,001
Trading liabilities	151,089	–	–	–	–	–	–	–	151,089
Financial liabilities designated at fair value	–	7,086	–	–	–	–	–	–	7,086
Derivatives	455,932	–	–	–	–	–	1,727	73	457,732
Debt securities in issue	–	–	–	–	–	34,855	–	–	34,855
Amounts due to group companies	34,540	–	–	–	–	83,141	–	–	117,681
Other liabilities	–	–	–	–	–	45,592	–	–	45,592
Subordinated liabilities	–	–	–	–	–	10,602	–	–	10,602
Preference shares	–	–	–	–	–	92,870	–	–	92,870
Total financial liabilities	641,561	7,086	–	–	–	2,354,198	1,727	73	3,004,645

10 Cash and short-term funds

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Cash in hand	**11,761**	10,864	**6,854**	6,861
Sight balances with central banks	**79,014**	118,326	**78,967**	118,303
Placings with banks with remaining maturity of one month or less	**441,862**	336,731	**275,538**	238,540
Treasury bills and other eligible bills	**359,538**	131,651	**296,406**	117,998
	892,175	597,572	**657,765**	481,702

As at 31 December 2009, included within notes 10 and 11, the total amount placed with central banks, including sight balances, made by the Group amounted to HK$256,074 million (*2008: HK$234,582 million*). Placings with central banks made by the Bank amounted to HK$182,643 million (*2008: HK$205,125 million*).

Deposits required by overseas government regulations included in cash and short-term funds and placings with banks maturing after one month (note 11) are as follows:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Balances with banks and central banks	**36,237**	37,397	**18,011**	22,290
Treasury bills and other eligible bills	**15,519**	848	**14,938**	746
	51,756	38,245	**32,949**	23,036

Treasury bills and other eligible bills are analysed as follows:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Treasury bills and other eligible bills – available-for-sale				
– which may be repledged or resold by counterparties	**–**	1,041	**–**	–
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**359,538**	130,610	**296,406**	117,998
	359,538	131,651	**296,406**	117,998

Treasury bills and other eligible bills held for trading are included under 'Trading assets' (note 14). Treasury bills and other eligible bills are largely unlisted.

Notes on the Financial Statements (continued)

11 Placings with banks maturing after one month

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Gross placings with banks maturing after one month but not more than one year	**103,252**	51,763	**64,219**	30,508
Gross placings with banks maturing after one year	**3,818**	3,806	**3,080**	3,246
Total placings with banks	**107,070**	55,569	**67,299**	33,754

There were no rescheduled placings included in the above table. Details of overdue placings are included in note 52.

12 Certificates of deposit

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Held-to-maturity	**4,458**	4,472	**–**	–
Available-for-sale	**32,930**	52,606	**20,492**	36,980
	37,388	57,078	**20,492**	36,980

Certificates of deposit held are largely unlisted.

There were no disposals of held-to-maturity certificates of deposit during the year *(2008: nil)*.

13 Hong Kong SAR currency notes in circulation

The Hong Kong Special Administrative Region currency notes in circulation are secured by the deposit of funds in respect of which the Government of the Hong Kong Special Administrative Region certificates of indebtedness are held.

14 Trading assets

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Trading assets				
– which may be repledged or resold by counterparties	**921**	232	**711**	232
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**321,810**	493,438	**215,769**	328,891
	322,731	493,670	**216,480**	329,123

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**138,020**	187,236	**104,158**	147,381
Equity shares	**13,780**	12,012	**13,077**	11,282
Treasury bills and other eligible bills	**145,676**	238,778	**82,680**	125,644
Other	**25,255**	55,644	**16,565**	44,816
	322,731	493,670	**216,480**	329,123

The amount of treasury bills and other eligible bills which were listed amounted to HK$23,819m at both group and Bank level as at 31 December 2009 *(2008: nil)*. These related to treasury bills listed on Korean Stock Exchange, which is regarded as a recognised exchange from 2009.

a *Debt securities*

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**21,323**	23,848	**18,612**	20,217
– listed outside Hong Kong	**48,654**	11,648	**48,497**	11,208
	69,977	35,496	**67,109**	31,425
Unlisted	**68,043**	151,740	**37,049**	115,956
	138,020	187,236	**104,158**	147,381
Issued by public bodies				
– central governments and central banks	**96,713**	83,044	**70,330**	54,909
– other public sector entities	**5,361**	2,309	**4,220**	1,929
	102,074	85,353	**74,550**	56,838
Issued by other bodies				
– banks	**20,934**	86,780	**16,330**	76,969
– corporate entities	**15,012**	15,103	**13,278**	13,574
	138,020	187,236	**104,158**	147,381

Notes on the Financial Statements (continued)

14 Trading assets *(continued)*

b *Equity shares*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**3,106**	2,461	**3,100**	2,461
– listed outside Hong Kong	**8,851**	4,573	**8,333**	4,573
	11,957	7,034	**11,433**	7,034
Unlisted	**1,823**	4,978	**1,644**	4,248
	13,780	12,012	**13,077**	11,282
Issued by other bodies				
– banks	**1,270**	1,634	**1,270**	1,634
– corporate entities	**12,510**	10,378	**11,807**	9,648
	13,780	12,012	**13,077**	11,282

15 Financial assets designated at fair value

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**18,300**	19,730	**1,801**	1,722
Equity shares	**29,392**	20,817	**–**	–
Other	**395**	6	**–**	6
	48,087	40,553	**1,801**	1,728

a *Debt securities*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**1,409**	2,331	**802**	696
– listed outside Hong Kong	**2,939**	3,096	**770**	505
	4,348	5,427	**1,572**	1,201
Unlisted	**13,952**	14,303	**229**	521
	18,300	19,730	**1,801**	1,722

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**3,134**	4,505	**587**	571
– other public sector entities	**2,395**	2,020	**354**	434
	5,529	6,525	**941**	1,005
Issued by other bodies				
– banks	**7,577**	9,543	**–**	–
– corporate entities	**5,194**	3,662	**860**	717
	18,300	19,730	**1,801**	1,722

15 Financial assets designated at fair value *(continued)*

b *Equity shares*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,883**	2,399	**–**	–
– listed outside Hong Kong	**11,165**	8,315	**–**	–
	14,048	10,714	**–**	–
Unlisted	**15,344**	10,103	**–**	–
	29,392	20,817	**–**	–
Issued by other bodies				
– banks	**1,326**	758	**–**	–
– corporate entities	**28,066**	20,059	**–**	–
	29,392	20,817	**–**	–

16 Derivatives

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices.

Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.

Derivatives are carried at fair value and shown in the statement of financial position as separate totals of assets and liabilities. Asset and liability values represent the cost or benefit to the group of replacing all transactions with positive or negative fair value respectively, assuming that all the group's relevant counterparties default at the same time, and that transactions can be replaced instantaneously.

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. Changes in the values of derivatives are recognised in accordance with the group's accounting policy as described in note 4j.

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in HKAS 39. All other derivative instruments are classified as held for trading.

The held for trading classification includes two types of derivative instruments. The first type are those used in sales and trading activities, including those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second type of held for trading category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with offsetting deals being utilised to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures as are used for traditional lending.

Notes on the Financial Statements (continued)

16 Derivatives *(continued)*

a *Trading derivatives*

Most of the group's 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 includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

(i) Contract amounts of derivatives held for trading purposes by product type

	2009		2008	
	Group	*Bank*	*Group*	*Bank*
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**5,398,523**	**4,796,545**	6,462,356	5,961,152
Interest rate	**10,150,894**	**9,998,057**	9,614,270	9,476,072
Equities	**246,876**	**255,708**	313,779	325,712
Credit derivatives	**612,691**	**614,144**	778,795	778,795
Commodity and other	**24,953**	**19,485**	26,355	23,672
Total derivatives	**16,433,937**	**15,683,939**	17,195,555	16,565,403

Other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge ineffectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes and do not meet the criteria for hedge accounting.

Included in the above table are the contract amount of derivatives managed in conjunction with financial instruments designated at fair value that are included within trading derivatives:

	2009		2008	
	Group	*Bank*	*Group*	*Bank*
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**3,182**	**546**	611	611
Interest rate	**1,167**	**1,007**	7,853	6,050
Equities	**775**	**702**	771	723
Credit derivatives	**–**	**–**	–	–
Commodity and other	**–**	**–**	–	–
Total derivatives	**5,124**	**2,255**	9,235	7,384

16 Derivatives *(continued)*

(ii) Fair values of outstanding trading derivatives

Group

	2009		2008	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**89,770**	**88,031**	185,271	193,979
Interest rate	**114,110**	**111,864**	197,443	191,906
Equities	**15,979**	**17,618**	28,374	41,696
Credit derivatives	**12,621**	**12,141**	35,470	34,357
Commodity and other	**566**	**430**	1,087	1,550
Total derivatives	**233,046**	**230,084**	447,645	463,488

Bank

	2009		2008	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**86,348**	**86,763**	182,235	188,409
Interest rate	**113,061**	**110,600**	195,014	189,348
Equities	**16,872**	**17,848**	34,645	41,577
Credit derivatives	**12,624**	**12,584**	34,918	34,356
Commodity and other	**447**	**428**	774	2,242
Total derivatives	**229,352**	**228,223**	447,586	455,932

(iii) Risk exposure by counterparty type

	2009		2008	
	Group	*Bank*	*Group*	*Bank*
	%	%	%	%
Government	**–**	**–**	–	–
Banks	**78**	**78**	76	77
Other financial institutions	**8**	**8**	8	8
Other	**14**	**14**	16	15
Total	**100**	**100**	100	100

b *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 mitigate the market risk which would otherwise arise from imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or net investment hedges.

(i) Contract amounts of derivatives held for hedging purposes by product type

	Group		*Bank*	
	Cash flow hedge	**Fair value hedge**	**Cash flow hedge**	**Fair value hedge**
	HK$m	**HK$m**	**HK$m**	**HK$m**
At 31 December 2009				
Interest rate	**251,130**	**129,509**	**168,163**	**101,363**

Notes on the Financial Statements (continued)

16 Derivatives *(continued)*

	Group		*Bank*	
	Cash flow hedge HK$m	Fair value hedge HK$m	Cash flow hedge HK$m	Fair value hedge HK$m
At 31 December 2008				
Interest rate	310,883	62,482	216,633	47,201

(ii) Fair values of outstanding derivatives designated as fair value hedges

	Group		*Bank*	
	Assets HK$m	**Liabilities HK$m**	**Assets HK$m**	**Liabilities HK$m**
At 31 December 2009				
Interest rate	**148**	**2,533**	**101**	**1,864**

	Group		*Bank*	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
At 31 December 2008				
Interest rate	140	2,332	140	1,727

(iii) Fair values of outstanding derivatives designated as cash flow hedges

	Group		*Bank*	
	Assets HK$m	**Liabilities HK$m**	**Assets HK$m**	**Liabilities HK$m**
At 31 December 2009				
Interest rate	**1,977**	**229**	**1,545**	**56**

	Group		*Bank*	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
At 31 December 2008				
Interest rate	6,138	384	4,483	73

The cash flows of the above hedging derivatives are expected to affect the income statement in 2010 and beyond.

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their own contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly 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 2009, the amount transferred to the income statement comprised HK$2,689 million (*2008:HK$2,478 million*) included in net interest income. The group does not enter into forecast transactions on non-financial assets and liabilities.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2009, a gain of HK$15 million *(2008: loss of HK$50 million)* was recognised due to hedge ineffectiveness and termination of forecast transactions.

16 Derivatives *(continued)*

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2009 is as follows:

	3 months or less HK$m	More than 3 months but less than 1 year HK$m	5 years or less but more than 1 year HK$m
At 31 December 2009			
Cash inflows from assets	**220,822**	**209,085**	**27,546**
Cash outflows from liabilities	**(5,784)**	**(5,783)**	**(3,877)**
Net cash inflows	**215,038**	**203,302**	**23,669**
At 31 December 2008			
Cash inflows from assets	242,720	139,768	34,906
Cash outflows from liabilities	(6,888)	(6,888)	(4,665)
Net cash inflow	235,832	132,880	30,241

c *Unobservable inception profits*

Any initial gain or loss on financial instruments, where the valuation is dependent on unobservable parameters is deferred over the life of the contract or until the instrument is redeemed, transferred or sold or the fair value becomes observable. All derivatives that are part of qualifying hedging relationships have valuations based on observable market parameters.

The table below sets out the aggregate difference yet to be recognised in the income statement at the beginning and end of the year with a reconciliation of the changes of the balance during the year.

Group

	2009 HK$m	2008 HK$m
Balance at 1 January	**119**	496
Deferrals on new transactions	**82**	403
Reduction due to amortisation	**(37)**	(565)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(48)**	(194)
Exchange differences and others	**12**	(21)
Balance at 31 December	**128**	119

Bank

	2009 HK$m	2008 HK$m
Balance at 1 January	**119**	498
Deferrals on new transactions	**78**	377
Reduction due to amortisation	**(37)**	(565)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(40)**	(168)
Exchange differences and others	**4**	(23)
Balance at 31 December	**124**	119

Notes on the Financial Statements (continued)

17 Advances to customers

a *Advances to customers*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers	**1,364,924**	1,297,103	**762,425**	826,288
Impairment allowances (note 18a)	**(14,280)**	(10,958)	**(9,851)**	(8,292)
	1,350,644	1,286,145	**752,574**	817,996

Included in advances to customers are:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Trade bills	**57,520**	59,820	**37,435**	51,870
Individually assessed impairment allowances	**(788)**	(329)	**(485)**	(286)
	56,732	59,491	**36,950**	51,584

b *Analysis of advances to customers based on categories used by the HSBC Group*

The following analysis of advances to customers is based on categories used by the HSBC Group, including The Hongkong and Shanghai Banking Corporation Limited and its subsidiary companies, to manage associated risks.

Group

2009	*Hong Kong*	*Rest of Asia-Pacific*	*Total*
	HK$m	HK$m	HK$m
Residential mortgages	**244,328**	**169,016**	**413,344**
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**26,801**	**–**	**26,801**
Credit card advances	**35,545**	**31,654**	**67,199**
Other personal	**41,384**	**35,550**	**76,934**
Total personal	**348,058**	**236,220**	**584,278**
Commercial, industrial and international trade	**137,461**	**219,631**	**357,092**
Commercial real estate	**105,404**	**50,131**	**155,535**
Other property-related lending	**78,028**	**30,030**	**108,058**
Government	**3,416**	**4,615**	**8,031**
Other commercial	**56,821**	**55,312**	**112,133**
Total corporate and commercial	**381,130**	**359,719**	**740,849**
Non-bank financial institutions	**19,088**	**17,976**	**37,064**
Settlement accounts	**2,437**	**296**	**2,733**
Total financial	**21,525**	**18,272**	**39,797**
Gross advances to customers	**750,713**	**614,211**	**1,364,924**
Individually assessed impairment allowances	**(3,724)**	**(4,364)**	**(8,088)**
Collectively assessed impairment allowances	**(2,412)**	**(3,780)**	**(6,192)**
Net advances to customers	**744,577**	**606,067**	**1,350,644**

17 Advances to customers *(continued)*

2008	Hong Kong	Rest of Asia-Pacific/ Other	Total
	HK$m	HK$m	HK$m
Residential mortgages	223,066	118,737	341,803
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	30,086	–	30,086
Credit card advances	36,255	25,120	61,375
Other personal	41,267	37,255	78,522
Total personal	330,674	181,112	511,786
Commercial, industrial and international trade	156,438	203,259	359,697
Commercial real estate	109,266	50,787	160,053
Other property-related lending	78,757	21,653	100,410
Government	7,367	4,386	11,753
Other commercial	50,540	52,607	103,147
Total corporate and commercial	402,368	332,692	735,060
Non-bank financial institutions	18,617	29,870	48,487
Settlement accounts	1,651	119	1,770
Total financial	20,268	29,989	50,257
Gross advances to customers	753,310	543,793	1,297,103
Individually assessed impairment allowances	(3,108)	(1,925)	(5,033)
Collectively assessed impairment allowances	(2,460)	(3,465)	(5,925)
Net advances to customers	747,742	538,403	1,286,145

Bank

2009	Hong Kong	Rest of Asia-Pacific/ Other	Total
	HK$m	**HK$m**	**HK$m**
Residential mortgages	**132,426**	**87,732**	**220,158**
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**12,155**	**–**	**12,155**
Credit card advances	**21,727**	**18,749**	**40,476**
Other personal	**24,037**	**20,959**	**44,996**
Total personal	**190,345**	**127,440**	**317,785**
Commercial, industrial and international trade	**91,703**	**110,668**	**202,371**
Commercial real estate	**76,826**	**27,732**	**104,558**
Other property-related lending	**16,546**	**12,935**	**29,481**
Government	**2,675**	**3,986**	**6,661**
Other commercial	**37,194**	**33,147**	**70,341**
Total corporate and commercial	**224,944**	**188,468**	**413,412**
Non-bank financial institutions	**16,233**	**14,930**	**31,163**
Settlement accounts	**–**	**65**	**65**
Total financial	**16,233**	**14,995**	**31,228**
Gross advances to customers	**431,522**	**330,903**	**762,425**
Individually assessed impairment allowances	**(2,290)**	**(3,081)**	**(5,371)**
Collectively assessed impairment allowances	**(1,702)**	**(2,778)**	**(4,480)**
Net advances to customers	**427,530**	**325,044**	**752,574**

Notes on the Financial Statements (continued)

17 Advances to customers *(continued)*

2008	*Hong Kong*	*Rest of Asia-Pacific*	*Total*
	HK$m	HK$m	HK$m
Residential mortgages	120,158	80,694	200,852
Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	13,346	–	13,346
Credit card advances	23,414	20,745	44,159
Other personal	25,119	32,238	57,357
Total personal	182,037	133,677	315,714
Commercial, industrial and international trade	108,378	133,453	241,831
Commercial real estate	79,937	28,281	108,218
Other property-related lending	21,734	13,750	35,484
Government	6,706	3,722	10,428
Other commercial	32,562	39,205	71,767
Total corporate and commercial	249,317	218,411	467,728
Non-bank financial institutions	15,458	27,385	42,843
Settlement accounts	–	3	3
Total financial	15,458	27,388	42,846
Gross advances to customers	446,812	379,476	826,288
Individually assessed impairment allowances	(2,038)	(1,578)	(3,616)
Collectively assessed impairment allowances	(1,757)	(2,919)	(4,676)
Net advances to customers	443,017	374,979	817,996

The geographical information shown above has been classified by the location of the principal operations of the subsidiary company or, in the case of the Bank, by the location of the branch responsible for advancing the funds.

17 Advances to customers *(continued)*

c *Analysis of advances to customers by industry sectors based on categories and definitions used by the Hong Kong Monetary Authority.*

The following analysis of advances to customers is based on the categories contained in the 'Quarterly Analysis of Loans and Advances and Provisions' return required to be submitted to the Hong Kong Monetary Authority by branches of the Bank and by banking subsidiary companies in Hong Kong.

	Group			
	Gross Advances		*Collateral and other security*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**50,034**	55,646	**15,140**	15,280
Property investment	**144,396**	139,174	**107,472**	108,386
Financial concerns	**9,442**	9,417	**2,203**	3,071
Stockbrokers	**1,155**	744	**227**	308
Wholesale and retail trade	**46,145**	51,580	**14,199**	16,828
Manufacturing	**27,318**	31,811	**5,597**	5,927
Transport and transport equipment	**21,543**	29,026	**16,036**	17,552
Recreational activities	**330**	55	**18**	28
Information technology	**5,336**	4,189	**33**	75
Others	**49,963**	49,562	**16,212**	12,555
	355,662	371,204	**177,137**	180,010
Individuals				
Advances for the purchase of flats under the Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**26,801**	30,086	**26,619**	29,777
Advances for the purchase of other residential properties	**217,626**	198,982	**217,187**	197,547
Credit card advances	**35,545**	36,255	**–**	–
Others	**32,641**	34,232	**12,010**	11,628
	312,613	299,555	**255,816**	238,952
Gross advances to customers for use in Hong Kong	**668,275**	670,759	**432,953**	418,962
Trade finance	**54,015**	64,758	**17,297**	21,965
Gross advances to customers for use outside Hong Kong made by branches of the Bank and subsidiary companies in Hong Kong	**28,423**	17,793	**905**	3,005
Gross advances to customers made by branches of the Bank and subsidiary companies in Hong Kong	**750,713**	753,310	**451,155**	443,932
Gross advances to customers made by branches of the Bank and subsidiary companies outside Hong Kong	**614,211**	543,793	**274,986**	221,776
Gross advances to customers	**1,364,924**	1,297,103	**726,141**	665,708

Notes on the Financial Statements (continued)

17 Advances to customers *(continued)*

	Bank			
	Gross Advances		*Collateral and other security*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**26,416**	30,332	**6,615**	7,000
Property investment	**69,132**	72,985	**45,504**	50,554
Financial concerns	**6,683**	6,231	**1,282**	1,162
Stockbrokers	**675**	218	**21**	102
Wholesale and retail trade	**38,332**	45,594	**10,335**	13,468
Manufacturing	**15,234**	18,067	**1,924**	2,450
Transport and transport equipment	**15,033**	20,604	**10,611**	10,958
Recreational activities	**293**	29	**3**	11
Information technology	**4,089**	3,114	**2**	26
Others	**23,188**	27,375	**3,726**	3,473
	199,075	224,549	**80,023**	89,204
Individuals				
Advances for the purchase of flats under the Hong Kong SAR Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**12,155**	13,346	**11,991**	13,056
Advances for the purchase of other residential properties	**120,975**	109,313	**120,852**	108,417
Credit card advances	**21,727**	23,414	**–**	–
Others	**20,626**	21,580	**6,543**	6,972
	175,483	167,653	**139,386**	128,445
Gross advances to customers for use in Hong Kong	**374,558**	392,202	**219,409**	217,649
Trade finance	**34,800**	45,719	**10,451**	14,069
Gross advances to customers for use outside Hong Kong made by branches of the Bank in Hong Kong	**22,164**	8,891	**225**	147
Gross advances to customers made by branches of the Bank in Hong Kong	**431,522**	446,812	**230,085**	231,865
Gross advances to customers made by branches of the Bank outside Hong Kong	**330,903**	379,476	**141,611**	147,747
Gross advances to customers	**762,425**	826,288	**371,696**	379,612

The categories of advances, and the relevant definitions, used by the Hong Kong Monetary Authority differ from those used for internal purposes by the HSBC Group, including The Hongkong and Shanghai Banking Corporation Limited and its subsidiary companies, as disclosed in note 17b.

The geographical information shown above has been classified by the location of the principal operations of the subsidiary company or, in the case of the Bank, by the location of the branch responsible for advancing the funds.

17 Advances to customers *(continued)*

d *Advances to customers include equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases:*

Group

	2009			2008		
	Present value of the minimum lease payments	*Unearned future finance income*	*Total minimum lease payments*	*Present Value of the minimum lease payments*	*Unearned future finance income*	*Total minimum lease payments*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Amounts receivable						
– Within one year	**3,086**	**576**	**3,662**	3,570	720	4,290
– After one year but within five years	**7,404**	**1,329**	**8,733**	8,825	1,640	10,465
– After five years	**9,754**	**1,441**	**11,195**	10,330	1,695	12,025
	20,244	**3,346**	**23,590**	22,725	4,055	26,780
Impairment allowances	**(68)**			(46)		
Net investment in finance leases and hire purchase contracts	**20,176**			22,679		

Bank

	2009			2008		
	Present value of the minimum lease payments	*Unearned future finance income*	*Total minimum lease payments*	*Present Value of the minimum lease payments*	*Unearned future finance income*	*Total minimum lease payments*
	HK$m	**HK$m**	**HK$m**	HK$m	HK$m	HK$m
Amounts receivable						
– Within one year	**1,826**	**277**	**2,103**	2,253	337	2,590
– After one year but within five years	**4,158**	**693**	**4,851**	5,197	793	5,990
– After five years	**5,753**	**806**	**6,559**	5,273	814	6,087
	11,737	**1,776**	**13,513**	12,723	1,944	14,667
Impairment allowances	**(38)**			(15)		
Net investment in finance leases and hire purchase contracts	**11,699**			12,708		

Notes on the Financial Statements (continued)

18 Impairment allowances against advances to customers

a *Impairment allowances against advances to customers*

Group

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2009	**HK$m**	**HK$m**	**HK$m**
At 1 January	**5,033**	**5,925**	**10,958**
Amounts written off	**(1,610)**	**(7,761)**	**(9,371)**
Recoveries of advances written off in previous years	**188**	**1,102**	**1,290**
Net charge to income statement (note 5k)	**4,181**	**6,498**	**10,679**
Unwinding of discount of loan impairment	**(82)**	**(215)**	**(297)**
Exchange and other adjustments	**378**	**643**	**1,021**
At 31 December (note 17b)	**8,088**	**6,192**	**14,280**

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2008	HK$m	HK$m	HK$m
At 1 January	2,182	5,078	7,260
Amounts written off	(628)	(5,920)	(6,548)
Recoveries of advances written off in previous years	169	823	992
Net charge to income statement (note 5k)	3,551	6,542	10,093
Unwinding of discount of loan impairment	(69)	(211)	(280)
Exchange and other adjustments	(172)	(387)	(559)
At 31 December (note 17b)	5,033	5,925	10,958

Bank

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2009	**HK$m**	**HK$m**	**HK$m**
At 1 January	**3,616**	**4,676**	**8,292**
Amounts written off	**(997)**	**(6,261)**	**(7,258)**
Recoveries of advances written off in previous years	**112**	**839**	**951**
Net charge to income statement	**2,508**	**5,325**	**7,833**
Unwinding of discount of loan impairment	**(50)**	**(214)**	**(264)**
Exchange and other adjustments	**182**	**115**	**297**
At 31 December (note 17b)	**5,371**	**4,480**	**9,851**

	Individually assessed allowances	*Collectively assessed allowances*	*Total*
2008	HK$m	HK$m	HK$m
At 1 January	1,657	4,067	5,724
Amounts written off	(446)	(5,132)	(5,578)
Recoveries of advances written off in previous years	113	716	829
Net charge to income statement	2,571	5,577	8,148
Unwinding of discount of loan impairment	(56)	(211)	(267)
Exchange and other adjustments	(223)	(341)	(564)
At 31 December (note 17b)	3,616	4,676	8,292

18 Impairment allowances against advances to customers *(continued)*

b *Impaired advances to customers and allowances*

Group

	Hong Kong	*Rest of Asia-Pacific*	*Total*
2009	**HK$m**	**HK$m**	**HK$m**
Impairment allowance charge	**3,487**	**7,192**	**10,679**
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	**6,358**	**9,838**	**16,196**
Individually assessed allowances	**(3,724)**	**(4,364)**	**(8,088)**
	2,634	**5,474**	**8,108**
Individually assessed allowances as a percentage of gross impaired advances	**58.6%**	**44.4%**	**49.9%**
Gross impaired advances as a percentage of gross advances to customers	**0.8%**	**1.6%**	**1.2%**

	Hong Kong	*Rest of Asia-Pacific*	*Total*
2008	HK$m	HK$m	HK$m
Impairment allowance charge	4,210	5,883	10,093
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	6,601	6,479	13,080
Individually assessed allowances	(3,108)	(1,925)	(5,033)
	3,493	4,554	8,047
Individually assessed allowances as a percentage of gross impaired advances	47.1%	29.7%	38.5%
Gross impaired advances as a percentage of gross advances to customers	0.9%	1.2%	1.0%

1 *Please refer to note 52 for the group policy on the credit risk rating system.*

Notes on the Financial Statements (continued)

18 Impairment allowances against advances to customers *(continued)*

Bank

2009	*Hong Kong*	*Rest of Asia-Pacific*	*Total*
	HK$m	**HK$m**	**HK$m**
Impairment allowance charge	**1,943**	**5,890**	**7,833**
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	**3,737**	**6,324**	**10,061**
Individually assessed allowances	**(2,290)**	**(3,081)**	**(5,371)**
	1,447	**3,243**	**4,690**
Individually assessed allowances as a percentage of gross impaired advances	**61.3%**	**48.7%**	**53.4%**
Gross impaired advances as a percentage of gross advances to customers	**0.9%**	**1.9%**	**1.3%**

2008	*Hong Kong*	*Rest of Asia-Pacific*	*Total*
	HK$m	HK$m	HK$m
Impairment allowance charge	3,038	5,110	8,148
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	4,081	4,637	8,718
Individually assessed allowances	(2,038)	(1,578)	(3,616)
	2,043	3,059	5,102
Individually assessed allowances as a percentage of gross impaired advances	49.9%	34.0%	41.5%
Gross impaired advances as a percentage of gross advances to customers	0.9%	1.2%	1.1%

1 *Please refer to note 52 for the group policy on the credit risk rating system.*

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

The individually assessed allowances are made after taking into account the value of collateral in respect of such advances.

18 Impairment allowances against advances to customers *(continued)*

c *Individually assessed impaired advances*

Group

	Hong Kong	*Rest of Asia-Pacific*	*Total*
	HK$m	**HK$m**	**HK$m**
At 31 December 2009			
Gross individually assessed impaired advances	**6,222**	**8,330**	**14,552**
Individually assessed impairment allowances	**(3,724)**	**(4,364)**	**(8,088)**
	2,498	**3,966**	**6,464**
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.8%**	**1.4%**	**1.1%**
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**1,879**	**3,284**	**5,163**
At 31 December 2008			
Gross individually assessed impaired advances	6,295	5,050	11,345
Individually assessed impairment allowances	(3,108)	(1,925)	(5,033)
	3,187	3,125	6,312
Gross individually assessed impaired advances as a percentage of gross advances to customers	0.8%	0.9%	0.9%
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	3,243	2,988	6,231

Bank

	Hong Kong	*Rest of Asia-Pacific*	*Total*
	HK$m	**HK$m**	**HK$m**
At 31 December 2009			
Gross individually assessed impaired advances	**3,617**	**5,216**	**8,833**
Individually assessed impairment allowances	**(2,290)**	**(3,081)**	**(5,371)**
	1,327	**2,135**	**3,462**
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.8%**	**1.6%**	**1.2%**
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**1,093**	**1,620**	**2,713**

Notes on the Financial Statements (continued)

18 Impairment allowances against advances to customers *(continued)*

At 31 December 2008	*Hong Kong* HK$m	*Rest of Asia-Pacific* HK$m	*Total* HK$m
Gross individually assessed impaired advances	3,883	3,365	7,248
Individually assessed impairment allowances	(2,038)	(1,578)	(3,616)
	1,845	1,787	3,632
Gross individually assessed impaired advances as a percentage of gross advances to customers	0.9%	0.9%	0.9%
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	1,721	1,879	3,600

For individually assessed customer advances where the industry sectors comprise more than 10 per cent of total gross advances to customers, the analysis of gross impaired advances and allowances by major industry sectors based on categories and definitions used by the HSBC Group are as follows:

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 has been included.

Group *Figures in HK$m*	*Total gross advances*	*Gross impaired advances*	*Individually assessed allowances*	*Collectively assessed allowances*	*Net new impairment allowances*	*Advances written-off in year*
At 31 December 2009						
Residential mortgages	**413,344**	**2,772**	**(323)**	**(326)**	**43**	**76**
Commercial, industrial and international trade	**357,092**	**8,079**	**(5,766)**	**(2,243)**	**2,973**	**1,275**
Commercial real estate	**155,535**	**1,339**	**(560)**	**(96)**	**662**	**12**
At 31 December 2008						
Residential mortgages	341,803	2,590	(191)	(311)	106	43
Commercial, industrial and international trade	359,697	6,137	(3,821)	(2,185)	3,464	360
Commercial real estate	160,053	255	(105)	(83)	127	22

18 Impairment allowances against advances to customers *(continued)*

Bank *Figures in HK$m*	*Total gross advances*	*Gross impaired advances*	*Individually assessed allowances*	*Collectively assessed allowances*	*Net new impairment allowances*	*Advances written-off in year*
At 31 December 2009						
Residential mortgages	**220,158**	**1,749**	**(160)**	**(184)**	**35**	**61**
Commercial, industrial and international trade	**202,371**	**5,395**	**(4,146)**	**(1,471)**	**2,172**	**801**
Commercial real estate	**104,558**	**242**	**(51)**	**(62)**	**(30)**	**12**
At 31 December 2008						
Residential mortgages	200,852	1,545	(152)	(205)	88	35
Commercial, industrial and international trade	241,831	3,961	(2,712)	(1,511)	2,470	244
Commercial real estate	108,218	204	(105)	(75)	126	19

Collectively assessed allowances refer to impairment allowances which are assessed on a collective basis for those individually assessed advances where an individual impairment has not yet been identified.

d *Overdue advances to customers*

Group

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
2009	**HK$m**	**%**	**HK$m**	**%**	**HK$m**	**%**
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	**583**	**0.1**	**2,728**	**0.4**	**3,311**	**0.2**
– more than six months but not more than one year	**1,206**	**0.1**	**1,888**	**0.3**	**3,094**	**0.2**
– more than one year	**1,963**	**0.3**	**2,865**	**0.5**	**4,828**	**0.4**
	3,752	**0.5**	**7,481**	**1.2**	**11,233**	**0.8**
Individually assessed impairment allowances made in respect of such overdue advances	**(2,224)**		**(2,957)**		**(5,181)**	
Fair value of collateral held in respect of overdue advances	**959**		**2,123**		**3,082**	

Notes on the Financial Statements (continued)

18 Impairment allowances against advances to customers *(continued)*

2008	*Hong Kong* HK$m	*Hong Kong* %	*Rest of Asia-Pacific* HK$m	*Rest of Asia-Pacific* %	*Total* HK$m	*Total* %
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	1,059	0.1	2,559	0.5	3,618	0.3
– more than six months but not more than one year	603	0.1	859	0.2	1,462	0.1
– more than one year	881	0.1	1,613	0.3	2,494	0.2
	2,543	0.3	5,031	1.0	7,574	0.6
Individually assessed impairment allowances made in respect of such overdue advances	(809)		(1,088)		(1,897)	
Fair value of collateral held in respect of overdue advances	1,293		1,805		3,098	

18 Impairment allowances against advances to customers *(continued)*

Bank

2009	*Hong Kong* HK$m	%	*Rest of Asia-Pacific* HK$m	%	*Total* HK$m	%
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	**362**	**0.1**	**1,780**	**0.5**	**2,142**	**0.3**
– more than six months but not more than one year	**865**	**0.2**	**1,293**	**0.4**	**2,158**	**0.3**
– more than one year	**1,421**	**0.3**	**1,544**	**0.5**	**2,965**	**0.4**
	2,648	**0.6**	**4,617**	**1.4**	**7,265**	**1.0**
Individually assessed impairment allowances made in respect of such overdue advances	**(1,341)**		**(1,828)**		**(3,169)**	
Fair value of collateral held in respect of overdue advances	**704**		**877**		**1,581**	

2008	*Hong Kong* HK$m	%	*Rest of Asia-Pacific* HK$m	%	*Total* HK$m	%
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	827	0.2	1,773	0.5	2,600	0.3
– more than six months but not more than one year	206	0.0	591	0.2	797	0.1
– more than one year	779	0.2	1,159	0.3	1,938	0.2
	1,812	0.4	3,523	1.0	5,335	0.6
Individually assessed impairment allowances made in respect of such overdue advances	(303)		(939)		(1,242)	
Fair value of collateral held in respect of overdue advances	848		1,141		1,989	

Notes on the Financial Statements (continued)

18 Impairment allowances against advances to customers *(continued)*

e *Rescheduled advances to customers*

Group

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
	HK$m	**%**	**HK$m**	**%**	**HK$m**	**%**
2009	**2,379**	**0.3**	**2,671**	**0.4**	**5,050**	**0.4**
2008	1,688	0.2	1,472	0.3	3,160	0.2

Bank

	Hong Kong		*Rest of Asia-Pacific*		*Total*	
	HK$m	**%**	**HK$m**	**%**	**HK$m**	**%**
2009	**1,813**	**0.4**	**2,327**	**0.7**	**4,140**	**0.5**
2008	1,406	0.3	1,377	0.4	2,783	0.3

Rescheduled advances to customers are those advances which have been restructured or renegotiated because of a deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule.

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 to customers' (note 18d).

19 Impairment allowances against advances to banks and other assets

There are no significant impaired or rescheduled advances to banks or overdue or rescheduled other assets as at 31 December 2009 and 31 December 2008. Information relating to overdue balances can be found in note 52.

20 Financial investments

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Financial investments				
– which may be repledged or resold by counterparties	**418**	1,443	**277**	1,173
– which may not be repledged or resold or are not subject to repledge or resale by counterparties	**882,271**	584,718	**564,461**	339,627
	882,689	586,161	**564,738**	340,800

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– available-for-sale	**718,195**	472,018	**515,923**	311,412
– held-to-maturity	**106,263**	77,502	–	–
Equity shares				
– available-for-sale	**58,231**	36,641	**48,815**	29,388
	882,689	586,161	**564,738**	340,800

a *Held-to-maturity debt securities*

Group

	Book value		Fair value	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**1,688**	3,533	**1,671**	3,860
– listed outside Hong Kong	**16,836**	10,144	**17,178**	10,925
	18,524	13,677	**18,849**	14,785
Unlisted	**87,739**	63,825	**89,864**	69,241
	106,263	77,502	**108,713**	84,026

	Book value		Fair value	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**2,211**	2,032	**2,313**	2,281
– other public sector entities	**16,775**	5,831	**17,302**	6,270
	18,986	7,863	**19,615**	8,551
Issued by other bodies				
– banks	**65,997**	59,804	**67,631**	64,725
– corporate entities	**21,280**	9,835	**21,467**	10,750
	106,263	77,502	**108,713**	84,026

Notes on the Financial Statements (continued)

20 Financial investments *(continued)*

b *Available-for-sale debt securities*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**7,581**	5,841	**1,311**	2,163
– listed outside Hong Kong	**281,462**	212,380	**220,397**	149,743
	289,043	218,221	**221,708**	151,906
Unlisted	**429,152**	253,797	**294,215**	159,506
	718,195	472,018	**515,923**	311,412

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Issued by public bodies				
– central governments and central banks	**246,206**	109,354	**188,703**	76,018
– other public sector entities	**61,076**	8,208	**40,290**	6,107
	307,282	117,562	**228,993**	82,125
Issued by other bodies				
– banks	**360,112**	318,623	**247,796**	205,466
– corporate entities	**50,801**	35,833	**39,134**	23,821
	718,195	472,018	**515,923**	311,412

c *Available-for-sale equity shares*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**43,253**	23,898	**41,772**	23,056
– listed outside Hong Kong	**1,226**	1,214	**934**	961
	44,479	25,112	**42,706**	24,017
Unlisted	**13,752**	11,529	**6,109**	5,371
	58,231	36,641	**48,815**	29,388

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Issued by other bodies				
– banks	**8,848**	6,629	**4,221**	3,997
– corporate entities	**49,383**	30,012	**44,594**	25,391
	58,231	36,641	**48,815**	29,388

21 Securitisations and other structured transactions

The group enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties or to special purpose entities. These transfers may give rise to full or partial derecognition of the financial assets concerned.

- Full derecognition occurs when the group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, and transfers substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.
- Partial derecognition occurs when the group sells or otherwise transfers financial assets in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These financial assets are recognised in the statement of financial position to the extent of the group's continuing involvement.

The majority of financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets transferred to third parties that did not qualify for derecognition during 2009 and 2008, and their associated financial liabilities:

Group

	2009		2008	
	Carrying amount of transferred assets HK$m	**Carrying amount of associated liabilities HK$m**	Carrying amount of transferred assets HK$m	Carrying amount of associated liabilities HK$m
Repurchase agreements	**879**	**898**	2,353	2,351
Securities lending agreements	**852**	**32**	363	8
	1,731	**930**	2,716	2,359

Bank

	2009		2008	
	Carrying amount of transferred assets HK$m	**Carrying amount of associated liabilities HK$m**	Carrying amount of transferred assets HK$m	Carrying amount of associated liabilities HK$m
Repurchase agreements	**277**	**295**	1,266	1,265
Securities lending agreements	**711**	**32**	139	8
	988	**327**	1,405	1,273

The carrying amount of assets transferred by the group to other HSBC Group entities under repurchase agreements is HK$474 million *(2008: nil)* and by the Bank is HK$10,126 million *(2008: HK$2,144 million)*. The associated liabilities assumed by the group are HK$472 million *(2008: nil)* and by the Bank is HK$10,122 million *(2008: HK$2,144 million)*.

The carrying amount of assets transferred under securities lending agreements to other HSBC Group entities is HK$514 million *(2008: HK$1,316 million)* by both the group and the Bank. The associated liabilities assumed are HK$577 million *(2008: HK$1,288m)*.

Notes on the Financial Statements (continued)

22 Investments in subsidiary companies

	Bank	
	2009	2008
	HK$m	HK$m
Investments in subsidiary companies:		
Unlisted investments	**38,741**	16,091
Listed investment	**865**	865
	39,606	16,956

The principal subsidiary companies of the Bank are:

	Place of incorporation	*Principal activity*	*Issued equity capital*	*Group's interest in equity capital*
Hang Seng Bank Limited	Hong Kong SAR	Banking	HK$9,559m	62.14%
HSBC Bank Malaysia Berhad	Malaysia	Banking	RM$114m	100%
HSBC Bank (China) Company Limited	People's Republic of China	Banking	RMB8,000m	100%
HSBC Bank Australia Limited*	Australia	Banking	A$657m	100%
HSBC Insurance (Asia) Limited*	Hong Kong SAR	Insurance	HK$125m	100%
HSBC Life (International) Limited*	Bermuda	Retirement benefits and life assurance	HK$327m	100%

* *Held indirectly*

The principal countries of operation are the same as the countries of incorporation except for HSBC Life (International) Limited which operates mainly in the Hong Kong SAR.

All of the above companies are controlled subsidiaries and have been consolidated in the financial statements.

The 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.

Acquisitions

The group made the following acquisitions of subsidiaries in 2009:

On 2 January 2009, HSBC Bank Malaysia Berhad was transferred to The Hongkong and Shanghai Banking Corporation Limited from another Group entity. The transfer was made at net asset value of RM$3,863 million with no resulting goodwill. HSBC Bank Malaysia Berhad contributed HK$1,601 million to the net profit of the group during 2009.

On 22 May 2009, the group completed the acquisition of 88.9 per cent of PT Bank Ekonomi Raharja Tbk ('Bank Ekonomi'), in Indonesia, for cash consideration of US$608 million, paid in US dollars and directly attributable cost of US$4 million. Goodwill was measured at HK$3,671 million.

Following acquisition of the initial stake, the group was required under Indonesian law to make a mandatory tender offer for a further holding of up to 10.1 per cent. The group completed the mandatory tender offer on 23 July 2009 resulting in an additional 10.1 per cent being acquired for a cash consideration of US$71.6 million taking the group's shareholding in Bank Ekonomi to 99.0 per cent. Goodwill was increased by HK$468 million. As a result of the outcome of the mandatory tender offer, the cash consideration for the acquisition of the 88.9 per cent was subsequently adjusted to US$602 million in accordance with the mandatory tender offer agreement.

22 Investments in subsidiary companies *(continued)*

At the date of acquisition, the group recognised the following assets and liabilities: Cash and short-term funds and placings with banks HK$4,865 million; Advances to customers HK$5,913 million; Amounts due from HSBC Group companies HK$1,786 million; Financial investments HK$1,129 million; Other assets HK$521 million; Customer accounts HK$13,214 million; Other liabilities HK$297 million; and Intangible assets of HK$451 million. As Bank Ekonomi did not prepare financial statements under HKFRSs, it is impracticable to determine what the carrying amounts of the assets and liabilities would have been under HKFRSs immediately prior to the acquisition. Since the date of acquisition, Bank Ekonomi has contributed HK$265 million to the net profit of the group.

The goodwill recognised on the acquisition is mainly attributable to the synergies expected to be achieved from integrating Bank Ekonomi into the group's existing business.

23 Investments in associates and joint ventures

	Group	
	2009	2008
	HK$m	HK$m
Share of net assets	**46,804**	41,007
Goodwill	**4,842**	4,895
Intangible assets	**2,649**	3,115
Deferred tax on intangible assets	**(612)**	(747)
	53,683	48,270

At 31 December 2009, the group's investments in associates amounted to HK$52,473 million (*2008: HK$47,343 million*).

	Bank	
	2009	2008
	HK$m	HK$m
Unlisted investments	**1,751**	1,751
Listed investment	**19,381**	19,381
	21,132	21,132

Shareholdings in associated companies held by the Bank include listed investments of HK$19,381 million *(2008: HK$19,381 million).* As at the balance sheet date, the fair value of these investments held by the group, based on quoted market prices, was HK$113,163 million *(2008: HK$62,653 million)*.

Notes on the Financial Statements (continued)

23 Investments in associates and joint ventures *(continued)*

a *Principal associates*

The principal associated companies of the group are:

	Place of incorporation	*Principal activity*	*Issued equity capital*	*Group's interest in equity capital*
Listed				
Bank of Communications Co., Ltd	People's Republic of China	Banking	RMB48,994m	19.01%
Industrial Bank Co., Ltd.*	People's Republic of China	Banking	RMB5,000m	12.78%
Unlisted				
Barrowgate Limited*	Hong Kong SAR	Property investment	–[1]	24.64%
Yantai City Commercial Bank	People's Republic of China	Banking	RMB2,000m	20.00%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND 5,400bn	19.91%

1 *Issued equity capital is less than HK$1 million*
* *Held indirectly*

The principal countries of operation are the same as the countries of incorporation.

Hang Seng Bank Limited holds a 12.78 per cent stake in Industrial Bank Co., Ltd. and The Hongkong and Shanghai Banking Corporation Limited holds a 19.01 per cent interest in Bank of Communications Co., Ltd. These companies are accounted for as associated companies, as the group has representation on the Board of Directors of each bank, and in accordance with the Technical Support and Assistance Agreements, the group is assisting in the development of financial and operating policies. In respect of Bank of Communications Co., Ltd, a number of staff have been seconded to assist in this process.

In respect of Industrial Bank Co., Ltd., Hang Seng Bank Limited also has representation on the executive committee, whilst for Bank of Communications Co., Ltd, The Hongkong and Shanghai Banking Corporation Limited has representation on the senior executive remuneration committee and on the audit committee.

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

Interest in associates includes intangible assets with respect to customer relationships and brand names which are amortised over a period of 10 years.

In July 2009, Vietnam Technological and Commercial Joint Stock Bank issued shares to its employees which slightly reduced the group's equity interest from 20.0 per cent to 19.91 per cent.

23 Investments in associates and joint ventures *(continued)*

b *Summarised aggregate financial information on associates and joint ventures*

	Assets	*Liabilities*	*Equity*	*Revenue*	*Expenses*	*Profit*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
2009						
100 per cent	**5,283,305**	**5,020,983**	**262,322**	**129,484**	**82,826**	**46,658**
Group's effective interest[1]	**847,698**	**804,564**	**43,134**	**21,978**	**14,559**	**7,419**
2008						
100 per cent	3,959,659	3,731,484	228,175	121,352	75,068	46,284
Group's effective interest[1]	637,237	599,380	37,857	19,831	12,507	7,324

1 *The group's effective interest is stated net of minority interest.*

At 31 December 2009, the group's share of associates and joint ventures' contingent liabilities was HK$150,105 million *(2008: HK$127,650 million)*.

c *Movement in investments in associates and joint ventures*

	2009	
	Group	*Bank*
	HK$m	**HK$m**
At 1 January	**48,270**	**21,132**
Additions	**46**	**–**
Disposals	**(19)**	**–**
Retained profits	**5,533**	**–**
Amortisation of intangible assets (net of deferred tax)	**(350)**	**–**
Exchange and other movements	**203**	**–**
At 31 December	**53,683**	**21,132**

There is no impairment of investments in associates and joint ventures *(2008: nil)*.

d *Amounts due from/to associates and joint ventures*

Group	**2009**		2008	
	Highest balance during the year[1]	**Balance at 31 December[1]**	Highest balance during the year[1]	Balance at 31 December[1]
	HK$m	**HK$m**	HK$m	HK$m
Amounts due from associates – unsubordinated	**8,686**	**8,176**	7,781	1,752
Amounts due from joint ventures – unsubordinated	**1,135**	**789**	1,242	904
Amounts due to associates	**3,814**	**926**	5,445	2,211
Amounts due to joint ventures	**909**	**903**	359	357

Notes on the Financial Statements (continued)

23 Investments in associates and joint ventures *(continued)*

Bank	**2009** Highest balance during the year [1] HK$m	**2009** Balance at 31 December [1] HK$m	2008 Highest balance during the year [1] HK$m	2008 Balance at 31 December [1] HK$m
Amounts due from associates – unsubordinated	**2,858**	**2,349**	3,247	139
Amounts due from joint ventures – unsubordinated	**1,135**	**789**	1,242	904
Amounts due to associates	**1,210**	**746**	1,118	632
Amounts due to joint ventures	**908**	**902**	359	357

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

e *The principal joint ventures of the group are:*

	Place of incorporation	*Principal activity*	*Issued equity capital*	*Group's interest in equity capital*
Hana HSBC Life Insurance Co., Ltd	South Korea	Insurance Manufacturing	KRW60,201m	49.99%
Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited	India	Insurance Manufacturing	INR5,000m	26.00%

24 Goodwill and intangible assets

Goodwill and intangible assets includes goodwill arising on business combinations, the present value of in-force long-term assurance business, and other intangible assets.

	Group **2009** HK$m	*Group* 2008 HK$m	*Bank* **2009** HK$m	*Bank* 2008 HK$m
Goodwill	**7,519**	2,523	**1,104**	1,020
The present value of in-force long-term assurance business	**10,554**	7,638	**–**	–
Other intangible assets	**6,996**	6,020	**5,650**	5,348
	25,069	16,181	**6,754**	6,368

24 Goodwill and intangible assets *(continued)*

a *Goodwill*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Cost				
At 1 January	**2,523**	2,158	**1,020**	1,063
Additions	**4,418**	552	**–**	9
Reclassified as held for sale	**–**	–	**–**	–
Exchange and other movements	**578**	(187)	**84**	(52)
Net book value at 31 December	**7,519**	2,523	**1,104**	1,020

Segmental analysis of goodwill

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Personal Financial Services	**12**	12	–	–
Hong Kong – Commercial Banking	**36**	36	**24**	24
Hong Kong – Global Banking and Markets	**754**	754	**498**	498
Rest of Asia-Pacific – Personal Financial Services	**1,530**	895	**77**	59
Rest of Asia-Pacific – Commercial Banking	**4,148**	313	**4**	8
Rest of Asia-Pacific – Global Banking and Markets	**1,039**	513	**501**	431
	7,519	2,523	**1,104**	1,020

During 2009 there was no impairment of goodwill (*2008: HK$nil*). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs') determined at 1 July 2009 based on a value in use calculation. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current Gross Domestic Product and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of the business units making up the CGUs. The discount rate used is based on the cost of capital HSBC allocates to investments in the countries in which the CGU operates.

The cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement.

Management judgement is required in estimating the future cash flows of the CGUs. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects.

If some or all of the goodwill allocated to a CGU was acquired in a business combination during the current annual period, that unit is tested for impairment before the end of the current annual period. As a result, goodwill was retested as at 1 October 2009. This testing confirmed that goodwill remained unimpaired.

Notes on the Financial Statements (continued)

24 Goodwill and intangible assets *(continued)*

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the nominal long-term growth rate. The discount rates used in the impairment test at 1 October 2009 were in the range of 9 per cent to 12 per cent *(2008: 9 per cent to 11 per cent)* across different CGUs. The nominal long-term growth rates used in the impairment test at 1 October 2009 for Hong Kong and Rest of Asia-Pacific were 4.7 per cent and 6.5 per cent respectively *(2008: 5.1 per cent and 8.2 per cent).*

b The present value of in-force long-term assurance business ('PVIF')

(i) PVIF specific assumptions

The following are the key assumptions used in the computation of PVIF for Hong Kong, being the main life insurance operations:

	2009	2008
Risk free rate	**2.58%**	1.14%
Risk adjusted discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Lapse rate	**0%-17% for the first policy year and 0%-15% for renewal years**	0%-15% for the first policy year and 0%-15% for renewal years

(ii) Movement in the PVIF for the year ended 31 December

	Group	
	2009	2008
	HK$m	HK$m
At 1 January	**7,638**	6,824
Addition from current year new business	**2,684**	1,601
Movement from in-force business	**204**	(778)
Exchange and other adjustments	**28**	(9)
At 31 December	**10,554**	7,638

c *Other intangible assets*

Group

	Computer software	*Customer/ merchant relationships*	*Other*[1]	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Cost				
At 1 January 2009	**5,340**	**1,012**	**2,033**	**8,385**
Additions	**1,270**	**451**	**1**	**1,722**
Disposals/amounts written-off	**(61)**	**–**	**–**	**(61)**
Exchange and other movements	**317**	**280**	**56**	**653**
At 31 December 2009	**6,866**	**1,743**	**2,090**	**10,699**
Accumulated amortisation and impairment				
At 1 January 2009	**2,094**	**264**	**7**	**2,365**
Amortisation charge for the year	**1,008**	**156**	**13**	**1,177**
Disposals/amounts written-off	**(38)**	**–**	**–**	**(38)**
Exchange and other movements	**139**	**59**	**1**	**199**
At 31 December 2009	**3,203**	**479**	**21**	**3,703**
Net book value at 31 December 2009	**3,663**	**1,264**	**2,069**	**6,996**

24 Goodwill and intangible assets *(continued)*

Group

	Computer software	*Customer/ merchant relationships*	*Other*[1]	*Total*
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 January 2008	3,749	1,208	11	4,968
Additions	1,700	30	2,186	3,916
Disposals/amounts written-off	(70)	–	(1)	(71)
Exchange and other movements	(39)	(226)	(163)	(428)
At 31 December 2008	5,340	1,012	2,033	8,385
Accumulated amortisation and impairment				
At 1 January 2008	1,449	189	3	1,641
Amortisation charge for the year	712	117	3	832
Disposals/amounts written-off	(65)	–	(1)	(66)
Exchange and other movements	(2)	(42)	2	(42)
At 31 December 2008	2,094	264	7	2,365
Net book value at 31 December 2008	3,246	748	2,026	6,020

Bank

	Computer software	*Customer/ merchant relationships*	*Other*[1]	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**
Cost				
At 1 January 2009	**4,602**	**896**	**1,924**	**7,422**
Additions	**964**	**–**	**–**	**964**
Disposals/amounts written-off	**(18)**	**–**	**–**	**(18)**
Exchange and other movements	**9**	**239**	**51**	**299**
At 31 December 2009	**5,557**	**1,135**	**1,975**	**8,667**
Accumulated amortisation and impairment				
At 1 January 2009	**1,856**	**214**	**4**	**2,074**
Amortisation charge for the year	**803**	**91**	**3**	**897**
Disposals/amounts written-off	**(18)**	**–**	**–**	**(18)**
Exchange and other movements	**7**	**56**	**1**	**64**
At 31 December 2009	**2,648**	**361**	**8**	**3,017**
Net book value at 31 December 2009	**2,909**	**774**	**1,967**	**5,650**

Notes on the Financial Statements (continued)

24 Goodwill and intangible assets *(continued)*

Bank

	Computer software	*Customer/ merchant relationships*	*Other*[1]	*Total*
	HK$m	HK$m	HK$m	HK$m
Cost				
At 1 January 2008	3,297	1,120	3	4,420
Additions	1,370	2	2,090	3,462
Disposals/amounts written-off	(54)	–	–	(54)
Exchange and other movements	(11)	(226)	(169)	(406)
At 31 December 2008	4,602	896	1,924	7,422
Accumulated amortisation and impairment				
At 1 January 2008	1,294	159	3	1,456
Amortisation charge for the year	625	96	–	721
Disposals/amounts written-off	(54)	–	–	(54)
Exchange and other movements	(9)	(41)	1	(49)
At 31 December 2008	1,856	214	4	2,074
Net book value at 31 December 2008	2,746	682	1,920	5,348

1 *'Other' includes branch operating rights of HK$2,084 million which were recognised during the acquisition of the assets, liabilities and operations of The Chinese Bank in Taiwan in 2008. These have an indefinite useful life as there are no economic or legal restrictions to limit their use. The carrying value of this intangible asset was allocated to relevant business units in Taiwan.*

The above intangible assets are amortised over their finite useful lives as follows:

Computer software	from 3 years to 5 years
Customer/merchant relationships	from 3 years to 12 years
Other (excluding branch operating rights)	from 3 years to 10 years

An impairment test was carried out in respect of the branch operating rights in Taiwan as at 1 July 2009. The result confirmed that there was no impairment. The impairment test was performed by comparing the recoverable amount of the relevant cash generating units ('CGUs') determined by a value in use calculation. The calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a long-term growth rate applicable to the banking industry in Taiwan. The discount rate used is based on the cost of capital the group allocates to Taiwan.

The cost of capital used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is derived from the capital asset pricing model which is the same model used to compute the discount rate for goodwill impairment testing.

Management judgement is required in estimating the future cash flows of the CGUs. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available and to assumptions regarding the long-term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects.

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the long-term growth rate. The discount rate and the long-term growth rate used in the impairment testing at 1 July 2009 were 12 per cent (*2008: 11 per cent*) and 3 per cent (*2008: 6.6 per cent*) respectively.

25 Property, plant and equipment

a

	Group			Bank		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Cost or valuation at 1 January 2009	**27,376**	**2,824**	**16,385**	**17,269**	**125**	**11,497**
Exchange and other adjustments	**120**	**15**	**382**	**90**	**1**	**134**
Additions	**766**	**–**	**2,339**	**293**	**–**	**976**
Disposals	**(56)**	**–**	**(646)**	**(56)**	**–**	**(326)**
Elimination of accumulated depreciation on revalued premises	**(888)**	**–**	**–**	**(583)**	**–**	**–**
Surplus/(deficits) on revaluation	**665**	**262**	**–**	**(497)**	**–**	**–**
Reclassifications	**(363)**	**13**	**–**	**(91)**	**–**	**–**
At 31 December 2009	**27,620**	**3,114**	**18,460**	**16,425**	**126**	**12,281**

	Group			Bank		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Accumulated depreciation at 1 January 2009	**7**	**–**	**10,693**	**–**	**–**	**7,507**
Exchange and other adjustments	**(1)**	**–**	**269**	**–**	**–**	**97**
Charge for the year	**871**	**–**	**2,033**	**589**	**–**	**1,352**
Acquisition of subsidiaries	**28**	**–**	**460**	**–**	**–**	**–**
Disposals	**(5)**	**–**	**(599)**	**(5)**	**–**	**(306)**
Elimination of accumulated depreciation on revalued premises	**(888)**	**–**	**–**	**(583)**	**–**	**–**
Reclassifications	**(1)**	**–**	**–**	**(1)**	**–**	**–**
At 31 December 2009	**11**	**–**	**12,856**	**–**	**–**	**8,650**
Net book value at 31 December 2009	**27,609**	**3,114**	**5,604**	**16,425**	**126**	**3,631**
Total at 31 December 2009			**36,327**			**20,182**

Notes on the Financial Statements (continued)

25 Property, plant and equipment *(continued)*

	Group			*Bank*		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Cost or valuation at 1 January 2008	25,935	2,808	14,800	15,763	125	10,429
Exchange and other adjustments	(167)	–	(597)	(128)	–	(511)
Additions	432	–	3,160	424	–	2,189
Disposals	(21)	–	(978)	(21)	–	(610)
Elimination of accumulated depreciation on revalued premises	(804)	–	–	(528)	–	–
Surplus on revaluation	2,006	11	–	1,759	–	–
Reclassifications	(5)	5	–	–	–	–
At 31 December 2008	27,376	2,824	16,385	17,269	125	11,497

	Group			*Bank*		
	Premises	*Investment properties*	*Equipment*	*Premises*	*Investment properties*	*Equipment*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Accumulated depreciation at 1 January 2008	3	–	10,184	–	–	7,022
Exchange and other adjustments	(3)	–	(406)	(4)	–	(302)
Charge for the year	830	–	1,779	551	–	1,311
Disposals	(19)	–	(864)	(19)	–	(524)
Elimination of accumulated depreciation on revalued premises	(804)	–	–	(528)	–	–
At 31 December 2008	7	–	10,693	–	–	7,507
Net book value at 31 December 2008	27,369	2,824	5,692	17,269	125	3,990
Total at 31 December 2008			35,885			21,384

b *The carrying amount of premises had it been stated at cost less accumulated depreciation would have been as follows:*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Cost less accumulated depreciation	**12,240**	12,075	**8,376**	8,566

25 Property, plant and equipment *(continued)*

c *An analysis of premises carried at valuation or cost (before deduction of accumulated depreciation) is as follows:*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Premises carried at valuation	**27,446**	27,202	**16,425**	17,269
Other premises stated at cost	**174**	174	**–**	–
Premises before deduction of accumulated depreciation	**27,620**	27,376	**16,425**	17,269

d *The net book value of premises and investment properties comprises:*

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**9,865**	10,254	**6,067**	6,795
Medium-term leaseholds (between ten and fifty years)	**15,865**	15,390	**6,996**	7,015
Short leaseholds (less than ten years)	**106**	111	**106**	111
	25,836	25,755	**13,169**	13,921
Outside Hong Kong:				
Freeholds	**3,741**	3,394	**3,126**	3,213
Long leaseholds (over fifty years)	**108**	92	**65**	61
Medium-term leaseholds (between ten and fifty years)	**938**	922	**154**	169
Short leaseholds (less than ten years)	**100**	30	**37**	30
	4,887	4,438	**3,382**	3,473
	30,723	30,193	**16,551**	17,394
Analysed as follows:				
Premises	**27,609**	27,369	**16,425**	17,269
Investment properties	**3,114**	2,824	**126**	125
	30,723	30,193	**16,551**	17,394

The group’s premises and investment properties were revalued at 30 November 2009 and updated for any material changes at 31 December 2009. The basis of valuation for premises and investment properties was open market value, depreciated replacement cost or surrender value as noted in note 4o. In determining the open market value of investment properties, expected future cash flows have been discounted to their present values. The net book value of ‘Premises’ includes HK$7,935 million *(2008: HK$9,034 million)* in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$927 million *(2008: HK$2,017 million)*. Amounts of HK$470 million *(2008: HK$1,543 million)* and HK$119 million *(2008: HK$71 million)* were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$470 million *(2008: HK$1,543 million)* is stated after deduction of minority interests of HK$265 million *(2008: HK$65 million)* and deferred tax of HK$73 million *(2008: HK$338 million)*. The amount credited to the income statement comprises the surplus of HK$262 million on revaluation of investment properties, less HK$143 million of revaluation deficits that arose when the value of certain premises fell below depreciated historical cost or surrender value, and when premises were newly acquired with revaluation losses.

Premises and investment properties in the Hong Kong SAR, the Macau SAR and mainland China, representing 94 per cent by value of the group’s properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited who have recent experience in the location and type of properties. The valuations were carried out by qualified valuers who are members of the Hong Kong Institute of Surveyors. Properties in twelve countries, which represent 6 per cent by value of the group’s properties, were valued by different independent professionally qualified valuers.

25 Property, plant and equipment *(continued)*

e *Properties leased to customers*

The group's investment properties are rented out under operating leases. The leases typically run for a period of 2-3 years and may contain an option to renew and the terms will then be renegotiated. During the current year, HK$169 million *(2008: HK$153 million)* was recognised as rental income in the income statement in respect of operating leases.

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

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**120**	128	**6**	6
After one but within five years	**62**	85	**5**	10
	182	213	**11**	16

26 Leasehold land and land use rights

The group's interest in leasehold land and land use rights are accounted for as operating leases and their net book value is analysed as follows:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Leases over fifty years	**2,837**	2,860	**2,438**	2,454
Leases of between ten to fifty years	**954**	1,037	**116**	119
	3,791	3,897	**2,554**	2,573
Outside Hong Kong:				
Leases over fifty years	**10**	–	**–**	–
Leases of between ten to fifty years	**3**	–	**–**	–
	13	–	**–**	–
	3,804	3,897	**2,554**	2,573

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 27).

27 Other assets

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Current taxation recoverable	**889**	1,371	**706**	1,210
Assets held for sale	**228**	338	**123**	123
Prepayments and accrued income	**6,002**	6,557	**3,645**	5,091
Accrued interest receivable	**9,948**	12,493	**5,621**	7,262
Acceptances and endorsements	**22,211**	31,453	**16,073**	26,006
Other accounts	**22,978**	23,719	**11,723**	10,320
	62,256	75,931	**37,891**	50,012

Assets held for sale comprised assets acquired by repossession of collateral for realisation as well as own properties held for sale.

28 Customer accounts

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**536,350**	408,891	**352,151**	290,299
Savings accounts	**1,591,351**	1,172,406	**1,068,952**	824,854
Other deposit accounts	**816,838**	994,787	**481,468**	651,848
	2,944,539	2,576,084	**1,902,571**	1,767,001

29 Trading liabilities

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**2,545**	8,593	**2,453**	6,040
Other debt securities in issue	**17,708**	36,505	**11,665**	25,619
Short positions in securities	**68,826**	32,511	**55,674**	23,745
Deposits by banks	**3,039**	8,611	**2,972**	8,611
Customer accounts	**62,248**	124,367	**30,692**	87,074
	154,366	210,587	**103,456**	151,089

30 Financial liabilities designated at fair value

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**253**	258	**253**	258
Customer accounts	**1,604**	1,782	**1,604**	1,782
Subordinated liabilities (note 36)	**1,003**	994	**–**	–
Debt securities in issue	**–**	6,102	**–**	5,046
Liabilities to customers under investment contracts	**33,849**	30,790	**–**	–
	36,709	39,926	**1,857**	7,086

At 31 December 2009 the carrying amount of financial liabilities designated at fair value was HK$37 million higher than the contractual amount at maturity (*2008: the carrying amount was HK$140 million lower than the contractual amount*). At 31 December 2009, the accumulated gain in fair value attributable to changes in credit risk was HK$46 million (*2008: HK$78 million*).

31 Debt securities in issue

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**25,090**	33,051	**19,610**	25,942
Other debt securities	**18,306**	15,749	**8,640**	8,913
	43,396	48,800	**28,250**	34,855

Notes on the Financial Statements (continued)

32 Other liabilities and provisions

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**18,209**	19,717	**11,836**	13,588
Provisions for liabilities and charges (note 35)	**1,226**	1,093	**800**	714
Acceptances and endorsements	**22,232**	31,479	**16,094**	26,032
Other liabilities	**14,315**	11,030	**9,299**	7,563
	55,982	63,319	**38,029**	47,897

33 Liabilities under insurance contracts issued

	2009		
	Gross	**Reinsurance**	**Net**
	HK$m	**HK$m**	**HK$m**
Non-life insurance			
Unearned premiums	**1,233**	**(113)**	**1,120**
Outstanding claims	**953**	**(235)**	**718**
Claims incurred but not reported	**320**	**(38)**	**282**
Provision for unexpired risk	**8**	**–**	**8**
Other	**119**	**(1)**	**118**
	2,633	**(387)**	**2,246**
Policyholders' liabilities			
Life (non-linked)	**116,180**	**(67)**	**116,113**
Investment contracts with discretionary participation features	**269**	**–**	**269**
Life (linked)	**25,846**	**(6,237)**	**19,609**
	142,295	**(6,304)**	**135,991**
Total liabilities under insurance contracts	**144,928**	**(6,691)**	**138,237**

	2008		
	Gross	Reinsurance	Net
	HK$m	HK$m	HK$m
Non-life insurance			
Unearned premiums	1,117	(78)	1,039
Outstanding claims	1,024	(233)	791
Claims incurred but not reported	389	(49)	340
Provision for unexpired risk	8	–	8
Other	206	(1)	205
	2,744	(361)	2,383
Policyholders' liabilities			
Life (non-linked)	90,383	(144)	90,239
Investment contracts with discretionary participation features	260	–	260
Life (linked)	20,044	(7,334)	12,710
	110,687	(7,478)	103,209
Total liabilities under insurance contracts	113,431	(7,839)	105,592

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

33 Liabilities under insurance contracts issued *(continued)*

a *Movement of liabilities under insurance contracts*

(i) Non-life insurance

	2009		
	Gross HK$m	**Reinsurance HK$m**	**Net HK$m**
Unearned premiums			
At 1 January	**1,117**	**(78)**	**1,039**
Gross written premiums	**2,754**	**(394)**	**2,360**
Gross earned premiums	**(2,638)**	**361**	**(2,277)**
Foreign exchange and other movements	**–**	**(2)**	**(2)**
At 31 December	**1,233**	**(113)**	**1,120**
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	**1,024**	**(233)**	**791**
– Claims incurred but not reported	**389**	**(49)**	**340**
	1,413	**(282)**	**1,131**
Claims paid in current year	**(1,227)**	**110**	**(1,117)**
Claims incurred	**1,084**	**(92)**	**992**
Foreign exchange and other movements	**3**	**(9)**	**(6)**
At 31 December			
– Notified claims	**953**	**(235)**	**718**
– Claims incurred but not reported	**320**	**(38)**	**282**
Total at 31 December	**1,273**	**(273)**	**1,000**

	2008		
	Gross HK$m	Reinsurance HK$m	Net HK$m
Unearned premiums			
At 1 January	962	(76)	886
Gross written premiums	2,581	(351)	2,230
Gross earned premiums	(2,442)	347	(2,095)
Foreign exchange and other movements	16	2	18
At 31 December	1,117	(78)	1,039
Notified and incurred but not reported claims			
At 1 January			
– Notified claims	1,203	(294)	909
– Claims incurred but not reported	299	(59)	240
	1,502	(353)	1,149
Claims paid in current year	(1,184)	121	(1,063)
Claims incurred	1,102	(46)	1,056
Foreign exchange and other movements	(7)	(4)	(11)
At 31 December			
– Notified claims	1,024	(233)	791
– Claims incurred but not reported	389	(49)	340
Total at 31 December	1,413	(282)	1,131

Notes on the Financial Statements (continued)

33 Liabilities under insurance contracts issued *(continued)*

(ii) Policyholders' liabilities

	2009		
	Gross HK$m	Reinsurance HK$m	Net HK$m
Life (non-linked)			
At 1 January	**90,383**	**(144)**	**90,239**
Benefits paid	**(3,001)**	**149**	**(2,852)**
Claims incurred	**28,294**	**(57)**	**28,237**
Foreign exchange and other movements	**504**	**(15)**	**489**
At 31 December	**116,180**	**(67)**	**116,113**
Investment contracts with discretionary participation features			
At 1 January	**260**	**–**	**260**
Benefits paid	**(2)**	**–**	**(2)**
Claims incurred	**2**	**–**	**2**
Foreign exchange and other movements	**9**	**–**	**9**
At 31 December	**269**	**–**	**269**
Life (linked)			
At 1 January	**20,044**	**(7,334)**	**12,710**
Benefits paid	**(884)**	**95**	**(789)**
Claims incurred	**6,590**	**1,310**	**7,900**
Foreign exchange and other movements	**96**	**(308)**	**(212)**
At 31 December	**25,846**	**(6,237)**	**19,609**
Total policyholders' liabilities	**142,295**	**(6,304)**	**135,991**

33 Liabilities under insurance contracts issued *(continued)*

	2008		
	Gross HK$m	Reinsurance HK$m	Net HK$m
Life (non-linked)			
At 1 January	69,461	(51)	69,410
Benefits paid	(2,644)	58	(2,586)
Claims incurred	22,598	(133)	22,465
Foreign exchange and other movements	968	(18)	950
At 31 December	90,383	(144)	90,239
Investment contracts with discretionary participation features			
At 1 January	226	–	226
Benefits paid	(3)	–	(3)
Claims incurred	(9)	–	(9)
Foreign exchange and other movements	46	–	46
At 31 December	260	–	260
Life (linked)			
At 1 January	19,380	(9)	19,371
Benefits paid	(1,796)	234	(1,562)
Claims incurred	2,680	(11,425)	(8,745)
Foreign exchange and other movements	(220)	3,866	3,646
At 31 December	20,044	(7,334)	12,710
Total policyholders' liabilities	110,687	(7,478)	103,209

Notes on the Financial Statements (continued)

34 Deferred tax

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

(i) Deferred tax assets

Group

	Accelerated capital allowances and short term timing differences	*Leasing transactions*	*Impairment losses on financial assets*	*Revaluation of properties*	*Others*	*Total*
2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January	**355**	**–**	**1,197**	**(1,147)**	**1,294**	**1,699**
Exchange and other adjustments	**384**	**–**	**32**	**713**	**(914)**	**215**
Credit/(charge) to income statement (note 6)	**364**	**–**	**224**	**(3)**	**(21)**	**564**
(Charge)/credit to reserves	**(3)**	**–**	**7**	**(10)**	**196**	**190**
At 31 December	**1,100**	**–**	**1,460**	**(447)**	**555**	**2,668**
2008						
At 1 January	467	–	972	(395)	522	1,566
Exchange and other adjustments	(72)	–	(22)	(831)	(43)	(968)
(Charge)/credit to income statement (note 6)	(40)	–	247	57	117	381
Credit to reserves	–	–	–	22	698	720
At 31 December	355	–	1,197	(1,147)	1,294	1,699

34 Deferred tax *(continued)*

Bank

2009	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**279**	**–**	**854**	**(389)**	**75**	**819**
Exchange and other adjustments	**4**	**–**	**67**	**(67)**	**(16)**	**(12)**
Credit/(charge) to income statement	**131**	**–**	**319**	**(3)**	**(94)**	**353**
Credit to reserves	**–**	**–**	**6**	**7**	**263**	**276**
At 31 December	**414**	**–**	**1,246**	**(452)**	**228**	**1,436**
2008						
At 1 January	214	–	812	(408)	359	977
Exchange and other adjustments	36	–	(105)	(11)	(145)	(225)
Credit to income statement	29	–	147	30	5	211
Charge to reserves	–	–	–	–	(144)	(144)
At 31 December	279	–	854	(389)	75	819

(ii) Deferred tax liabilities

Group

2009	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**2,306**	**(31)**	**(265)**	**2,168**	**255**	**4,433**
Exchange and other adjustments	**338**	**5**	**(155)**	**803**	**(413)**	**578**
Charge/(credit) to income statement (note 6)	**(585)**	**(6)**	**42**	**(46)**	**1,064**	**469**
Charge/(credit) to reserves	**–**	**–**	**5**	**15**	**1,858**	**1,878**
At 31 December	**2,059**	**(32)**	**(373)**	**2,940**	**2,764**	**7,358**
2008						
At 1 January	2,093	96	(292)	2,813	438	5,148
Exchange and other adjustments	(953)	(113)	100	(855)	849	(972)
Charge/(credit) to income statement (note 6)	1,166	(14)	(73)	(38)	(388)	653
Charge/(credit) to reserves	–	–	–	248	(644)	(396)
At 31 December	2,306	(31)	(265)	2,168	255	4,433

34 Deferred tax *(continued)*

Bank

2009	*Accelerated capital allowances and short term timing differences* HK$m	*Leasing transactions* HK$m	*Impairment losses on financial assets* HK$m	*Revaluation of properties* HK$m	*Others* HK$m	*Total* HK$m
At 1 January	**2,172**	**(38)**	**(267)**	**1,431**	**(1,191)**	**2,107**
Exchange and other adjustments	**64**	**6**	**9**	**(1)**	**549**	**627**
(Credit)/charge to income statement	**(446)**	**–**	**21**	**(52)**	**160**	**(317)**
Charge/(credit) to reserves	**–**	**–**	**5**	**(128)**	**1,024**	**901**
At 31 December	**1,790**	**(32)**	**(232)**	**1,250**	**542**	**3,318**
2008						
At 1 January	1,945	90	(193)	1,219	(659)	2,402
Exchange and other adjustments	(860)	(133)	2	(38)	538	(491)
Charge/(credit) to income statement	1,087	5	(76)	(28)	(511)	477
Charge/(credit) to reserves	–	–	–	278	(559)	(281)
At 31 December	2,172	(38)	(267)	1,431	(1,191)	2,107

(iii) Net deferred tax liabilities

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Deferred tax liabilities recognised on the balance sheet	**7,358**	4,433	**3,318**	2,107
Deferred tax assets recognised on the balance sheet	**(2,668)**	(1,699)	**(1,436)**	(819)
	4,690	2,734	**1,882**	1,288

There is no significant deferred taxation liability not provided for.

At 31 December 2009, the group has not recognised potential future tax benefits from tax losses of approximately HK$482 million *(2008: HK$508 million)* as it is not probable that future taxable profits against which the benefits can be utilised will be available in the relevant tax jurisdiction and entity. The losses do not expire under current tax legislation.

35 Provisions for liabilities and charges

Group

	Provisions for commitments, guarantees and similar obligations	Other provisions	Total
	HK$m	HK$m	HK$m
2009			
At 1 January	**895**	**198**	**1,093**
Additional provisions/increase in provisions	**251**	**122**	**373**
Provisions utilised	**(80)**	**(145)**	**(225)**
Amounts reversed	**(84)**	**(19)**	**(103)**
Exchange and other movements	**87**	**1**	**88**
At 31 December	**1,069**	**157**	**1,226**
2008			
At 1 January	659	158	817
Additional provisions/increase in provisions	322	156	478
Provisions utilised	(11)	(44)	(55)
Amounts reversed	(29)	(27)	(56)
Exchange and other movements	(46)	(45)	(91)
At 31 December	895	198	1,093

Bank

	Provisions for commitments, guarantees and similar obligations	Other provisions	Total
	HK$m	HK$m	HK$m
2009			
At 1 January	**563**	**151**	**714**
Additional provisions/increase in provisions	**208**	**94**	**302**
Provisions utilised	**(15)**	**(129)**	**(144)**
Amounts reversed	**(78)**	**(15)**	**(93)**
Exchange and other movements	**20**	**1**	**21**
At 31 December	**698**	**102**	**800**
2008			
At 1 January	312	142	454
Additional provisions/increase in provisions	309	115	424
Provisions utilised	(11)	(22)	(33)
Amounts reversed	(25)	(26)	(51)
Exchange and other movements	(22)	(58)	(80)
At 31 December	563	151	714

Notes on the Financial Statements (continued)

36 Subordinated liabilities

Subordinated liabilities consist of undated primary capital notes and other loan capital having an original term to maturity of five years or more, raised by the group for the development and expansion of its business.

		2009	2008
		HK$m	HK$m
US$1,200m	Undated floating rate primary capital notes	**9,393**	9,411
Rs 2,000m	Fixed rate (13.05%) subordinated notes due 2009	**–**	319
TW$1,499m	Non-callable floating rate subordinated notes due 2009	**–**	354
TW$330m	Non-callable floating rate subordinated notes due 2010	**80**	78
TW$1,865m	Non-callable floating rate subordinated notes due 2010	**452**	440
Bank		**9,925**	10,602
A$200m	Floating rate subordinated notes due 2016, callable from 2011[1]	**1,396**	1,064
A$42m	Floating rate subordinated notes due 2018, callable from 2013[2]	**293**	224
HK$1,500m	Floating rate subordinated notes due 2015, callable from 2010[3]	**1,499**	1,498
US$450m	Floating rate subordinated notes due 2016, callable from 2011[4]	**3,483**	3,478
US$300m	Floating rate subordinated notes due 2017, callable from 2012[5]	**2,321**	2,318
RM500m*	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[6]	**1,136**	–
RM500m*	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[7]	**1,128**	–
Group		**21,181**	19,184

* *These subordinated notes were acquired with the transfer of HSBC Bank Malaysia Berhad from a Group company.*
1 *The interest rate on the A$200m callable subordinated floating rate notes 2016 will increase by 0.5 per cent from May 2011.*
2 *The interest rate on the A$42m callable subordinated floating rate notes 2018 will increase by 0.5 per cent from March 2013.*
3 *The interest rate on the HK$1,500m callable subordinated floating rate notes 2015 will increase by 0.5 per cent from June 2010.*
4 *The interest rate on the US$450m callable subordinated floating rate notes 2016 will increase by 0.5 per cent from July 2011.*
5 *The interest rate on the US$300m callable subordinated floating rate notes 2017 will increase by 0.5 per cent from July 2012.*
6 *The interest rate on the 4.35 per cent callable subordinated bonds due 2022 will increase by 1 per cent from June 2017.*
7 *The interest rate on the 5.05 per cent callable subordinated bonds due 2027 will increase by 1 per cent from November 2022.*

The following subordinated note was classified as 'Financial liabilities designated at fair value' (note 30):

		Group	
		2009	2008
		HK$m	HK$m
HK$1,000m	Callable fixed rate (4.125%) subordinated notes due 2015[1]	**1,003**	994

1 *The interest rate on the 4.125 per cent callable subordinated notes will change in June 2010 to three-month HIBOR plus 0.825 per cent.*

37 Preference shares

Authorised

At 31 December 2009, the authorised preference share capital of the Bank was US$13,450,500,000 *(2008: US$ 12,400,500,000)* comprising 3,750,500,000 cumulative redeemable preference shares of US$1 each, 7,500 million non-cumulative irredeemable preference shares of US$1 each and 2,200 million cumulative irredeemable preference shares of US$1 each *(2008: comprising 2,700,500,000 cumulative redeemable preference shares of US$1 each, 7,500 million non-cumulative irredeemable preference shares of US$1 each and 2,200 million cumulative irredeemable preference shares of US$1 each).*

At a group level, there was an additional Rs.870,000,000 *(2008: Rs.nil)* of authorised preference share capital comprising 8,700,000 compulsorily convertible preference shares of Rs.100 each.

Issued and fully paid	*Group*		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Redeemable preference shares	**29,083**	20,930	**29,083**	20,930
Irredeemable preference shares	**68,252**	68,069	**68,107**	68,069
Share premium	**3,873**	3,871	**3,873**	3,871
	101,208	92,870	**101,063**	92,870

500,000 cumulative redeemable preference shares were issued in 1997, which have a mandatory redemption date of 2 January 2019 but may be redeemed at the Bank's option on or after 2 January 2003, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1,000 per share, comprising nominal value of US$1 per share and premium on issue of US$999 per share. 550,000,000 cumulative redeemable preference shares were issued in 2006, which have a mandatory redemption date of 21 December 2016 but may be redeemed at the Bank's option on or after 21 December 2011, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 1,750,000,000 cumulative redeemable preference shares were issued in 2007, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share.

400,000,000 cumulative redeemable preferences shares were issued in 2008, which have a mandatory redemption date of 29 March 2023 but may be redeemed at the Bank's option on or after 29 March 2018, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 1,050,000,000 cumulative redeemable preferences shares were issued in 2009, which have a mandatory redemption date of 2 January 2024 but may be redeemed at the Bank's option on or after 2 January 2019, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. The total number of issued cumulative redeemable preference shares at 31 December 2009 was 3,750,500,000 *(2008: 2,700,500,000)*.

The non-cumulative irredeemable preference shares were issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. On redemption, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of redemption, subject to the Bank having sufficient distributable profits. The number of issued non-cumulative irredeemable preference shares at 31 December 2009 was 6,653 million *(2008: 6,653 million)*. No shares were issued during the year *(2008: nil)*.

The cumulative irredeemable preference shares were issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. On redemption, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of redemption, subject to the Bank having sufficient distributable profits. The number of issued cumulative irredeemable preference shares at 31 December 2009 was 2,130 million *(2008: 2,130 million)*. No shares were issued during the year *(2008: nil)*.

37 Preference shares *(continued)*

The holders of the preference shares are entitled to one vote per share at the meetings of the Bank.

8,700,000 compulsory convertible preference shares (CCPS) were issued in 2009 at a nominal value of Rs.100 each. The shares are irredeemable and may be converted into fully paid equity shares of HSBC InvestDirect Securities (India) Ltd at any time after three years from the date of allotment of the CCPSs by written notice. The conversion shall be made at par or premium as may be determined by the Board at the time of the conversion. The CCPSs shall carry a fixed dividend of 0.001 per cent of the face value per annum. After ten years following the allotment of the CCPSs all outstanding CCPSs shall be converted at par or premium as may be determined by the Board at the time of the conversion.

38 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2009 and 2008 was HK$30,000 million divided into 12,000 million ordinary shares of HK$2.50 each. No new shares were issued during 2009 *(2008: nil)*.

Issued and fully paid	*Bank and Group*	
	2009	2008
	HK$m	HK$m
Ordinary share capital	**22,494**	22,494

The holders of the ordinary shares are entitled to receive dividends as declared from time to time, rank equally with regard to the Bank’s residual assets and are entitled to one vote per share at the meetings of the Bank.

39 Reconciliation of non-owner changes in equity

Bank	2009							
			Other reserves					
	Share capital	*Retained profits*	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total equity*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 1 January 2009	**22,494**	**69,424**	**3,512**	**16,584**	**1,516**	**(4,174)**	**2,195**	**111,551**
Profit for the year	**–**	**35,343**	**–**	**–**	**–**	**–**	**–**	**35,343**
Other comprehensive income								
Available-for-sale investments:								
– fair value changes taken to equity	**–**	**–**	**–**	**22,984**	**–**	**–**	**–**	**22,984**
– fair value changes transferred to the income statement on disposal	**–**	**–**	**–**	**(700)**	**–**	**–**	**–**	**(700)**
– fair value changes transferred to the income statement on impairment	**–**	**–**	**–**	**406**	**–**	**–**	**–**	**406**
– fair value changes transferred to the income statement on hedged items due to hedged risk	**–**	**–**	**–**	**363**	**–**	**–**	**–**	**363**
– income taxes	**–**	**–**	**–**	**(654)**	**–**	**–**	**–**	**(654)**
Cash flow hedges:								
– fair value changes taken to equity	**–**	**–**	**–**	**–**	**1,208**	**–**	**–**	**1,208**
– fair value changes transferred to the income statement	**–**	**–**	**–**	**–**	**(2,140)**	**–**	**–**	**(2,140)**
– income taxes	**–**	**–**	**–**	**–**	**139**	**–**	**–**	**139**
Property revaluation:								
– fair value changes taken to equity	**–**	**–**	**(398)**	**–**	**–**	**–**	**–**	**(398)**
– income taxes	**–**	**(42)**	**135**	**–**	**–**	**–**	**–**	**93**
Actuarial gains on defined benefit plans:								
– before income taxes	**–**	**1,463**	**–**	**–**	**–**	**–**	**–**	**1,463**
– income taxes	**–**	**(244)**	**–**	**–**	**–**	**–**	**–**	**(244)**
Exchange differences	**–**	**1**	**–**	**87**	**41**	**2,816**	**16**	**2,961**
Other comprehensive income for the year, net of tax	**–**	**1,178**	**(263)**	**22,486**	**(752)**	**2,816**	**16**	**25,481**
Total comprehensive income	**–**	**36,521**	**(263)**	**22,486**	**(752)**	**2,816**	**16**	**60,824**
Owner changes in equity	**-**	**(25,958)**	**(248)**	**(20)**	**(1)**	**45**	**(726)**	**(26,908)**
At 31 December 2009	**22,494**	**79,987**	**3,001**	**39,050**	**763**	**(1,313)**	**1,485**	**145,467**

Notes on the Financial Statements (continued)

39 Reconciliation of non-owner changes in equity *(continued)*

Bank

	2008							
			Other reserves					
	Share capital	*Retained profits*	*Property revaluation reserve*	*Available-for-sale investment reserve*	*Cash flow hedge reserve*	*Foreign exchange reserve*	*Other*	*Total equity*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 1 January 2008	22,494	58,096	2,154	53,309	535	4,245	1,017	141,850
Profit for the year	–	44,734	–	–	–	–	–	44,734
Other comprehensive income								
Available-for-sale investments:								
– fair value changes taken to equity	–	–	–	(35,383)	–	–	–	(35,383)
– fair value changes transferred to the income statement on disposal	–	–	–	(1,254)	–	–	–	(1,254)
– fair value changes transferred to the income statement on impairment	–	–	–	1,163	–	–	–	1,163
– fair value changes transferred to the income statement on hedged items due to hedged risk	–	–	–	(1,424)	–	–	–	(1,424)
– income taxes	–	–	–	122	–	–	–	122
Cash flow hedges:								
– fair value changes taken to equity	–	–	–	–	3,428	–	–	3,428
– fair value changes transferred to the income statement	–	–	–	–	(2,271)	–	–	(2,271)
– income taxes	–	–	–	–	(171)	–	–	(171)
Property revaluation:								
– fair value changes taken to equity	–	–	1,791	–	–	–	–	1,791
– income taxes	–	(31)	(235)	–	–	–	–	(266)
Actuarial gains on defined benefit plans:								
– before income taxes	–	(2,850)	–	–	–	–	–	(2,850)
– income taxes	–	452	–	–	–	–	–	452
Exchange differences		38	–	104	6	(8,508)	(39)	(8,399)
Other comprehensive income for the year, net of tax	–	(2,391)	1,556	(36,672)	992	(8,508)	(39)	(45,062)
Total comprehensive income	–	42,343	1,556	(36,672)	992	(8,508)	(39)	(328)
Owner changes in equity	–	(31,015)	(198)	(53)	(11)	89	1,217	(29,971)
At 31 December 2008	22,494	69,424	3,512	16,584	1,516	(4,174)	2,195	111,551

39 Reconciliation of non-owner changes in equity *(continued)*

Regulatory reserve

The Bank and its banking subsidiary companies operate under regulatory jurisdictions which require the maintenance of minimum impairment provisions in excess of those required under HKFRS.

The regulatory reserve is maintained to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. Movements in the reserve are made directly through retained earnings.

At 31 December 2009, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$6,413 million (*2008: HK$4,395 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.

Property revaluation reserve

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

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.

Cash flow hedge reserve

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

Foreign exchange reserve

The foreign exchange reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations as well as from the translation of liabilities that hedge the Bank's net investments in foreign operations.

Other reserve

The other reserve mainly comprises the share-based payment reserve account and other non-distributable reserves. The share-based payment reserve account is used to record the amount relating to share options granted to employees of the group directly by HSBC Holdings plc.

The property revaluation, available-for-sale investment, cash flow hedge and other reserves do not represent realised profits and are not available for distribution.

40 Maturity analysis of assets and liabilities

The following is an analysis of assets and liabilities by remaining contractual maturities at the balance sheet date:

Group

2009	*On demand*	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS										
Cash and short-term funds	90,775	524,948	220,718	55,734	–	–	–	–	–	892,175
Items in the course of collection from other banks	–	15,528	–	–	–	–	–	–	–	15,528
Placings with banks maturing after one month	–	–	83,555	19,697	3,758	60	–	–	–	107,070
Certificates of deposit	–	8,297	10,667	8,218	8,563	1,605	38	–	–	37,388
Hong Kong SAR Government certificates of indebtedness	135,414	–	–	–	–	–	–	–	–	135,414
Trading assets	–	–	–	–	–	–	–	322,731	–	322,731
Financial assets designated at fair value	–	81	280	3,655	11,053	3,634	29,384	–	–	48,087
Derivatives	–	–	–	–	–	–	–	233,046	2,125	235,171
Advances to customers	87,084	151,698	135,083	192,583	424,029	374,447	(14,280)	–	–	1,350,644
Financial investments	–	41,444	56,333	164,777	490,111	70,241	59,783	–	–	882,689
Amounts due from Group companies	23,157	47,392	7,654	9,029	5,804	12	–	41,463	–	134,511
Investments in associates and joint ventures	–	–	–	–	–	–	53,683	–	–	53,683
Goodwill and intangible assets	–	–	–	–	–	–	25,069	–	–	25,069
Property, plant and equipment	–	–	–	–	–	–	36,327	–	–	36,327
Deferred tax assets	–	–	–	–	–	–	2,668	–	–	2,668
Retirement benefits	–	–	–	–	–	–	292	–	–	292
Other assets	319	16,904	14,829	10,256	5,822	6,805	7,321	–	–	62,256
Total assets at 31 December 2009	336,749	806,292	529,119	463,949	949,140	456,804	200,285	597,240	2,125	4,341,703

40 Maturity analysis of assets and liabilities *(continued)*

Group

	On demand	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
LIABILITIES										
Hong Kong SAR currency notes in circulation	**135,414**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**135,414**
Items in the course of transmission to other banks	**–**	**22,960**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**22,960**
Deposits by banks	**57,386**	**46,724**	**2,517**	**3,135**	**1,234**	**210**	**–**	**–**	**–**	**111,206**
Customer accounts	**2,215,921**	**299,215**	**272,083**	**126,854**	**29,544**	**922**	**–**	**–**	**–**	**2,944,539**
Trading liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**154,366**	**–**	**154,366**
Financial liabilities designated at fair value	**129**	**50**	**159**	**1,050**	**1,343**	**733**	**33,245**	**–**	**–**	**36,709**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**230,084**	**2,762**	**232,846**
Debt securities in issue	**958**	**8,487**	**7,077**	**13,696**	**9,956**	**3,222**	**–**	**–**	**–**	**43,396**
Retirement benefit liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**3,922**	**–**	**–**	**3,922**
Amounts due to Group companies	**25,894**	**5,770**	**5,048**	**1,209**	**9**	**2,101**	**–**	**10,811**	**–**	**50,842**
Other liabilities and provisions	**4,240**	**14,522**	**20,944**	**9,810**	**2,611**	**194**	**3,661**	**–**	**–**	**55,982**
Liabilities under insurance contracts issued	**680**	**–**	**–**	**–**	**–**	**–**	**144,248**	**–**	**–**	**144,928**
Current tax liabilities	**–**	**434**	**855**	**2,830**	**–**	**–**	**–**	**–**	**–**	**4,119**
Deferred tax liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**7,358**	**–**	**–**	**7,358**
Subordinated liabilities	**–**	**–**	**–**	**2,031**	**7,493**	**2,264**	**9,393**	**–**	**–**	**21,181**
Preference shares	**–**	**–**	**–**	**–**	**–**	**32,956**	**68,252**	**–**	**–**	**101,208**
Total liabilities at 31 December 2009	**2,440,622**	**398,162**	**308,683**	**160,615**	**52,190**	**42,602**	**270,079**	**395,261**	**2,762**	**4,070,976**

Notes on the Financial Statements (continued)

40 Maturity analysis of assets and liabilities *(continued)*

Bank

2009	*On demand* HK$m	*Due within 1 month* HK$m	*Due between 1 and 3 months* HK$m	*Due between 3 and 12 months* HK$m	*Due between 1 and 5 years* HK$m	*Due after 5 years* HK$m	*No contractual maturity* HK$m	*Trading instruments* HK$m	*Non-trading derivatives* HK$m	*Total* HK$m
ASSETS										
Cash and short-term funds	85,821	337,108	206,479	28,357	–	–	–	–	–	657,765
Items in the course of collection from other banks	–	11,151	–	–	–	–	–	–	–	11,151
Placings with banks maturing after one month	–	–	46,484	17,735	3,020	60	–	–	–	67,299
Certificates of deposit	–	7,041	6,712	5,000	1,739	–	–	–	–	20,492
Hong Kong SAR Government certificates of indebtedness	135,414	–	–	–	–	–	–	–	–	135,414
Trading assets	–	–	–	–	–	–	–	216,480	–	216,480
Financial assets designated at fair value	–	–	–	76	1,725	–	–	–	–	1,801
Derivatives	–	–	–	–	–	–	–	229,352	1,646	230,998
Advances to customers	54,152	85,728	71,655	98,677	241,786	210,427	(9,851)	–	–	752,574
Financial investments	–	34,860	35,233	121,141	312,386	11,160	49,958	–	–	564,738
Amounts due from Group companies	14,042	58,140	10,430	19,708	3,473	8,400	–	47,562	–	161,755
Investments in subsidiary companies	–	–	–	–	–	–	39,606	–	–	39,606
Investments in associates and joint ventures	–	–	–	–	–	–	21,132	–	–	21,132
Goodwill and intangible assets	–	–	–	–	–	–	6,754	–	–	6,754
Property, plant and equipment	–	–	–	–	–	–	20,182	–	–	20,182
Deferred tax assets	–	–	–	–	–	–	1,436	–	–	1,436
Retirement benefits	–	–	–	–	–	–	176	–	–	176
Other assets	217	11,249	10,145	6,780	3,903	386	5,211	–	–	37,891
Total assets at 31 December 2009	289,646	545,277	387,138	297,474	568,032	230,433	134,604	493,394	1,646	2,947,644

40 Maturity analysis of assets and liabilities *(continued)*

Bank

	On demand	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
LIABILITIES										
Hong Kong SAR currency notes in circulation	**135,414**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**135,414**
Items in the course of transmission to other banks	**–**	**15,796**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**15,796**
Deposits by banks	**44,229**	**45,433**	**1,299**	**3,094**	**596**	**210**	**–**	**–**	**–**	**94,861**
Customer accounts	**1,468,558**	**182,008**	**163,704**	**63,642**	**23,930**	**729**	**–**	**–**	**–**	**1,902,571**
Trading liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**103,456**	**–**	**103,456**
Financial liabilities designated at fair value	**–**	**50**	**42**	**–**	**1,343**	**388**	**34**	**–**	**–**	**1,857**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**228,223**	**1,920**	**230,143**
Debt securities in issue	**958**	**7,798**	**6,883**	**9,684**	**2,927**	**–**	**–**	**–**	**–**	**28,250**
Retirement benefit liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**1,986**	**–**	**–**	**1,986**
Amounts due to Group companies	**39,815**	**36,327**	**12,466**	**5,762**	**38**	**2,103**	**–**	**26,691**	**–**	**123,202**
Other liabilities and provisions	**2,830**	**9,819**	**15,465**	**6,395**	**1,563**	**78**	**1,879**	**–**	**–**	**38,029**
Current tax liabilities	**–**	**355**	**782**	**2,319**	**–**	**–**	**–**	**–**	**–**	**3,456**
Deferred tax liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**3,318**	**–**	**–**	**3,318**
Subordinated liabilities	**–**	**–**	**–**	**532**	**–**	**–**	**9,393**	**–**	**–**	**9,925**
Preference shares	**–**	**–**	**–**	**–**	**–**	**32,956**	**68,107**	**–**	**–**	**101,063**
Total liabilities at 31 December 2009	**1,691,804**	**297,586**	**200,641**	**91,428**	**30,397**	**36,464**	**84,717**	**358,370**	**1,920**	**2,793,327**

40 Maturity analysis of assets and liabilities *(continued)*

Group

2008	*On demand*	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS										
Cash and short-term funds	259,394	232,320	34,508	58,793	12,557	–	–	–	–	597,572
Items in the course of collection from other banks	–	13,949	–	–	–	–	–	–	–	13,949
Placings with banks maturing after one month	–	–	45,022	6,741	3,793	13	–	–	–	55,569
Certificates of deposit	–	400	23,110	20,030	11,136	2,367	35	–	–	57,078
Hong Kong SAR Government certificates of indebtedness	119,024	–	–	–	–	–	–	–	–	119,024
Trading assets	–	–	–	–	–	–	–	493,670	–	493,670
Financial assets designated at fair value	–	173	1,627	4,924	9,535	3,453	20,841	–	–	40,553
Derivatives	–	–	–	–	–	–	–	447,645	6,278	453,923
Advances to customers	127,110	128,385	132,790	173,891	409,325	325,602	(10,958)	–	–	1,286,145
Financial investments	5	26,337	34,842	89,405	338,253	59,173	38,146	–	–	586,161
Amounts due from group companies	49,803	236,092	1,971	12,449	9,532	15,440	–	53,375	–	378,662
Investments in associates and joint ventures	–	–	–	–	–	–	48,270	–	–	48,270
Goodwill and intangible assets	–	–	–	–	–	–	16,181	–	–	16,181
Property, plant and equipment	–	–	–	–	–	–	35,885	–	–	35,885
Deferred tax assets	–	–	–	–	–	–	1,699	–	–	1,699
Retirement benefits	–	–	–	–	–	–	84	–	–	84
Other assets	3,538	14,357	20,771	23,608	4,441	1,039	8,177	–	–	75,931
Total assets at 31 December 2008	558,874	652,013	294,641	389,841	798,572	407,087	158,360	994,690	6,278	4,260,356

40 Maturity analysis of assets and liabilities *(continued)*

Group

	On demand	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
LIABILITIES										
Hong Kong SAR currency notes in circulation	119,024	–	–	–	–	–	–	–	–	119,024
Items in the course of transmission to other banks	–	31,334	–	–	–	–	–	–	–	31,334
Deposits by banks	123,384	37,491	24,814	10,321	450	214	–	–	–	196,674
Customer accounts	1,756,629	466,144	232,545	108,646	11,355	765	–	–	–	2,576,084
Trading liabilities	–	–	–	–	–	–	–	210,587	–	210,587
Financial liabilities designated at fair value	93	88	335	5,983	2,737	982	29,708	–	–	39,926
Derivatives	–	–	–	–	–	–	–	463,488	2,716	466,204
Debt securities in issue	1,065	5,102	16,277	16,662	6,352	3,342	–	–	–	48,800
Retirement benefit liabilities	–	–	–	–	–	–	7,486	–	–	7,486
Amounts due to Group companies	14,471	11,421	1,582	2,185	14	2,092	–	19,479	–	51,244
Other liabilities and provisions	6,030	12,381	27,656	11,742	1,545	187	3,778	–	–	63,319
Liabilities under insurance contracts issued	257	–	–	–	–	–	113,174	–	–	113,431
Current tax liabilities	–	262	248	2,760	–	–	–	–	–	3,270
Deferred tax liabilities	–	–	–	–	–	–	4,433	–	–	4,433
Subordinated liabilities	–	–	–	673	9,100	–	9,411	–	–	19,184
Preference shares	–	–	–	–	–	24,801	68,069	–	–	92,870
Total liabilities at 31 December 2008	2,020,953	564,223	303,457	158,972	31,553	32,383	236,059	693,554	2,716	4,043,870

Notes on the Financial Statements (continued)

40 Maturity analysis of assets and liabilities *(continued)*

Bank

2008	*On demand*	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
ASSETS										
Cash and short-term funds	210,658	170,532	29,610	58,345	12,557	–	–	–	–	481,702
Items in the course of collection from other banks	–	9,908	–	–	–	–	–	–	–	9,908
Placings with banks maturing after one month	–	–	26,413	4,095	3,234	12	–	–	–	33,754
Certificates of deposit	–	–	19,019	15,437	2,524	–	–	–	–	36,980
Hong Kong SAR Government certificates of indebtedness	119,024	–	–	–	–	–	–	–	–	119,024
Trading assets	–	–	–	–	–	–	–	329,123	–	329,123
Financial assets designated at fair value	–	138	–	83	937	570	–	–	–	1,728
Derivatives	–	–	–	–	–	–	–	447,586	4,623	452,209
Advances to customers	88,089	89,567	89,856	108,532	249,343	200,901	(8,292)	–	–	817,996
Financial investments	–	21,425	14,198	52,847	212,291	9,281	30,758	–	–	340,800
Amounts due from Group companies	54,138	234,155	3,069	15,583	3,711	30,326	–	56,979	–	397,961
Investments in subsidiary companies	–	–	–	–	–	–	16,956	–	–	16,956
Investments in associates and joint ventures	–	–	–	–	–	–	21,132	–	–	21,132
Goodwill and intangible assets	–	–	–	–	–	–	6,368	–	–	6,368
Property, plant and equipment	–	–	–	–	–	–	21,384	–	–	21,384
Deferred tax assets	–	–	–	–	–	–	819	–	–	819
Retirement benefits	–	–	–	–	–	–	52	–	–	52
Other assets	2,874	9,071	17,476	9,631	3,871	555	6,534	–	–	50,012
Total assets at 31 December 2008	474,783	534,796	199,641	264,553	488,468	241,645	95,711	833,688	4,623	3,137,908

40 Maturity analysis of assets and liabilities *(continued)*

Bank

	On demand	*Due within 1 month*	*Due between 1 and 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*No contractual maturity*	*Trading instruments*	*Non-trading derivatives*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
LIABILITIES										
Hong Kong SAR currency notes in circulation	119,024	–	–	–	–	–	–	–	–	119,024
Items in the course of transmission to other banks	–	26,581	–	–	–	–	–	–	–	26,581
Deposits by banks	105,898	33,837	24,400	10,183	–	214	–	–	–	174,532
Customer accounts	1,235,470	305,735	142,498	74,924	7,916	458	–	–	–	1,767,001
Trading liabilities	–	–	–	–	–	–	–	151,089	–	151,089
Financial liabilities designated at fair value	–	88	335	4,748	1,573	336	6	–	–	7,086
Derivatives	–	–	–	–	–	–	–	455,932	1,800	457,732
Debt securities in issue	1,065	4,334	13,615	12,282	3,559	–	–	–	–	34,855
Retirement benefit liabilities	–	–	–	–	–	–	3,550	–	–	3,550
Amounts due to Group companies	20,891	35,790	13,265	11,053	48	2,094	–	34,540	–	117,681
Other liabilities and provisions	4,596	8,949	22,618	8,073	1,284	71	2,306	–	–	47,897
Current tax liabilities	–	237	215	2,128	–	–	–	–	–	2,580
Deferred tax liabilities	–	–	–	–	–	–	2,107	–	–	2,107
Subordinated liabilities	–	–	–	673	518	–	9,411	–	–	10,602
Preference shares	–	–	–	–	–	24,801	68,069	–	–	92,870
Total liabilities at 31 December 2008	1,486,944	415,551	216,946	124,064	14,898	27,974	85,449	641,561	1,800	3,015,187

Notes on the Financial Statements (continued)

41 Analysis of cash flows payable under financial liabilities by remaining contractual maturities at the reporting date

Group

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2009						
Hong Kong SAR currency notes in circulation	**135,414**	**–**	**–**	**–**	**–**	**135,414**
Items in the course of transmission to other banks	**–**	**22,960**	**–**	**–**	**–**	**22,960**
Deposits by banks	**57,404**	**49,295**	**3,215**	**1,244**	**211**	**111,369**
Customer accounts	**2,216,572**	**573,658**	**129,540**	**32,608**	**1,243**	**2,953,621**
Trading liabilities	**154,366**	**–**	**–**	**–**	**–**	**154,366**
Financial liabilities designated at fair value	**129**	**220**	**1,080**	**1,408**	**33,955**	**36,792**
Derivatives	**230,288**	**509**	**1,345**	**721**	**52**	**232,915**
Debt securities in issue	**958**	**15,745**	**14,127**	**10,849**	**4,558**	**46,237**
Amounts due to Group companies	**36,705**	**10,820**	**1,222**	**73**	**2,169**	**50,989**
Other financial liabilities	**3,381**	**34,524**	**8,200**	**2,240**	**276**	**48,621**
Subordinated liabilities	**–**	**172**	**2,398**	**9,259**	**15,700**	**27,529**
Preference shares	**–**	**1,300**	**1,816**	**12,462**	**129,244**	**144,822**
	2,835,217	**709,203**	**162,943**	**70,864**	**187,408**	**3,965,635**
Loan commitments	**315,071**	**193,569**	**393,279**	**205,236**	**28,320**	**1,135,475**
Financial guarantee contracts	**1,082**	**11,573**	**15,941**	**6,964**	**1,928**	**37,488**
	3,151,370	**914,345**	**572,163**	**283,064**	**217,656**	**5,138,598**

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 31 December 2008						
Hong Kong SAR currency notes in circulation	119,024	–	–	–	–	119,024
Items in the course of transmission to other banks	–	31,334	–	–	–	31,334
Deposits by banks	123,398	62,782	10,570	500	218	197,468
Customer accounts	1,757,891	701,645	111,025	13,200	936	2,584,697
Trading liabilities	210,587	–	–	–	–	210,587
Financial liabilities designated at fair value	93	442	6,185	2,829	30,800	40,349
Derivatives	463,614	136	528	2,044	110	466,432
Debt securities in issue	1,065	21,668	17,523	7,276	5,055	52,587
Amounts due to Group companies	33,950	13,015	2,225	215	2,235	51,640
Other financial liabilities	5,233	35,606	10,803	1,115	359	53,116
Subordinated liabilities	–	243	1,291	11,566	13,582	26,682
Preference shares	–	1,049	2,983	16,130	128,449	148,611
	2,714,855	867,920	163,133	54,875	181,744	3,982,527
Loan commitments	345,946	178,522	417,754	185,773	22,608	1,150,603
Financial guarantee contracts	2,666	11,665	21,080	5,529	3,557	44,497
	3,063,467	1,058,107	601,967	246,177	207,909	5,177,627

41 Analysis of cash flows payable under financial liabilities by remaining contractual maturities at the reporting date *(continued)*

Bank

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2009						
Hong Kong SAR currency notes in circulation	**135,414**	**–**	**–**	**–**	**–**	**135,414**
Items in the course of transmission to other banks	**–**	**15,796**	**–**	**–**	**–**	**15,796**
Deposits by banks	**44,230**	**46,773**	**3,152**	**603**	**211**	**94,969**
Customer accounts	**1,468,883**	**346,576**	**64,533**	**26,037**	**973**	**1,907,002**
Trading liabilities	**103,456**	**–**	**–**	**–**	**–**	**103,456**
Financial liabilities designated at fair value	**–**	**94**	**20**	**1,408**	**401**	**1,923**
Derivatives	**228,359**	**397**	**941**	**387**	**60**	**230,144**
Debt securities in issue	**958**	**14,708**	**9,753**	**2,985**	**–**	**28,404**
Amounts due to Group companies	**66,506**	**48,796**	**5,775**	**102**	**2,171**	**123,350**
Other financial liabilities	**2,373**	**24,310**	**5,622**	**1,139**	**48**	**33,492**
Subordinated liabilities	**–**	**120**	**746**	**1,295**	**12,543**	**14,704**
Preference shares	**–**	**1,300**	**1,816**	**12,462**	**129,099**	**144,677**
	2,050,179	**498,870**	**92,358**	**46,418**	**145,506**	**2,833,331**
Loan commitments	**263,267**	**137,161**	**319,719**	**29,883**	**24,577**	**774,607**
Financial guarantee contracts	**744**	**5,771**	**12,892**	**4,930**	**1,497**	**25,834**
	2,314,190	**641,802**	**424,969**	**81,231**	**171,580**	**3,633,772**

	On Demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 31 December 2008						
Hong Kong SAR currency notes in circulation	119,024	–	–	–	–	119,024
Items in the course of transmission to other banks	–	26,581	–	–	–	26,581
Deposits by banks	105,910	58,678	10,401	9	218	175,216
Customer accounts	1,236,360	450,336	76,123	9,336	557	1,772,712
Trading liabilities	151,089	–	–	–	–	151,089
Financial liabilities designated at fair value	–	429	4,873	1,648	469	7,419
Derivatives	456,056	89	542	1,589	58	458,334
Debt securities in issue	1,065	18,063	12,788	3,662	–	35,578
Amounts due to Group companies	55,432	49,063	11,091	249	2,237	118,072
Other financial liabilities	4,234	28,338	7,426	909	10	40,917
Subordinated liabilities	–	146	1,000	2,247	13,582	16,975
Preference shares	–	1,049	2,983	16,130	128,449	148,611
	2,129,170	632,772	127,227	35,779	145,580	3,070,528
Loan commitments	317,265	120,781	402,336	20,455	22,281	883,118
Financial guarantee contracts	2,477	7,928	18,035	4,442	3,181	36,063
	2,448,912	761,481	547,598	60,676	171,042	3,989,709

41 Analysis of cash flows payable under financial liabilities by remaining contractual maturities at the reporting date *(continued)*

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

The balances in the above table will not agree with the balances in the statement of financial position 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, loan 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 loan commitments expire without being drawn upon.

The group's approach to managing liquidity risk is set out in note 52b.

42 Reconciliation of operating profit to cash generated from/(used in) operations

	2009 **HK$m**	2008 HK$m
Operating profit	**54,822**	60,001
Net interest income	**(58,432)**	(69,045)
Dividend income	**(364)**	(852)
Depreciation and amortisation	**4,081**	3,441
Amortisation of prepaid operating lease payments	**58**	59
Loan impairment charges and other credit risk provisions	**11,235**	12,000
Advances written off net of recoveries	**(8,081)**	(5,556)
Other provisions for liabilities and charges	**116**	553
Provisions utilised	**(225)**	(55)
Deficit/(Surplus) arising on property revaluation	**143**	(60)
Gains on investment properties	**(262)**	(11)
(Profit)/Loss on disposal of property, plant and equipment and assets held for sale	**(696)**	63
Loss on disposal of subsidiaries, associates and business portfolios	**6**	96
Gains less losses from financial investments	**131**	2,976
Share based payments granted cost free	**1,105**	1,045
Interest received	**68,481**	108,097
Interest paid	**(22,117)**	(52,474)
Operating profit before changes in working capital	**50,001**	60,278
Change in treasury bills with original term to maturity of more than three months	**(226,872)**	11,395
Change in placings with banks maturing after one month	**(49,381)**	3,627
Change in certificates of deposit with original term to maturity of more than three months	**14,664**	30,921
Change in trading assets	**132,978**	(99,209)
Change in trading liabilities	**(61,745)**	(55,088)
Change in financial assets designated as fair value	**(7,534)**	22,599
Change in financial liabilities designated as fair value	**(3,217)**	1,779
Change in derivative assets	**221,419**	(273,604)
Change in derivative liabilities	**(235,528)**	293,001
Change in financial investments held for backing liabilities to long-term policyholders	**(31,037)**	(35,484)
Change in advances to customers	**5,811**	(68,824)
Change in amounts due from Group companies	**247,848**	(13,931)
Change in other assets	**(125,686)**	(24,684)
Change in deposits by banks	**(88,548)**	19,931
Change in customer accounts	**264,655**	73,722
Change in amounts due to Group companies	**(3,313)**	(12,983)
Change in debt securities in issue	**(6,906)**	(36,723)
Change in liabilities under insurance contracts issued	**31,497**	21,701
Change in other liabilities	**(10,784)**	16,002
Exchange adjustments	**5,467**	(9,915)
Cash generated from/(used in) operations	**123,789**	(75,489)

Notes on the Financial Statements (continued)

43 Analysis of cash and cash equivalents

a *Change in cash and cash equivalents during the year*

	2009 HK$m	2008 HK$m
Balance at 1 January	**650,885**	819,637
Net cash inflow/(outflow) before the effect of foreign exchange movements	**5,155**	(158,792)
Effect of foreign exchange movements	**19,194**	(9,960)
Balance at 31 December	**675,234**	650,885

b *Analysis of balances of cash and cash equivalents in the consolidated statement of financial position*

	2009 HK$m	2008 HK$m
Cash in hand and sight balances with central banks	**90,775**	129,190
Items in the course of collection from other banks	**15,528**	13,949
Placings with banks	**461,645**	380,628
Treasury bills	**108,736**	136,356
Certificates of deposit	**20,206**	22,096
Other eligible bills	**1,304**	–
Less: items in the course of transmission to other banks	**(22,960)**	(31,334)
	675,234	650,885

c *Analysis of net inflow/(outflow) of cash and cash equivalents in respect of the acquisition of and increased shareholding in subsidiary companies*

	2009 HK$m	2008 HK$m
Cash consideration	**(13,927)**	(1,371)
Cash and cash equivalents acquired	**29,198**	131
	15,271	(1,240)

d *Analysis of net inflow/(outflow) of cash and cash equivalents in respect of the sale of interests in business portfolios*

	2009 HK$m	2008 HK$m
Sale proceeds	**251**	1,876
Cash and cash equivalents transferred	**–**	(1,909)
	251	(33)

e *Analysis of net inflow of cash and cash equivalents in respect of the purchase of interests in business portfolios*

	2009 HK$m	2008 HK$m
Cash consideration received	**–**	12,274
Cash and cash equivalents acquired	**–**	1,718
	–	13,992

44 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	Group		Bank	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**142,469**	143,797	**110,053**	122,110
Other contingent liabilities	**191**	165	**178**	165
	142,660	143,962	**110,231**	122,275
Commitments				
Documentary credits and short-term trade-related transactions	**32,079**	30,874	**21,004**	25,394
Forward asset purchases and forward forward deposits placed	**1,308**	1,369	**823**	706
Undrawn formal standby facilities, credit lines and other commitments to lend	**1,102,088**	1,118,360	**752,780**	857,018
	1,135,475	1,150,603	**774,607**	883,118

The above table discloses the nominal principal amounts of off-balance sheet transactions, the amounts relating to other contingent liabilities and the nominal principal amounts relating to financial guarantee contracts. Contingent liabilities and commitments are mainly credit-related instruments which include non-financial guarantees and commitments to extend credit. Contractual amounts represent the amounts at risk should contracts be fully drawn upon and clients default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contractual amounts is not representative of future liquidity requirements.

Notes on the Financial Statements (continued)

44 Contingent liabilities and commitments *(continued)*

b *Guarantees (including financial guarantee contracts)*

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December 2009, were as follows:

Group	**At 31 December 2009**		At 31 December 2008	
	Guarantees in favour of third parties	*Guarantees by the group in favour of other HSBC Group entities*	*Guarantees in favour of third parties*	*Guarantees by the group in favour of other HSBC Group entities*
	HK$m	**HK$m**	HK$m	HK$m
Guarantee type				
Financial guarantee contracts[1]	**20,561**	**1,213**	21,093	1,952
Standby letters of credit which are financial guarantee contracts[2]	**15,670**	**44**	21,424	28
Other direct credit substitutes[3]	**27,260**	**8**	26,565	20
Performance bonds[4]	**41,105**	**4,384**	40,440	3,585
Bid bonds[4]	**1,454**	**233**	1,207	157
Standby letters of credit related to particular transactions[4]	**3,699**	**7**	2,481	37
Other transaction-related guarantees[4]	**25,521**	**4,055**	23,438	3,494
	135,270	**9,944**	136,648	9,273

Bank	**At 31 December 2009**		At 31 December 2008	
	Guarantees in favour of third parties	*Guarantees by the group in favour of other HSBC Group entities*	*Guarantees in favour of third parties*	*Guarantees by the group in favour of other HSBC Group entities*
	HK$m	**HK$m**	HK$m	HK$m
Guarantee type				
Financial guarantee contracts[1]	**12,993**	**1,208**	16,418	1,952
Standby letters of credit which are financial guarantee contracts[2]	**11,589**	**44**	17,665	28
Other direct credit substitutes[3]	**22,845**	**4**	23,709	20
Performance bonds[4]	**31,086**	**3,464**	33,071	3,351
Bid bonds[4]	**1,164**	**164**	1,042	156
Standby letters of credit related to particular transactions[4]	**2,343**	**3**	1,583	33
Other transaction-related guarantees[4]	**19,529**	**3,617**	19,987	3,096
	101,549	**8,504**	113,475	8,636

1 *Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.*

2 *Standby letters of credit which are financial guarantee contracts are irrevocable obligations on the part of the group to pay third parties when customers fail to make payments when due.*

3 *Other direct credit substitutes include re-insurance letters of credit related to particular transactions and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*

4 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on the group to make payment depends on the outcome of a future event.*

44 Contingent liabilities and commitments *(continued)*

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures from guarantees are captured and managed in accordance with HSBC's overall credit risk management policies and procedures. Approximately half of the above guarantees have a term of less than one year. Guarantees with terms of more than one year are subject to HSBC's annual credit review process.

c *Contingencies*

The group is named in and defending legal actions in a number of jurisdictions including Hong Kong, arising out of its normal business operations. None of the actions is regarded as material litigation, and none is 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.

45 Assets pledged as security for liabilities

Liabilities of the group amounting to HK$52,888 million *(2008: HK$68,570 million)* and of the Bank amounting to HK$45,668 million *(2008: HK$56,407 million)* are secured by the deposit of assets, including assets pledged in respect of sale and repurchase agreements, to cover short positions and to facilitate settlement processes with clearing houses. The amount of assets pledged by the group to secure these liabilities is HK$57,126 million *(2008: HK$72,543 million)* and by the Bank is HK$39,915 million *(2008: HK$60,337 million)*. These assets comprise treasury bills, debt securities, equities, and deposits.

In respect of reverse repo and stock borrowing transactions, the fair value of collateral held by the group which was permitted to be sold or repledged amounted to HK$124,922 million *(2008: HK$287,398 million)*, and by the Bank of HK$106,365 million *(2008: HK$276,727 million)*. The fair value of such collateral actually sold or repledged by the group amounted to HK$7,944 million *(2008: HK$39,789 million)* and by the Bank of HK$7,028 million *(2008: HK$39,789 million)*.

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

46 Capital commitments

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**4,174**	4,804	**1,800**	2,242
Expenditure authorised by the Directors but not contracted for	**360**	1,056	**354**	1,056
	4,534	5,860	**2,154**	3,298

The capital commitments mainly relate to the commitment to purchase premises and equipment as well as to invest in the HSBC Private Equity Fund 6 Limited which has committed to make private equity investments in Asian companies that are seeking capital to expand existing operations or fund management buy-outs.

Notes on the Financial Statements (continued)

47 Lease commitments

The group leases certain properties and equipment under operating leases. The leases normally run for a period of one to ten years and may include an option to renew. Lease payments are usually adjusted annually to reflect market rentals. None of the leases include contingent rentals. Future minimum lease payments under non-cancellable operating leases are as follows:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**2,351**	2,212	**1,257**	1,310
– five years or less but over one year	**2,889**	3,039	**1,871**	2,018
– over five years	**220**	187	**182**	185
	5,460	5,438	**3,310**	3,513
Equipment				
Amounts payable within				
– one year or less	**51**	61	**25**	35
– five years or less but over one year	**43**	47	**34**	29
– over five years	**–**	–	**–**	–
	94	108	**59**	64

48 Segmental analysis

The group's operating segments are organised into two geographical regions, Hong Kong and Rest of Asia-Pacific. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by retail businesses and global businesses. Although the chief operating decision-maker reviews information on a number of bases, capital resources are allocated and performance assessed primarily by geographical region and the segmental analysis is presented on that basis. In addition, the economic conditions of each geographical region are highly influential in determining performance across the different types of business activity carried out in the region. Therefore, provision of segment performance on a geographical basis provides the most meaningful information with which to understand the performance of the business.

Geographical information is classified by the location of the principal operations of the subsidiary or, in the case of the Bank, by the location of the branch responsible for reporting the results or advancing the funds.

Information provided to the chief operating decision-maker of the group to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with HKFRSs. Due to the nature of the group's structure, the analysis of profits shown below includes intra-segment items between geographical regions with the elimination shown in a separate column. Such transactions are conducted on an arm's length basis. Shared costs are included in segments on the basis of actual recharges made.

Products and services

The group provides a comprehensive range of banking and related financial services to its customers in its two geographical regions. The products and services offered to customers are organised by customer groups and global businesses:

- Personal Financial Services offers a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance, wealth management and local and international payment services;

48 Segmental analysis *(continued)*

- Commercial Banking product offerings include the provision of financial services, payments and cash management, international trade finance, treasury and capital markets, commercial cards, insurance, wealth management and investment banking services;
- Global Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients worldwide. The client-focused business lines deliver a full range of banking capabilities including investment banking and financing solutions; a markets business that provides services in credit, rates, foreign exchange, money markets and securities services; global asset management services and principal investment activities; and
- Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

Total assets:

	2009		2008	
	HK$m	**%**	HK$m	%
Hong Kong	**2,952,294**	**68.0**	2,975,655	69.8
Rest of Asia-Pacific	**1,714,548**	**39.5**	1,545,516	36.3
Intra region	**(325,139)**	**(7.5)**	(260,815)	(6.1)
	4,341,703	**100.0**	4,260,356	100.0

Total liabilities:

	2009		2008	
	HK$m	%	HK$m	%
Hong Kong	**2,830,046**	**69.5**	2,856,247	70.6
Rest of Asia-Pacific	**1,566,069**	**38.5**	1,448,438	35.8
Intra region	**(325,139)**	**(8.0)**	(260,815)	(6.4)
	4,070,976	**100.0**	4,043,870	100.0

Investment in associates and joint ventures:

	2009		2008	
	HK$m	**%**	HK$m	%
Hong Kong	**1,215**	**2.3**	1,189	2.5
Rest of Asia-Pacific	**52,468**	**97.7**	47,081	97.5
	53,683	**100.0**	48,270	100.0

Credit commitments (contract amounts):

	2009		2008	
	HK$m	**%**	HK$m	%
Hong Kong	**618,975**	**48.4**	709,535	54.8
Rest of Asia-Pacific	**659,160**	**51.6**	585,030	45.2
	1,278,135	**100.0**	1,294,565	100.0

Goodwill and intangible assets acquired in the year:

	2009		2008	
	HK$m	**%**	HK$m	%
Hong Kong	–	–	–	–
Rest of Asia-Pacific	**4,869**	**100.0**	2,716	100.0
	4,869	**100.0**	2,716	100.0

Notes on the Financial Statements (continued)

48 Segmental analysis *(continued)*

Consolidated income statement:

2009	*Hong Kong* HK$m	*Rest of Asia-Pacific* HK$m	*Intra-segment elimination* HK$m	*Total* HK$m
Interest income	**39,291**	**45,667**	**(2,408)**	**82,550**
Interest expense	**(8,356)**	**(18,183)**	**2,421**	**(24,118)**
Net interest income	**30,935**	**27,484**	**13**	**58,432**
Fee income	**22,552**	**14,233**	**(1,202)**	**35,583**
Fee expense	**(3,433)**	**(3,074)**	**1,202**	**(5,305)**
Net trading income/(loss)	**8,427**	**12,112**	**(13)**	**20,526**
Net income from financial instruments designated at fair value	**6,391**	**868**	**–**	**7,259**
Gains less losses from financial investments	**117**	**(248)**	**–**	**(131)**
Dividend income	**245**	**119**	**–**	**364**
Net earned insurance premiums	**28,566**	**2,829**	**–**	**31,395**
Other operating income	**9,791**	**1,746**	**(4,279)**	**7,258**
Total operating income	**103,591**	**56,069**	**(4,279)**	**155,381**
Net insurance claims incurred and movement in policyholders' liabilities	**(34,070)**	**(3,061)**	**–**	**(37,131)**
Net operating income before loan impairment charges and other credit risk provisions	**69,521**	**53,008**	**(4,279)**	**118,250**
Loan impairment charges and other credit risk provisions	**(3,875)**	**(7,360)**	**–**	**(11,235)**
Net operating income	**65,646**	**45,648**	**(4,279)**	**107,015**
Operating expenses	**(28,918)**	**(27,554)**	**4,279**	**(52,193)**
Operating profit	**36,728**	**18,094**	**–**	**54,822**
Share of profit in associates and joint ventures	**59**	**7,682**	**–**	**7,741**
Profit before tax	**36,787**	**25,776**	**–**	**62,563**
Tax expense	**(6,401)**	**(5,518)**	**–**	**(11,919)**
Profit for the year	**30,386**	**20,258**	**–**	**50,644**
Profit attributable to shareholders	**26,402**	**19,406**	**–**	**45,808**
Profit attributable to minority interests	**3,984**	**852**	**–**	**4,836**
Net operating income				
– external	**61,497**	**45,930**	**–**	**107,427**
– inter-company/inter-segment	**4,149**	**(282)**	**(4,279)**	**(412)**
Depreciation and amortisation included in operating expenses	**(2,870)**	**(1,211)**	**–**	**(4,081)**

48 Segmental analysis *(continued)*

2008	*Hong Kong* HK$m	*Rest of Asia-Pacific* HK$m	*Intra-segment elimination* HK$m	*Total* HK$m
Interest income	69,020	62,055	(5,211)	125,864
Interest expense	(26,341)	(35,681)	5,203	(56,819)
Net interest income	42,679	26,374	(8)	69,045
Fee income	22,338	16,406	(993)	37,751
Fee expense	(3,880)	(4,097)	993	(6,984)
Net trading income	7,201	14,154	8	21,363
Net loss from financial instruments designated at fair value	(9,607)	(1,375)	–	(10,982)
Gains less losses from financial investments	(2,848)	(128)	–	(2,976)
Dividend income	363	489	–	852
Net earned insurance premiums	25,351	1,535	–	26,886
Other operating income	6,525	1,222	(3,671)	4,076
Total operating income	88,122	54,580	(3,671)	139,031
Net insurance claims incurred and movement in policyholders' liabilities	(14,981)	214	–	(14,767)
Net operating income before loan impairment charges and other credit risk provisions	73,141	54,794	(3,671)	124,264
Loan impairment charges and other credit risk provisions	(5,837)	(6,163)	–	(12,000)
Net operating income	67,304	48,631	(3,671)	112,264
Operating expenses	(28,811)	(27,123)	3,671	(52,263)
Operating profit	38,493	21,508	–	60,001
Share of profit in associates and joint ventures	120	7,569	–	7,689
Profit before tax	38,613	29,077	–	67,690
Tax expense	(6,626)	(6,084)	–	(12,710)
Profit for the year	31,987	22,993	–	54,980
Profit attributable to shareholders	27,844	22,462	–	50,306
Profit attributable to minority interests	4,143	531	–	4,674
Net operating income				
– external	59,549	47,358	–	106,907
– inter-company/inter-segment	7,755	1,273	(3,671)	5,357
Depreciation and amortisation included in operating expenses	(2,518)	(923)	–	(3,441)

Notes on the Financial Statements (continued)

48 Segmental analysis *(continued)*

Net operating income by customer group and global business

	Personal Financial Services HK$m	*Commercial Banking* HK$m	*Global Banking and Markets* HK$m	*Private Banking* HK$m	*Other* HK$m	*Inter-Segment* HK$m	*Total* HK$m
Year ended 31 December 2009							
External	**35,552**	**19,582**	**51,739**	**(50)**	**604**	**–**	**107,427**
Inter-segment	**10,093**	**634**	**(8,913)**	**336**	**3,805**	**(6,367)**	**(412)**
Year ended 31 December 2008							
External	24,872	21,293	64,982	(46)	(4,194)	–	106,907
Inter-segment	26,950	2,730	(21,473)	359	2,957	(6,166)	5,357

Information by country

	Net external operating income[1]		*Non-current assets*[2]	
	2009 HK$m	2008 HK$m	**2009 HK$m**	2008 HK$m
Hong Kong	**61,497**	59,549	**36,092**	37,045
Mainland China	**4,791**	6,663	**51,523**	45,868
Singapore	**6,346**	6,644	**719**	717
India	**5,665**	8,615	**2,659**	2,545
South Korea	**4,429**	4,844	**1,296**	1,053
Malaysia	**4,450**	143	**756**	15
Australia	**4,283**	4,088	**1,532**	1,266
Taiwan	**2,706**	3,250	**2,292**	2,289
Indonesia	**2,981**	2,523	**5,327**	223
Other	**10,279**	10,588	**4,184**	4,429
Total	**107,427**	106,907	**106,380**	95,450

1 *Net external operating income is attributable to countries on the basis of the customer's location.*
2 *Non-current assets consist of property, plant and equipment, goodwill, other intangible assets and certain other assets expected to be recovered more than 12 months after the reporting date.*

49 Related-party transactions

a *Immediate and ultimate holding company*

The group is controlled by HSBC Asia Holdings BV (incorporated in the Netherlands) which owns 100% of the ordinary shares. The ultimate parent of the group is HSBC Holdings plc (incorporated in England).

Transactions with the immediate holding company included the issuance of preference shares and the payment of interest on preference shares. As at 31 December 2009, the Bank has issued HK$101,063 million of preference shares to its immediate holding company (*2008: HK$92,870 million*). These are classified as liabilities on the balance sheet.

Transactions with the ultimate holding company included the issuance of subordinated liabilities and the payment of interest on subordinated liabilities. As at 31 December 2009, the Bank has issued HK$2,101million of subordinated liabilities to its ultimate holding company (*2008: HK$2,091 million*). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		*Ultimate holding company*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**3,937**	4,946	**31**	78
Other operating income	**–**	–	**62**	28
Other operating expenses	**33**	62	**1,450**	1,335

1 *Interest expense paid to the immediate holding company represents interest on preference shares. Interest expense paid to the ultimate holding company represents interest on subordinated liabilities.*

Information relating to preference shares can be found in the 'Notes on the Financial Statements' where the following are disclosed: interest expense on preference shares (note 5b) and preference shares issued (note 37).

Balances at 31 December

Group

	Immediate holding company		*Ultimate holding company*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**–**	–	**–**	–
Amounts due to[1]	**102,889**	94,786	**2,464**	2,317

Bank

	Immediate holding company		*Ultimate holding company*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**–**	–	**–**	–
Amounts due to[1]	**102,889**	94,786	**2,390**	2,265

1 *Amounts due to the immediate holding company included preference shares of HK$101,063 million (2008: HK$92,870 million). Amounts due to the ultimate holding company included subordinated liabilities of HK$2,101 million (2008: HK$2,091 million).*

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK$5,646 million *(2008: HK$3,975 million).*

Notes on the Financial Statements (continued)

49 Related-party transactions *(continued)*

Share option and share award schemes

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 51, 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 was treated as a capital contribution and was recorded under 'Other reserves' in 2008. In 2009, the group recognised a liability due to the ultimate holding company and a corresponding reduction in capital contribution. The liability amount is recognised on a straight-line basis over the vesting period for the amount of shares expected to vest and measured at the fair value of the shares at each reporting date. The balances of the capital contribution and the liability as at 31 December 2009 amounted to HK$2,006 million and HK$1,199 million respectively *(2008: HK$2,805 million and HK$nil respectively)*.

b *Subsidiaries and fellow subsidiaries*

The group entered into transactions with its fellow subsidiary companies in the normal course of business, including the acceptance and placement of interbank deposits, correspondent banking transactions and off-balance sheet transactions. The activities were on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The group shared certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow subsidiary companies and paid professional service fees on certain structured finance deals to a fellow subsidiary company. The commissions and fees in these transactions are priced on an 'arm's length' basis.

The aggregate amount of income and expenses arising from these transactions during the year and the balances of amounts due to and from the relevant parties at the year end are as follows:

Income and expenses for the year

	Fellow subsidiaries	
	2009	2008
	HK$m	HK$m
Interest income	**1,156**	8,063
Interest expense	**364**	730
Fee income	**1,596**	2,438
Fee expense	**862**	1,284
Other operating income	**1,925**	1,817
Other operating expenses[1]	**3,443**	4,459

1 *2009 included payment of HK$810 million (2008: HK$928 million) of software costs which were capitalised as intangible assets in the statement of financial position of the group.*

49 Related-party transactions *(continued)*

Balances at 31 December

Group

	Fellow subsidiaries	
	2009	2008
	HK$m	HK$m
Amounts due from	**134,511**	378,662
Amounts due to	**46,696**	47,011

Bank

	Subsidiaries		*Fellow subsidiaries*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**48,029**	32,242	**113,726**	365,719
Amounts due to	**76,438**	70,427	**42,547**	43,073

c *Associates and joint ventures*

Information relating to associates and joint venture can be found in note 23 where the following are disclosed:

- investments in associates and joint ventures;
- amounts due from/to associates and joint ventures; and
- principal associates.

The group has entered into Technical Support and Assistance Agreements with Bank of Communications (‘BoCom’), Industrial Bank, Vietnam Technological and Commercial Joint Stock Bank, Hana HSBC Life Insurance and Canara HSBC Oriental Bank of Commerce Life Insurance to provide technical support and assistance in relation to their banking and insurance business. The group has continued to assist BoCom in growing its credit card division and has provided technical support in the issuing of co-branded credit cards with HSBC. In October 2009, the group and BoCom have announced that they are in advanced discussion to transfer their existing joint credit card activities in China to a newly established joint venture company. The transaction remains subject to agreement of final terms and conditions and will be subject to regulatory approvals.

The transactions resulting in amounts to and from associates and joint ventures arose in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

d *Key management personnel*[1]

Key management compensation

	2009	2008
	HK$m	HK$m
Salaries and other short-term benefits	**187**	180
Retirement benefits		
– Defined contribution plans	**10**	9
– Defined benefit plans	**2**	3
Share-based payments	**79**	51
	278	243

In addition to their salaries, the group also provides non-cash benefits including share-based payments to directors and executive officers, and contributes to post-employment benefits on their behalf (see note 5o) regarding directors’ emoluments.

Notes on the Financial Statements (continued)

49 Related-party transactions *(continued)*

Transactions, arrangements and agreements involving key management personnel

Particulars of transactions, arrangements and agreements entered into by the group with companies that may be directly or indirectly influenced or controlled by certain directors of the group and their immediate relatives were as follows:

	2009	2008
	HK$m	HK$m
Average assets	**24,043**	25,159
Average liabilities	**17,893**	23,958

The aggregate contribution to the group's profit before tax from such transactions in 2009 was HK$460 million (*2008: HK$484 million*). As at the balance sheet date, guarantees made on behalf of such companies were HK$1,224 million (*2008: HK$6,957 million*).

The above transactions were entered into in the ordinary course of business and on substantially the same terms, including interest rates and security, as comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

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.

Loans to officers

Particulars of loans to officers disclosed pursuant to section 161B of the Hong Kong Companies Ordinance:

	Aggregate amount of loans outstanding at 31 December		*Maximum aggregate amount of loans outstanding during the year*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**61**	60	**95**	191
By subsidiary companies	**1**	–	**2**	1
	62	60	**97**	192

1 *Key management personnel are the Board of Directors of HSBC Holdings plc and the Board of Directors and executive committee members of The Hongkong and Shanghai Banking Corporation Ltd.*

The group adheres to Hong Kong Banking Ordinance Section 83 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.

e *Pension funds*

At 31 December 2009, HK$11.8 billion *(2008: HK$10.8 billion)* of pension fund assets were under management by group companies. Total fees paid or payable by pension plans to group companies for providing fund management, administrative and trustee services amounted to HK$42 million for the year (*2008: HK$39 million*).

50 Share-based payments

During 2009, HK$1,105 million was charged to the income statement in respect of share-based payment transactions settled in equity *(2008: HK$1,045 million)*. This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the Group's reward structures.

In April 2009, HSBC Holdings completed a rights issue. The terms of the share plans have been adjusted accordingly to maintain the value of the awards and these adjustments are set out in the tables below.

Calculation of fair value

The fair value of services received in return for shares awarded is measured by reference to the fair value of the shares.

Fair value of share options, measured at the date of grant of the option, is calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options with vesting dependent on HSBC's Total Shareholder Return over a period, these performance targets are incorporated into the model using Monte-Carlo simulation. Non-market conditions, such as HSBC meeting earnings per share targets, are not incorporated into the calculation of fair value at grant date but are reflected in the amount of compensation expense accrued over the vesting period.

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 value calculated is inherently subjective and uncertain due to the assumptions made and the limitations of the model used. Expected dividends are incorporated into the valuation model for share options and awards where applicable.

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

2009	*1-year Savings-Related Share Option Schemes*	*3-year Savings-Related Share Option Schemes*	*5-year Savings-Related Share Option Schemes*
Risk-free interest rate[1] (%)	**0.7**	**2.1**	**2.4**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**50**	**35**	**30**

2008	*1-year Savings-Related Share Option Schemes*	*3-year Savings-Related Share Option Schemes*	*5-year Savings-Related Share Option Schemes*
Risk-free interest rate[1] (%)	4.5	4.5	4.5
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	25	25	25

1 *The risk-free rate was determined from the UK gilts yield curve.*

2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*

3 *Expected volatility is estimated by considering both historical average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

Share Option Schemes

The share option schemes include The HSBC Holdings Group Share Option Plan, Executive Share Option Scheme and Savings-Related Share Option Plans.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

a *Executive Share Option Scheme and Group Share Option Plan*

The Executive Share Option Scheme and Group Share Option Plan were long-term incentive schemes under which certain HSBC employees were awarded share options between 1993 and 2005. The aim of the plan was to align the interests of those employees assessed as higher-performing to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets which must normally be attained in order for the awards to vest.

The Executive Share Option Scheme ('ESOS') ran from October 1993 until April 2000, after which it was replaced by the Group Share Option Plan ('GSOP') due to a change in UK legislation. In broad terms, the ESOS and GSOP were similar, in that:

- options were granted as part of the annual review process in recognition of past performance and future potential; and
- the exercise price of the option was equal to the share price at the date of grant and the options are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

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

Group

	2009		2008	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**21,194**	**7.93**	22,944	7.87
Exercised in the year	**(302)**	**6.44**	(1,394)	6.87
Transferred in the year	**1,040**	**7.83**	132	7.87
Lapsed in the year	**(2,836)**	**6.09**	(488)	8.41
Adjustment for rights issue	**3,283**	**7.93**	–	–
Outstanding at 31 December	**22,379**	**7.03**	21,194	7.93
Exercisable at 31 December	**22,379**	**7.03**	21,194	7.93

Bank

	2009		2008	
	Number	*Weighted average exercise price*	*Number*	*Weighted average exercise price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**16,492**	**7.92**	17,861	7.87
Exercised in the year	**(171)**	**6.41**	(1,094)	6.80
Transferred in the year	**(244)**	**7.24**	88	7.87
Lapsed in the year	**(2,290)**	**6.14**	(363)	8.45
Adjustment for rights issue	**2,393**	**7.92**	–	–
Outstanding at 31 December	**16,180**	**7.02**	16,492	7.92
Exercisable at 31 December	**16,180**	**7.02**	16,492	7.92

The options outstanding at the year end had an exercise price in the range of £6.02 to £7.96 (*2008: £6.38 to £9.14*), and a weighted average remaining contractual life of 2.94 years (*2008: 3.63 years*).

The weighted average share price during the year was £5.86 (*2008: £7.99*). No awards have been made under this plan since 2005.

50 Share-based payments *(continued)*

b *Savings-Related Share Option Schemes*

The Savings-Related Share Option Schemes, which represent equity settled share based payment arrangements, invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value.

The options are generally 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 contracts, respectively. The exercise price is set at a 20 per cent (*2008: 20 per cent*) discount to the market value immediately preceding the date of invitation.

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

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

Group

	2009		2008	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**8,193**	**6.82**	14,934	6.55
Granted in the year	**14,318**	**3.31**	2,568	6.82
Forfeited/expired in the year	**(8,315)**	**6.25**	(1,111)	6.85
Exercised in the year	**(764)**	**5.88**	(8,263)	6.32
Transferred in the year	**1,783**	**6.10**	65	6.60
Adjustment for rights issue	**936**	**6.92**	–	–
Outstanding at 31 December	**16,151**	**3.67**	8,193	6.82
Exercisable at 31 December	**422**	**6.28**	338	6.40

Bank

	2009		2008	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**6,648**	**6.83**	11,741	6.56
Granted in the year	**7,918**	**3.31**	2,171	6.82
Forfeited/expired in the year	**(5,372)**	**6.21**	(944)	6.86
Exercised in the year	**(503)**	**5.89**	(6,389)	6.31
Transferred in the year	**35**	**4.36**	69	6.58
Adjustment for rights issue	**633**	**6.91**	–	–
Outstanding at 31 December	**9,359**	**3.77**	6,648	6.83
Exercisable at 31 December	**330**	**6.28**	276	6.38

The options outstanding at the year end had an exercise price in the range of £3.31 to £6.69 (*2008: £5.35 to £7.67*), and a weighted average remaining contractual life of 3.06 years (*2008: 1.98 years*).

The weighted average share price at the date of exercise for share options exercised during the year was £6.56 (*2008:* £8.44). The weighted average fair value of options granted during the year was £1.40 (*2008: £2.10*).

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

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

Group

	2009		2008	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**HK$**	(000's)	HK$
Outstanding at 1 January	**14,404**	**106.14**	12,186	106.51
Granted in the year	**48,632**	**37.88**	7,998	106.25
Forfeited/expired in the year	**(15,096)**	**97.42**	(4,070)	106.56
Exercised in the year	**(19)**	**73.51**	(1,660)	108.42
Transferred in the year	**(1)**	**63.47**	(50)	106.11
Adjustment for rights issue	**593**	**105.87**	–	–
Outstanding at 31 December	**48,513**	**38.49**	14,404	106.14
Exercisable at 31 December	**148**	**90.14**	30	108.45

Bank

	2009		2008	
	Number	*Weighted average exercise price*	*Number*	*Weighted Average Exercise Price*
	(000's)	**HK$**	(000's)	HK$
Outstanding at 1 January	**9,242**	**106.10**	8,042	106.38
Granted in the year	**33,141**	**37.88**	5,425	106.25
Forfeited/expired in the year	**(9,773)**	**98.69**	(3,234)	106.41
Exercised in the year	**(13)**	**69.03**	(946)	108.41
Transferred in the year	**3**	**72.32**	(45)	106.00
Adjustment for rights issue	**417**	**105.84**	–	–
Outstanding at 31 December	**33,017**	**38.47**	9,242	106.10
Exercisable at 31 December	**110**	**90.14**	22	108.45

The options outstanding at the year end had an exercise price in the range of HK$37.88 to HK$94.51 (*2008: HK$103.44 to HK$108.45*), and a weighted average remaining contractual life of 3.67 years (*2008: 2.33 years*).

The weighted average share price at the date of exercise for share options exercised during the year was HK$83.33 (*2008:HK124.65*).

The weighted average fair value of options granted during the year was HK$15.65 (*2008: HK$29.64*).

During the year, options granted for schemes with option prices set in euros and US dollars were insignificant.

HSBC Share Plan

The HSBC Share Plan was adopted by HSBC in 2005. Under this Plan, Performance Share awards, Restricted Share awards and Achievement Share awards may be made. The aim of the share plan is to align the interests of executives to the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

50 Share-based payments *(continued)*

c *Performance Share Awards*

Performance Shares are awarded to executive Directors and other senior executives after taking into account individual performance in the previous year. For awards made prior to 2008, each award is divided into two equal parts for testing attainment against pre-determined benchmarks. One half of the award is subject to a Total Shareholder Return ("TSR") measure, based on HSBC's ranking against a comparator group of major banks; the other half is subject to an earnings per share target. For each element of the award, shares are released to the employee on a sliding scale from 30 to 100 per cent of the award, depending on the scale of achievement against the benchmarks, providing that the minimum criteria for each performance measure has been met.

For awards made during 2008 and prospectively, each award is divided into three parts for testing attainment against pre-determined benchmarks. 40 per cent of the award is subject to a TSR measure, based on HSBC's ranking against a comparator group of major banks; 40 per cent is subject to an economic profit measure, calculated as the average annual difference between return on invested capital and HSBC's benchmark cost of capital; and 20 per cent is subject to an earnings per share target. For the TSR and EPS elements of the awards, shares are released to the employee on a sliding scale from 20 to 100 per cent of the award, depending on the scale of achievement against the benchmarks. For the economic profit element of the awards, shares are released to the employee on a sliding scale from zero to 100 per cent, depending on the scale of achievement against the benchmark. In all cases, shares are only released when the minimum criteria for each performance measure has been met.

	Group		*Bank*	
	2009	2008	**2009**	2008
	Number	*Number*	*Number*	*Number*
	(000's)	(000's)	**(000's)**	(000's)
Outstanding at 1 January	**1,192**	2,430	**1,121**	2,003
Additions during the year	**31**	361	**30**	353
Released in the year	**(179)**	(682)	**(157)**	(481)
Transferred in the year	**28**	8	**14**	3
Lapsed in the year	**(566)**	(925)	**(492)**	(757)
Adjustment for rights issue	**170**	–	**160**	–
Outstanding at 31 December	**676**	1,192	**676**	1,121

The weighted average remaining vesting period was 0.70 years (*2008: 0.94 years*).

Additons during the year comprised reinvested scrip dividends, and nil shares were granted in year 2009. The weighted average fair value of shares granted during year 2008 with TSR conditions was £5.71 while shares with EPS and economic profit conditions had a fair value of £6.62 as at 31 December 2008.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

d *Restricted Share Awards*

Restricted share awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from the date of the award.

	Group		*Bank*	
	2009	2008	**2009**	2008
	Number	*Number*	*Number*	*Number*
	(000's)	(000's)	**(000's)**	(000's)
Outstanding at 1 January	**9,997**	6,517	**8,433**	6,527
Additions during the year	**15,459**	6,498	**13,693**	4,398
Released in the year	**(4,411)**	(2,623)	**(3,657)**	(2,244)
Transferred in the year	**(18)**	187	**(77)**	165
Lapsed in the year	**(2,145)**	(582)	**(1,465)**	(413)
Adjustment for rights issue	**2,877**	–	**2,499**	–
Outstanding at 31 December	**21,759**	9,997	**19,426**	8,433

The weighted average remaining vesting period as at year end was 1.82 years *(2008: 1.78 years)*.

The closing price of HSBC Holdings shares on 31 December 2009 was £7.09 *(31 December 2008: £6.62)*.

e *Achievement Share Awards*

Achievement shares were launched in 2005 and were utilised to promote widespread interest in HSBC shares amongst employees and are awarded to eligible employees after taking into account the employee's performance in the prior year. High-performing and/or high-potential senior and middle managers are normally eligible to receive achievement shares as part of the annual pay review process. 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.

Additional awards are made during the 3-year vesting period. At the end of three years, the original award together with the additional share awards will be released.

	Group		*Bank*	
	2009	2008	**2009**	2008
	Number	*Number*	*Number*	*Number*
	(000's)	(000's)	**(000's)**	(000's)
Outstanding at 1 January	**5,532**	3,685	**4,466**	3,063
Granted in the year	**423**	2,864	**315**	2,228
Released in the year	**(1,452)**	(934)	**(1,216)**	(790)
Transferred in the year	**404**	205	**86**	189
Lapsed in the year	**(557)**	(288)	**(425)**	(224)
Adjustment for rights issue	**853**	–	**638**	–
Outstanding at 31 December	**5,203**	5,532	**3,864**	4,466

The weighted average remaining vesting period as at year end was 0.67 years (*2008: 1.52 years)*.

51 Fair value of financial instruments

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 through profit or loss, derivatives, and financial instruments classified as available-for-sale (including treasury and other eligible bills, debt securities and equity securities).

Control framework

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

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of valuation models, independent determination or validation of valuation model inputs, independent determination or validation of any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, there is independent price determination or validation. The results of independent validation processes are reported to senior management, and adjustments to the fair values made as appropriate.

Determination of fair value of financial instruments carried at fair value

Fair values are determined according to the following hierarchy:

(a) Quoted market price – Level 1

Financial instruments with quoted prices for identical instruments in active markets.

(b) Valuation technique using observable inputs – Level 2

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.

(c) Valuation technique with significant non-observable inputs – Level 3

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 measurement derived is more judgemental. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (historical data may, for example, be used). Furthermore, the assessment of hierarchy level is based on the lowest level of input that is significant to the fair value of the financial instrument. Consequently, the level of uncertainty in the determination of the unobservable inputs will generally give rise to valuation uncertainty that is less than the fair value itself.

In certain circumstances, the group applies the fair value option to 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 not available, 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 the group reverse over the contractual life of the debt.

51 Fair value of financial instruments *(continued)*

Issued structured notes and certain other hybrid instrument liabilities are included within trading liabilities, and marked 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 tighter than credit spreads observed in vanilla debt or credit default swap markets.

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

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 anticipates that there are additional considerations not included within the valuation model, adjustments may be adopted outside the model. Examples of such adjustments are:

- Credit risk adjustment: an adjustment to reflect the credit worthiness of over-the-counter derivative counterparties.
- Market data/model uncertainty: an adjustment to reflect uncertainties in fair values based on uncertain market data inputs (e.g. as a result of illiquidity) or in areas where the choice of valuation model is particularly subjective.
- Inception profit (‘day 1 P&L reserves’): for financial instruments valued, at inception, on the basis of one or more significant unobservable inputs, the difference between transaction price and model value (as adjusted) at inception is not recognised in the consolidated income statement, but is deferred and included as part of the fair value.

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

The approach used to calculate the fair value of each type of financial instrument is as follows:

– Loans

Loans are valued from broker quotes and/or market data consensus providers where available. Where unavailable, fair value will be determined based on an appropriate credit spread derived from other market instruments issued by the same or comparable entities.

– 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 determined from observable and unobservable market data.

– 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 discrepancy 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 historic 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.

51 Fair value of financial instruments *(continued)*

– 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 and because of uncertainties inherent in estimating fair value for private equity investments, it is not until realisation of the investment that subjective valuation factors are removed.

Analysis of fair value determination

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

Group		*Valuation techniques:*				
	Quoted market price **HK$m**	*using observable inputs* **HK$m**	*with significant non-observable inputs* **HK$m**	*Third Party Total* **HK$m**	*Amounts with HSBC entities* **HK$m**	*Total* **HK$m**
At 31 December 2009						
Assets						
Trading assets	**237,253**	**82,887**	**2,591**	**322,731**	**–**	**322,731**
Financial assets designated at fair value	**31,185**	**11,012**	**5,890**	**48,087**	**–**	**48,087**
Derivatives	**1,877**	**182,463**	**1,891**	**186,231**	**48,940**	**235,171**
Available-for-sale investments[1]	**560,980**	**583,753**	**24,161**	**1,168,894**	**–**	**1,168,894**
Liabilities						
Trading liabilities	**72,870**	**70,139**	**11,357**	**154,366**	**–**	**154,366**
Financial liabilities designated at fair value	**–**	**36,709**	**–**	**36,709**	**–**	**36,709**
Derivatives	**1,838**	**177,084**	**2,981**	**181,903**	**50,943**	**232,846**
At 31 December 2008						
Assets						
Trading assets	202,855	284,515	6,300	493,670	–	493,670
Financial assets designated at fair value	16,894	21,688	1,971	40,553	–	40,553
Derivatives	1,498	359,348	4,642	365,488	88,435	453,923
Available-for-sale investments[1]	192,955	485,500	14,461	692,916	–	692,916
Liabilities						
Trading liabilities	37,163	161,272	12,152	210,587	–	210,587
Financial liabilities designated at fair value	–	39,926	–	39,926	–	39,926
Derivatives	976	356,433	5,410	362,819	103,385	466,204

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Bank

	Quoted market price HK$m	Valuation techniques: using observable inputs HK$m	Valuation techniques: with significant non-observable inputs HK$m	Third Party Total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2009						
Assets						
Trading assets	**160,998**	**53,749**	**1,733**	**216,480**	**–**	**216,480**
Financial assets designated at fair value	**–**	**1,634**	**167**	**1,801**	**–**	**1,801**
Derivatives	**1,356**	**175,846**	**1,759**	**178,961**	**52,037**	**230,998**
Available-for-sale investments[1]	**471,682**	**388,243**	**21,711**	**881,636**	**–**	**881,636**
Liabilities						
Trading liabilities	**59,676**	**38,921**	**4,859**	**103,456**	**–**	**103,456**
Financial liabilities designated at fair value	**–**	**1,857**	**–**	**1,857**	**–**	**1,857**
Derivatives	**1,727**	**172,561**	**2,911**	**177,199**	**52,944**	**230,143**
At 31 December 2008						
Assets						
Trading assets	187,534	136,984	4,605	329,123	–	329,123
Financial assets designated at fair value	–	1,503	225	1,728	–	1,728
Derivatives	1,031	347,798	4,372	353,201	99,008	452,209
Available-for-sale investments[1]	178,458	305,835	11,485	495,778	–	495,778
Liabilities						
Trading liabilities	33,589	112,094	5,406	151,089	–	151,089
Financial liabilities designated at fair value	–	7,086	–	7,086	–	7,086
Derivatives	933	345,022	5,410	351,365	106,367	457,732

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 9.*

51 Fair value of financial instruments *(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 **HK$m**	*Held for trading* **HK$m**	*Designated at fair value through profit or loss* **HK$m**	*Derivatives* **HK$m**	*Held for trading* **HK$m**	*Designated at fair value through profit or loss* **HK$m**	*Derivatives* **HK$m**
At 1 January 2009	**14,461**	**6,300**	**1,971**	**4,642**	**12,152**	**–**	**5,410**
Total gains or losses recognised in profit or loss	**(1,049)**	**368**	**755**	**(448)**	**1,056**	**–**	**3**
Total gains or losses recognised in other comprehensive income	**1,064**	**(60)**	**3**	**1**	**217**	**–**	**18**
Purchases	**6,076**	**658**	**564**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**797**	**–**	**–**
Sales	**(652)**	**(4,185)**	**(59)**	**–**	**–**	**–**	**–**
Settlements	**(3,866)**	**(79)**	**(46)**	**(450)**	**(1,267)**	**–**	**(516)**
Transfers out	**(8,734)**	**(1,795)**	**(1)**	**(2,850)**	**(2,817)**	**–**	**(2,717)**
Transfers in	**16,861**	**1,384**	**2,703**	**996**	**1,219**	**–**	**783**
At 31 December 2009	**24,161**	**2,591**	**5,890**	**1,891**	**11,357**	**–**	**2,981**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	**(732)**	**169**	**782**	**(240)**	**25**	**–**	**(161)**

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Bank	*Assets*				*Liabilities*		
	Available-for-sale HK$m	*Held for trading* HK$m	*Designated at fair value through profit or loss* HK$m	*Derivatives* HK$m	*Held for trading* HK$m	*Designated at fair value through profit or loss* HK$m	*Derivatives* HK$m
At 1 January 2009	**11,485**	**4,605**	**225**	**4,372**	**5,406**	**–**	**5,410**
Total gains or losses recognised in profit or loss	**8**	**190**	**18**	**(249)**	**720**	**–**	**(84)**
Total gains or losses recognised in other comprehensive income	**744**	**1**	**–**	**1**	**98**	**–**	**16**
Purchases	**5,781**	**590**	**–**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**791**	**–**	**–**
Sales	**(566)**	**(3,630)**	**(38)**	**–**	**–**	**–**	**–**
Settlements	**(3,781)**	**(72)**	**(38)**	**(450)**	**(591)**	**–**	**(512)**
Transfers out	**(8,734)**	**(725)**	**–**	**(2,808)**	**(1,681)**	**–**	**(2,686)**
Transfers in	**16,774**	**774**	**–**	**893**	**116**	**–**	**767**
At 31 December 2009	**21,711**	**1,733**	**167**	**1,759**	**4,859**	**–**	**2,911**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	**273**	**109**	**22**	**(281)**	**48**	**–**	**(72)**

For available-for-sale securities and assets held for trading, the unobservability of valuations of certain debt securities resulted in these assets being transferred into level 3 during the year. Transfers out of level 3 also occurred in respect of certain debt securities as valuations in these assets becoming observable during the year.

For derivative assets and liabilities, an increase in the observability of equity volatilities and correlations during the year, resulted in transfers out of level 3. In addition, the unobservability of specific asset prices underlying derivative structures resulted in derivative liabilities being transferred into level 3.

For held-for-trading liabilities, transfers into level 3 were primarily due to a reduction in the observability of volatilities and gap risk parameters. Transfers out of level 3 resulted from an increase in the observability of equity correlation.

During the year, there were some transfers from level 2 to level 1 for certain government bills held for trading and certain equity funds designated at fair value through profit or loss as quoted prices were available for the valuation of these assets.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under ‘Net trading income’.

Fair value changes on assets and liabilities designated at fair value are presented in the income statement under ‘Net income/(loss) from financial instruments designated at fair value’.

Realised gains and losses from available-for-sale securities are presented under ‘Gains less losses of financial investments’ in the income statement while unrealised gains and losses are presented in ‘Fair value changes taken to equity’ within ‘Available-for-sale investments’ in other comprehensive income.

51 Fair value of financial instruments *(continued)*

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

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

Group	*Reflected in income statement*		*Reflected in equity*	
	Favourable changes **HK$m**	*Unfavourable changes* **HK$m**	*Favourable changes* **HK$m**	*Unfavourable changes* **HK$m**
At 31 December 2009				
Derivatives/trading assets/trading liabilities	**413**	**(408)**	**–**	**–**
Financial assets/liabilities designated at fair value	**573**	**(573)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**964**	**(958)**
At 31 December 2008				
Derivatives/trading assets/trading liabilities	1,404	(1,393)	–	–
Financial assets/liabilities designated at fair value	175	(175)	–	–
Financial investments: available-for-sale	–	–	927	(1,154)

Bank	*Reflected in income statement*		*Reflected in equity*	
	Favourable changes **HK$m**	*Unfavourable changes* **HK$m**	*Favourable changes* **HK$m**	*Unfavourable changes* **HK$m**
At 31 December 2009				
Derivatives/trading assets/trading liabilities	**277**	**(272)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**719**	**(719)**
At 31 December 2008				
Derivatives/trading assets/trading liabilities	1,321	(1,330)	–	–
Financial investments: available-for-sale	–	–	578	(577)

Changes in fair value recorded in the income statement

The following table details changes in fair values recognised in the income statement during the period, 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; and
- there were significant assets and liabilities valued using observable inputs at 31 December 2008 that became valued with significant unobservable inputs during 2009; the table reflects the full change in fair value of those instruments during 2009, not just that element arising following the category change.

51 Fair value of financial instruments *(continued)*

Group	*Recorded in the income statement*	
	2009	2008
	HK$m	HK$m
At 31 December		
Derivatives/trading assets/trading liabilities	**(207)**	(15)
Financial assets/liabilities designated at fair value	**782**	633

Bank	*Recorded in the income statement*	
	2009	2008
	HK$m	HK$m
At 31 December		
Derivatives/trading assets/trading liabilities	**(196)**	479
Financial assets/liabilities designated at fair value	**22**	16

Fair value of financial instruments not carried at fair value

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

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

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

– 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 balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans.

– 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 earning streams of, equivalent quoted securities.

– Deposits and customer accounts

  The fair value of deposits and customer accounts 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.

– Debt securities in issue and subordinated liabilities

  The fair value of debt securities in issue and subordinated liabilities is based on quoted market prices for the same or similar instruments at the balance sheet date.

51 Fair value of financial instruments *(continued)*

The fair values in this note are stated at a specific date and may be significantly different from the amounts that 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 those financial instruments for which their carrying amounts are a reasonable approximation of fair values because, for example, they are short term in nature or reprice to current market rates frequently:

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission to other banks
Items in the course of collection from other banks	Endorsements and acceptances
Endorsements and acceptances	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals
Accrued income	

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	**31 December 2009**		31 December 2008	
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
	HK$m	**HK$m**	HK$m	HK$m
Assets				
Placings with banks	**548,932**	**549,009**	392,300	392,612
Loans and advances to customers	**1,350,644**	**1,352,528**	1,286,145	1,263,077
Financial instruments: debt securities	**110,721**	**113,288**	81,974	88,807
Liabilities				
Deposits by banks	**111,206**	**111,205**	196,674	196,756
Customer accounts	**2,944,539**	**2,944,629**	2,576,084	2,577,936
Debt securities in issue	**43,396**	**43,433**	48,800	48,947
Subordinated liabilities	**21,181**	**19,124**	19,184	15,134
Preference shares	**101,208**	**89,482**	92,870	72,553

Bank	**31 December 2009**		31 December 2008	
	Carrying value	*Fair value*	*Carrying value*	*Fair value*
	HK$m	**HK$m**	HK$m	HK$m
Assets				
Placings with banks	**342,837**	**342,904**	272,294	272,394
Loans and advances to customers	**752,574**	**752,589**	817,996	802,529
Liabilities				
Deposits by banks	**94,861**	**94,862**	174,532	174,606
Customer accounts	**1,902,571**	**1,902,672**	1,767,001	1,767,554
Debt securities in issue	**28,250**	**28,275**	34,855	34,906
Subordinated liabilities	**9,925**	**8,054**	10,602	8,027
Preference shares	**101,063**	**89,338**	92,870	72,553

52 Risk Management

The group's activities involve the analysis, evaluation, acceptance and management of financial risks. The principal financial risks are:

- credit risk;
- liquidity risk;
- market risk (including foreign exchange, interest rate and equity price risks);
- operational risk; and
- insurance risk.

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group worldwide. The group's risk management policies and procedures are subject to a high degree of oversight and guidance to ensure that all types of risk are systematically identified, measured, analysed and actively managed. In addition, internal audit is responsible for the independent review of risk management and the control environment.

a *Credit risk*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from lending, trade finance, treasury and leasing business, but also from off-balance sheet products such as guarantees and credit derivatives, and from the group's holding of debt securities. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities. The group's principal credit risk management procedures and policies, which follow policies established by HSBC Group Head Office, include the following:

- Formulating credit policies and documenting these in detail in dedicated manuals.
- Establishing and maintaining the group's large credit exposure policy. This policy delineates the group's maximum exposures to individual customers, customer groups and other risk concentrations.
- Establishing and complying with lending guidelines on the group's attitude towards, and appetite for, lending to specified market sectors and industries.
- Undertaking an objective assessment of risk. All commercial non-bank credit facilities originated by the group in excess of designated limits are subject to review prior to the facilities being committed to customers.
- Controlling exposures to banks and other financial institutions. The group's credit and settlement risk limits to counterparties in the finance and government sectors are designed to optimise the use of credit availability and avoid excessive risk concentration.
- Managing exposures to debt securities by establishing controls in respect of the liquidity of securities held for trading and setting issuer limits for financial investments. Separate portfolio limits are established for asset-backed securities and similar instruments.
- Controlling cross-border exposures to manage country and cross-border risk through the imposition of country limits with sub-limits by maturity and type of business.
- Controlling exposures to selected industries. When necessary, restrictions are imposed on new business, or exposures in the group's operating entities are capped.
- Maintaining and developing risk ratings in order to categorise exposures meaningfully and facilitate focused management of the attendant risks. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk-rating processes are increasingly used for the larger facilities, ultimate responsibility for setting risk grades rests in each case with the final approving executive. Risk grades are reviewed frequently and amendments, where necessary, are implemented promptly.

Both the HSBC Group Head Office and the Risk Management Committee ('RMC') receive regular reports on credit exposures. These include information on large credit exposures, concentrations, industry exposures, levels of impairment provisioning and country exposures.

52 Risk Management *(continued)*

The RMC, reports to EXCO and has the responsibility for exercising and delegating risk approval authorities, setting risk appetite and approving definitive risk policies and controls. It monitors risk inherent to the financial services business, receives reports, determines action to be taken and reviews the efficacy of risk management framework.

EXCO and RMC are supported by a dedicated group risk function headed by the Chief Risk Officer, who is a member of both EXCO and RMC and reports to the Chief Executive Officer.

Credit quality

The group's credit risk rating system differentiates exposures in order to highlight those with greater risk factors and higher potential severity of loss. For individually significant accounts, risk ratings are reviewed regularly and amendments, where necessary, are implemented promptly. Within the group's retail portfolios, risk is assessed and managed using a wide range of risk and pricing models.

The group's credit rating system is based on a sophisticated and granular methodology, using probability of default and loss estimates, compliant with an internal rating-based ('IRB') approach required to support the Basel II framework for calculating the group's minimum capital requirement. The integration of this framework into the group's reporting structure enables reporting to internal management in accordance with the group's IRB obligations.

Collateral and other credit enhancements

Loans and advances

The group has guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and the determination of valuation parameters. Such parameters are expected to be conservative, reviewed regularly and supported by empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfil 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. In certain cases, depending on the customer's standing and the type of product, facilities may be unsecured. The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

The group obtained assets by taking possession of collateral held as security, or calling other credit enhancements.

The carrying amount outstanding as at the year end was as follows:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**116**	183	**23**	38
Commercial and industrial properties	**24**	99	**15**	85
Other assets	**3**	4	**–**	–
	143	286	**38**	123

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.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Other financial assets

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.

The ISDA Master Agreement is the group's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across 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 other pre-agreed termination events occur. It is also common, and the group's preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market contingent counterparty risk inherent in the outstanding positions.

Settlement risk arises in any situation 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 for each counterparty, to cover the aggregate of all settlement risk arising from the group's investment banking and markets 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.

Maximum exposure to credit risk

Maximum exposure to credit risk before collateral held or other credit enhancements

Group

	2009	2008
	HK$m	HK$m
Cash and short-term funds	**892,175**	597,572
Items in the course of collection from other banks	**15,528**	13,949
Placings with banks maturing after one month	**107,070**	55,569
Certificates of deposit	**37,388**	57,078
Hong Kong SAR Government certificates of indebtedness	**135,414**	119,024
Trading assets	**308,951**	481,658
Debt securities	**138,020**	187,236
Treasury bills	**145,676**	238,778
Other	**25,255**	55,644
Financial assets designated at fair value	**18,695**	19,736
Debt securities	**18,300**	19,730
Other	**395**	6
Derivatives	**235,171**	453,923
Advances to customers	**1,350,644**	1,286,145
Financial investments: Debt securities	**824,458**	549,520
Amounts due from Group companies	**134,511**	378,662
Other assets	**54,744**	66,139
Acceptances and endorsements	**22,211**	31,453
Other	**32,533**	34,686
Financial guarantees and other credit-related contingent liabilities	**93,636**	97,046
Loan commitments and other credit-related commitments	**1,295,126**	1,302,304
At 31 December	**5,503,511**	5,478,325

52 Risk Management *(continued)*

Bank

	2009	2008
	HK$m	HK$m
Cash and short-term funds	**657,765**	481,702
Items in the course of collection from other banks	**11,151**	9,908
Placings with banks maturing after one month	**67,299**	33,754
Certificates of deposit	**20,492**	36,980
Hong Kong SAR Government certificates of indebtedness	**135,414**	119,024
Trading assets	**203,403**	317,841
Debt securities	**104,158**	147,381
Treasury bills	**82,680**	125,644
Other	**16,565**	44,816
Financial assets designated at fair value	**1,801**	1,728
Debt securities	**1,801**	1,722
Other	**–**	6
Derivatives	**230,998**	452,209
Advances to customers	**752,574**	817,996
Financial investments: Debt securities	**515,923**	311,412
Amounts due from group companies	**161,755**	397,961
Other assets	**32,469**	42,455
Acceptances and endorsements	**16,073**	26,006
Other	**16,396**	16,449
Financial guarantees and other credit-related contingent liabilities	**72,006**	83,039
Loan commitments and other credit-related commitments	**846,106**	954,725
At 31 December	**3,709,156**	4,060,734

Note 17b shows the analysis of advances to customers by industry sector and by geographical region.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Credit quality of financial instruments

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	Impaired

Quality classification definitions:

- Strong: Exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.
- Medium: Exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery processes.
- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.
- Impaired: Exposures have been assessed, individually or collectively, as impaired. The group observes the conservative disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ('Expected Loss') grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

The group's policy in respect of impairment on loans and advances and debt securities is set out in notes 4d and 4g on the Financial Statements. Analysis of impairment allowances as at 31 December 2009 and the movement of such allowances during the year are disclosed in note 18.

Granular risk rating scales:

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

The basis of reporting reflects risk rating systems under the Group's Basel II programme and to extend the range of financial instruments covered in the presentation of portfolio quality.

Impairment is not measured for financial instruments 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 the income statement.

52 Risk Management *(continued)*

Distribution of financial instruments by credit quality

Group	*Neither past due nor impaired*						
31 December 2009	*Strong* **HK$m**	*Medium*[1] **HK$m**	*Sub-standard* **HK$m**	*Past due not impaired* **HK$m**	*Impaired* **HK$m**	*Impairment allowances* **HK$m**	*Total* **HK$m**
Items in the course of collection from other banks	**13,831**	**1,696**	**1**	**–**	**–**	**–**	**15,528**
Trading assets	**276,294**	**30,076**	**2,581**	**–**	**–**	**–**	**308,951**
– treasury and other eligible bills	**142,907**	**1,880**	**889**	**–**	**–**	**–**	**145,676**
– debt securities	**114,097**	**23,349**	**574**	**–**	**–**	**–**	**138,020**
– loans and advances to banks	**18,272**	**1,076**	**1,118**	**–**	**–**	**–**	**20,466**
– loans and advances to customers	**1,018**	**3,771**	**–**	**–**	**–**	**–**	**4,789**
Financial assets designated at fair value	**17,387**	**1,288**	**20**	**–**	**–**	**–**	**18,695**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**16,992**	**1,288**	**20**	**–**	**–**	**–**	**18,300**
– loans and advances to banks	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– loans and advances to customers	**395**	**–**	**–**	**–**	**–**	**–**	**395**
Derivatives	**179,579**	**53,212**	**2,380**	**–**	**–**	**–**	**235,171**
Loans and advances held at amortised cost	**1,154,942**	**680,483**	**37,734**	**24,501**	**16,196**	**(14,280)**	**1,899,576**
– loans and advances to banks	**452,387**	**94,425**	**2,027**	**93**	**–**	**–**	**548,932**
– loans and advances to customers	**702,555**	**586,058**	**35,707**	**24,408**	**16,196**	**(14,280)**	**1,350,644**
Financial investments	**1,135,488**	**84,012**	**1,838**	**–**	**46**	**–**	**1,221,384**
– treasury and other eligible bills	**344,172**	**14,297**	**1,069**	**–**	**–**	**–**	**359,538**
– debt securities	**791,316**	**69,715**	**769**	**–**	**46**	**–**	**861,846**
Other assets	**15,438**	**37,379**	**1,544**	**296**	**87**	**–**	**54,744**
– endorsements and acceptances	**3,788**	**17,097**	**1,258**	**14**	**54**	**–**	**22,211**
– other	**11,650**	**20,282**	**286**	**282**	**33**	**–**	**32,533**

1 *Includes HK$62,029 million (31 December 2008: HK$60,715 million) of treasury and eligible bills and debt securities that have been classified as BBB– to BBB+ using the ratings of Standard & Poor's.*

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Group	*Neither past due nor impaired*						
	Strong	*Medium*[1]	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2008	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Items in the course of collection from other banks	12,344	1,605	–	–	–	–	13,949
Trading assets	443,134	34,804	563	3,157	–	–	481,658
– treasury and other eligible bills	238,083	533	162	–	–	–	238,778
– debt securities	159,247	27,946	43	–	–	–	187,236
– loans and advances to banks	38,506	2,230	356	3,157	–	–	44,249
– loans and advances to customers	7,298	4,095	2	–	–	–	11,395
Financial assets designated at fair value	18,209	1,527	–	–	–	–	19,736
– treasury and other eligible bill	–	–	–	–	–	–	–
– debt securities	18,209	1,521	–	–	–	–	19,730
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	6	–	–	–	–	6
Derivatives	375,566	73,558	4,761	1	37	–	453,923
Loans and advances held at amortised cost	1,058,105	557,570	31,752	28,896	13,080	(10,958)	1,678,445
– loans and advances to banks	364,370	26,070	1,543	317	–	–	392,300
– loans and advances to customers	693,735	531,500	30,209	28,579	13,080	(10,958)	1,286,145
Financial investments	667,162	70,624	–	251	212	–	738,249
– treasury and other eligible bills	120,458	11,193	–	–	–	–	131,651
– debt securities	546,704	59,431	–	251	212	–	606,598
Other assets	19,682	44,035	1,986	386	50	–	66,139
– endorsements and acceptances	7,044	22,888	1,365	142	14	–	31,453
– other	12,638	21,147	621	244	36	–	34,686

52 Risk Management *(continued)*

Bank	*Neither past due nor impaired*						
	Strong	*Medium*[1]	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Items in the course of collection from other banks	**9,456**	**1,694**	**1**	**–**	**–**	**–**	**11,151**
Trading assets	**177,847**	**24,131**	**1,425**	**–**	**–**	**–**	**203,403**
– treasury and other eligible bills	**80,010**	**1,781**	**889**	**–**	**–**	**–**	**82,680**
– debt securities	**85,524**	**18,313**	**321**	**–**	**–**	**–**	**104,158**
– loans and advances to banks	**11,316**	**629**	**215**	**–**	**–**	**–**	**12,160**
– loans and advances to customers	**997**	**3,408**	**–**	**–**	**–**	**–**	**4,405**
Financial assets designated at fair value	**941**	**860**	**–**	**–**	**–**	**–**	**1,801**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**941**	**860**	**–**	**–**	**–**	**–**	**1,801**
– loans and advances to banks	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– loans and advances to customers	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Derivatives	**177,542**	**51,109**	**2,347**	**–**	**–**	**–**	**230,998**
Loans and advances held at amortised cost	**646,717**	**416,030**	**19,172**	**13,282**	**10,061**	**(9,851)**	**1,095,411**
– loans and advances to banks	**260,225**	**81,409**	**1,110**	**93**	**–**	**–**	**342,837**
– loans and advances to customers	**386,492**	**334,621**	**18,062**	**13,189**	**10,061**	**(9,851)**	**752,574**
Financial investments	**765,917**	**65,032**	**1,838**	**–**	**34**	**–**	**832,821**
– treasury and other eligible bills	**286,580**	**8,757**	**1,069**	**–**	**–**	**–**	**296,406**
– debt securities	**479,337**	**56,275**	**769**	**–**	**34**	**–**	**536,415**
Other assets	**9,002**	**22,057**	**1,292**	**37**	**81**	**–**	**32,469**
– endorsements and acceptances	**2,792**	**12,129**	**1,090**	**8**	**54**	**–**	**16,073**
– other	**6,210**	**9,928**	**202**	**29**	**27**	**–**	**16,396**

1 *Includes HK$56,784 million (31 December 2008: HK$49,849million) of treasury and eligible bills and debt securities that have been classified as BBB- to BBB+ using the ratings of Standard & Poor's*.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Bank	*Neither past due nor impaired*						
	Strong	*Medium*[1]	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2008	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
Items in the course of collection from other banks	8,304	1,604	–	–	–	–	9,908
Trading assets	283,435	30,686	563	3,157	–	–	317,841
– treasury and other eligible bills	124,949	533	162	–	–	–	125,644
– debt securities	123,492	23,846	43	–	–	–	147,381
– loans and advances to banks	27,709	2,230	356	3,157	–	–	33,452
– loans and advances to customers	7,285	4,077	2	–	–	–	11,364
Financial assets designated at fair value	1,143	585	–	–	–	–	1,728
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	1,143	579	–	–	–	–	1,722
– loans and advances to banks	–	–	–	–	–	–	–
– loans and advances to customers	–	6	–	–	–	–	6
Derivatives	376,678	70,807	4,686	1	37	–	452,209
Loans and advances held at amortised cost	674,425	374,986	21,967	18,486	8,718	(8,292)	1,090,290
– loans and advances to banks	249,332	21,103	1,543	316	–	–	272,294
– loans and advances to customers	425,093	353,883	20,424	18,170	8,718	(8,292)	817,996
Financial investments	408,911	57,189	–	251	39	–	466,390
– treasury and other eligible bills	106,841	11,157	–	–	–	–	117,998
– debt securities	302,070	46,032	–	251	39	–	348,392
Other assets	12,938	27,716	1,644	117	40	–	42,455
– endorsements and acceptances	6,186	18,475	1,218	117	10	–	26,006
– other	6,752	9,241	426	–	30	–	16,449

52 Risk Management *(continued)*

Financial instruments which were past due but not impaired aging analysis

The amounts in the following table reflect exposures designated as 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; 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*
31 December 2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost	**18,610**	**3,961**	**1,618**	**186**	**126**	**24,501**
– loans and advances to banks	**93**	–	–	–	–	**93**
– loans and advances to customers[1]	**18,517**	**3,961**	**1,618**	**186**	**126**	**24,408**
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	**84**	**96**	**54**	**31**	**31**	**296**
	18,694	**4,057**	**1,672**	**217**	**157**	**24,797**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Group

31 December 2008	*Up to 29 days* HK$m	*30-59 days* HK$m	*60-89 days* HK$m	*90-180 days* HK$m	*Over 180 days* HK$m	*Total* HK$m
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	3,129	28	–	–	–	3,157
– loans and advances to banks	3,129	28	–	–	–	3,157
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	1	–	–	–	–	1
Loans and advances held at amortised cost	22,292	3,777	1,975	736	116	28,896
– loans and advances to banks	317	–	–	–	–	317
– loans and advances to customers[1]	21,975	3,777	1,975	736	116	28,579
Financial investments	251	–	–	–	–	251
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	251	–	–	–	–	251
Other assets	108	127	78	45	28	386
	25,781	3,932	2,053	781	144	32,691

52 Risk Management *(continued)*

Bank

31 December 2009	*Up to 29 days* HK$m	*30-59 days* HK$m	*60-89 days* HK$m	*90-180 days* HK$m	*Over 180 days* HK$m	*Total* HK$m
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–
Loans and advances held at amortised cost	**9,910**	**2,211**	**925**	**145**	**91**	**13,282**
– loans and advances to banks	**93**	–	–	–	–	**93**
– loans and advances to customers[1]	**9,817**	**2,211**	**925**	**145**	**91**	**13,189**
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	**24**	**7**	**4**	**1**	**1**	**37**
	9,934	**2,218**	**929**	**146**	**92**	**13,319**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Bank

31 December 2008	*Up to 29 days* HK$m	*30-59 days* HK$m	*60-89 days* HK$m	*90-180 days* HK$m	*Over 180 days* HK$m	*Total* HK$m
Items in the course of collection from other banks	–	–	–	–	–	–
Trading assets	3,129	28	–	–	–	3,157
– loans and advances to banks	3,129	28	–	–	–	3,157
– loans and advances to customers	–	–	–	–	–	–
Financial assets designated at fair value	–	–	–	–	–	–
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	–	–
Derivatives	1	–	–	–	–	1
Loans and advances held at amortised cost	14,404	2,249	1,387	396	50	18,486
– loans and advances to banks	316	–	–	–	–	316
– loans and advances to customers[1]	14,088	2,249	1,387	396	50	18,170
Financial investments	251	–	–	–	–	251
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	251	–	–	–	–	251
Other assets	73	30	–	13	1	117
	17,858	2,307	1,387	409	51	22,012

1 *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 4d.

Analyses of impairment allowances at 31 December 2009 and the movement of such allowances during the year are disclosed in note 18.

52 Risk Management *(continued)*

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 appropriately balanced and all funding obligations are met when due.

It is the responsibility of local management to ensure compliance with local regulatory requirements and limits set by the Group/regional head office. Liquidity is managed on a daily basis by local treasury functions, with the larger treasury sites providing support to smaller entities where required.

Compliance with liquidity requirements is monitored by local Asset and Liability Management Committees ('ALCO') which report to the group's Head Office on a regular basis. This process includes:

- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to deposit ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined limits;
- maintaining debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic 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.

A maturity analysis of assets and liabilities is disclosed in note 40, while an analysis of possible cash flows under contractual terms is disclosed in note 41.

52 Risk Management *(continued)*

Liquidity and advances to deposit ratios

The group emphasises the importance of core current accounts and savings accounts as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on group banking entities which restrict their ability to increase loans and advances to customers without corresponding growth in current accounts and savings accounts. This measure is referred to as the 'advances to deposit' ratio.

The ratio describes loans and advances as a percentage of the total of core customer current and savings accounts and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to deposits ratio, as are current accounts and savings deposits from customers deemed to be non-core. The definition of a non-core deposit includes a consideration of the size of the customer's total deposit balance. Due to the distinction between core and non-core depositors, the group's measure of advances to deposits will be more restrictive than that which could be inferred from the published financial statements.

Another measure used by the group for managing liquidity risk is the ratio of net liquid assets to customer liabilities. Net liquid assets are liquid assets less all funds maturing in the next 30 days from wholesale market sources and from customers who are deemed to be professional. For this purpose, the group defines liquid assets as cash balances, short-term interbank deposits and highly-rated debt securities available for immediate sale and for which a deep and liquid market exists. Contingent liquidity risk associated with committed loan facilities is not reflected in the ratios. The group's framework for monitoring this risk is outlined under 'Contingent liquidity risk' below.

Advances to deposit ratios and ratios of net liquid assets to customer liabilities are provided in the following table based on the month end figures, along with the Hong Kong dollar equivalents of net liquid assets:

	Advances to deposits ratio		*Ratio of net liquid assets to customer liabilities*		*Net liquid assets*	
	2009	2008	**2009**	2008	**2009**	2008
	%	%	**%**	%	**HK$ bn**	HK$ bn
Year-end	**70.9**	77.4	**30.0**	25.0	**658.2**	500.9
Maximum	**77.4**	82.9	**35.0**	25.0	**757.9**	500.9
Minimum	**68.6**	76.7	**25.0**	19.9	**500.9**	398.8
Average	**71.5**	80.6	**30.7**	21.9	**659.3**	440.8

Projected cash flow scenario analysis

The group uses a number of standard projected cash flow scenarios designed to model both group-specific and market-wide liquidity crises, in which the rate and timing of deposit withdrawls and drawdowns on committed lending facilities are varied, and the ability to access interbank funding and term debt markets and to generate funds from asset portfolios is restricted. The scenarios are modelled by all group banking entities. The appropriateness of the assumptions under each scenario is regularly reviewed.

Contingent liquidity risk

In the normal course of business, group entities provide customers with committed facilities and standby facilities to corporate customers. These facilities increase the funding requirements of the group when customers choose to raise drawdown levels over and above their normal utilisation rates. The liquidity risk consequences of increased levels of drawdown are analysed in the form of projected cash flows under different stress scenarios. Limits are set for non-cancellable contingent funding commitments by group after due consideration of each entity's ability to fund them. The limits are split according to the borrower and the size of the committed line.

Liquidity ratio under Hong Kong Banking Ordinance

The Hong Kong Banking Ordinance also requires banks operating in Hong Kong to maintain a minimum liquidity ratio. The requirement applies separately to the Hong Kong branches of the Bank and to those subsidiary companies which are Authorised Institutions under the Banking Ordinance in Hong Kong.

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c *Market risk*

Market risk is the risk that movements in foreign exchange rates, interest rates, credit spreads, or equity and commodity prices will result in profits or losses to the group. Market risk arises on financial instruments which are measured at fair value and those which are measured at amortised cost. The objective of market risk management is to control market risk exposures to achieve an optimal return while maintaining risk at acceptable levels.

The group monitors market risk separately for trading portfolios and non-trading portfolios. Trading portfolios include positions arising from market-making in exchange rate, interest rate, credit and equity derivative instruments, as well as in debt and equity securities. Trading risks arise either from customer-related business or from proprietary position-taking.

The management of market risk is principally undertaken in Global Markets through risk limits approved by the group's Executive Committee. Traded Credit and Market Risk, an independent unit within the Global Banking and Markets operation, develops risk management policies and measurement techniques.

Risk limits are determined for each location and, within location, for each portfolio. Limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk limits at a portfolio level. Similarly, option risks are controlled through full revaluation limits in conjunction with limits on the underlying variables that determine each option's value.

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (99 per cent for the group). VAR is calculated daily.

The group uses a historical simulation model which derives plausible future scenarios from historical market data. Potential movements in market prices are calculated with reference to market data from the last two years. The model used assumes a 1-day holding period, as this reflects the way the risk positions are managed.

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% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and

52 Risk Management *(continued)*

- 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 the VAR limits with other position and sensitivity limit structures, as well as with stress testing, both on individual portfolios and on a consolidated basis. The group's stress testing regime provides senior management with an assessment of the impact of extreme events on the market risk exposures of the group.

Fair value and price verification control

Where certain financial instruments are carried on the group's balance sheet at fair values, the valuation and the related price verification processes are subject to independent validation across the group. Financial instruments which are accounted for on a fair value basis include assets held in the trading portfolio, financial instruments designated at fair value, obligations relating to securities sold short, derivative financial instruments and available-for-sale securities.

The determination of fair values is therefore a significant element in the reporting of the group's Global Markets activities.

Responsibility for determining accounting policies and procedures governing valuation and validation ultimately rests with finance functions which report to the group Chief Financial Officer. All significant valuation policies, and any changes thereto, must be approved by senior finance management. The Finance functions have ultimate responsibility for the determination of fair values included in the financial statements, and for ensuring that the group's policies comply with all relevant accounting standards.

Trading

The group's control of market risk is based on restricting individual operations to trading within a list of permissible instruments authorised for each site by Traded Credit and Market Risk, and enforcing rigorous new product approval procedures. In particular, trading in the more complex derivative products is concentrated in offices with appropriate levels of product expertise and robust control systems.

In addition, at both portfolio and position levels, market risk in trading portfolios is monitored and controlled using a complementary set of techniques such as VAR and present value of a basis point, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

52 Risk Management *(continued)*

The total VAR for Global Markets was as follows:

	Group		*Bank*	
	2009	2008	**2009**	2008
	HK$m	HK$m	**HK$m**	HK$m
Total VAR				
Year end	**296**	210	**248**	206
Average	**245**	191	**226**	165
Maximum	**339**	288	**298**	213
Minimum	**184**	122	**171**	120
Total interest rate VAR				
Year end	**258**	193	**235**	198
Average	**230**	184	**214**	161
Maximum	**312**	291	**282**	212
Minimum	**160**	121	**166**	123
Trading VAR				
Year end	**172**	132	**187**	112
Average	**139**	121	**137**	114
Maximum	**213**	179	**222**	180
Minimum	**92**	80	**87**	75
Total Foreign exchange VAR				
Year end	**28**	44	**35**	42
Average	**36**	24	**34**	24
Maximum	**82**	45	**74**	42
Minimum	**15**	8	**14**	10
Foreign exchange trading VAR				
Year end	**31**	35	**41**	46
Average	**33**	23	**32**	22
Maximum	**72**	37	**81**	46
Minimum	**13**	10	**14**	12
Interest rate trading VAR				
Year end	**127**	97	**133**	96
Average	**127**	112	**128**	105
Maximum	**173**	173	**176**	146
Minimum	**82**	73	**81**	66
Equity trading VAR[1]				
Year end	**26**	56	**26**	56
Average	**36**	43	**34**	43
Maximum	**104**	97	**104**	97
Minimum	**10**	17	**10**	17

1 *In addition to equity trading positions managed by Global Markets, the group also has exposure to changes in equity prices and interest rates relating to guarantees given to customers who purchase certain HSBC investment contracts. As at 31 December 2009, a 10 per cent decrease in equity prices would reduce profit before tax and net assets by HK$123 million (2008: HK$113 million) and 100 basis points decrease in interest rate would reduce profit before tax and net assets by HK$31 million (2008: HK$51 million).*

52 Risk Management *(continued)*

Non-trading portfolios

Market 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. Analysis of this risk 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. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of the local Asset and Liability Management Committee ('ALCO').

The transfer of market risk to books managed by Global Markets 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. Local ALCOs regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by senior management.

As noted above, in certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to alternative investment products and the precise prepayment speeds of mortgages will vary at different interest rate levels. In such circumstances, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

Within the group, banking entities also monitor the sensitivity of projected net interest income under varying interest rate scenarios. 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.

A large part of the group's exposure to changes in net interest income arising from movements in interest rates relates to its core deposit franchise. The group's core deposit franchise is exposed to changes in the value of the deposits raised and spreads against wholesale funds. The value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is, however, asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.

Structural foreign exchange exposure

The group's gross structural foreign exchange exposure is represented by the net asset value of the group's foreign currency investments in subsidiaries, branches and associates, and the fair value of the group's long-term foreign currency equity investments.

The group's structural foreign currency exposures are managed by the group's ALCO with the primary objective of ensuring where practical, that the group's and the Bank's capital ratios are protected from the effect of changes in exchange rates. The group considers hedging structural foreign currency exposures only in limited circumstances to protect the capital ratios or the value of capital invested. Such hedging would be undertaken using foreign exchange contracts or by financing with borrowings in the same currencies as the functional currencies involved.

Foreign currency investments amounted to the foreign currency equivalent of HK$209,431 million (85 per cent of shareholders' funds) at 31 December 2009, an increase of HK$52,123 million from HK$157,308 million (81 per cent of shareholders' funds) at 31 December 2008. Gains or losses on structural foreign currency exposures are taken to reserves.

52 Risk Management *(continued)*

The group had the following structural foreign currency exposures that were not less than 10 per cent of the total net structural foreign currency positions in all foreign currencies:

	Group		*Bank*	
At 31 December 2009	**LCYm**	**HK$m**	**LCYm**	**HK$m**
Chinese renminbi	**95,389**	**108,347**	**40,088**	**45,534**
Indian rupees	**150,789**	**25,073**	**108,625**	**18,062**
Korean won	**1,674,579**	**11,146**	**1,542,518**	**10,267**

	Group		*Bank*	
At 31 December 2008	LCYm	HK$m	LCYm	HK$m
Chinese renminbi	73,792	83,819	23,812	27,048
Indian rupees	133,870	21,339	105,420	16,804
Korean won	1,593,044	9,802	1,469,202	9,040

Non-structural positions

The group had the following non-structural foreign currency positions that were not less than 10 per cent of the net non-structural positions in all foreign currencies:

Group

	United States dollars	*Singapore dollars*	*Brunei dollars*	*Chinese Renminbi*
At 31 December 2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Spot assets	**3,053,837**	**247,020**	**84,729**	**109,807**
Spot liabilities	**(3,010,444)**	**(311,720)**	**(27,308)**	**(92,862)**
Forward purchases	**2,560,540**	**189,887**	**170**	**342,940**
Forward sales	**(2,632,313)**	**(120,564)**	**(62,207)**	**(361,662)**
Net options positions	**13,870**	**–**	**–**	**–**
	(14,510)	**4,623**	**(4,616)**	**(1,777)**

	United States dollars	*Singapore dollars*	*Brunei dollars*	*Chinese Renminbi*
At 31 December 2008	HK$m	HK$m	HK$m	HK$m
Spot assets	2,947,677	113,295	73,565	97,229
Spot liabilities	(2,922,971)	(168,458)	(26,390)	(77,588)
Forward purchases	3,127,618	292,172	131	406,545
Forward sales	(3,160,163)	(234,203)	(50,115)	(428,163)
Net options positions	19,173	(12)	–	–
	11,334	2,794	(2,809)	(1,977)

Bank

	United States dollars	*Singapore dollars*	*Brunei dollars*	*Chinese Renminbi*
	HK$m	**HK$m**	**HK$m**	**HK$**
At 31 December 2009	**(18,682)**	**4,624**	**(4,624)**	**2,588**
At 31 December 2008	812	2,797	(2,809)	4,521

The net options positions reported above are calculated using the delta-weighted position of the options contracts.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

d *Operational risk*

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

The group manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken 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 learnt from publicised operational failures within the financial services industry.

The HSBC 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 HSBC Group's Audit Committee; and
- risk mitigation, including insurance, is considered where this is cost-effective.

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

Additional reviews and tests are conducted in the event that any HSBC office is affected by a business disruption event, to incorporate lessons learnt 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.

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e *Insurance risk*

Risk management objectives and policies for management of insurance risk

The group is exposed to the uncertainty surrounding the timing and severity of claims under insurance contracts. Contracts under which the group accepts significant insurance risk from another party by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event adversely affects the policyholder or other beneficiary are classified as insurance contracts. The principal insurance risk faced by the group is that, over time, the combined cost of claims, benefits, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income. The cost of a claim can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element the performance of the assets held to support the liabilities. Contracts under which the transfer of insurance risk from the policyholder to the group is not significant are classified as investment contracts or service contracts. Insurance risk is risk other than financial risk. Insurance contracts may also transfer some financial risk. Details of financial risk are disclosed below.

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.

All insurance products, whether internally manufactured or provided by a third party manufacturer, are reviewed by a product and pricing committee. Several methods are used 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.

52 Risk Management *(continued)*

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

Asset/liability management

A principal tool used by the group to manage its exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. The group actively manages its assets using an approach that considers asset quality, diversification, asset/liability matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Markets and Liquidity Risk Committee reviews and approves target portfolios on a periodic basis, establishes investment guidelines and limits, and provides oversight of the asset/liability management process.

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

The following table shows the composition of assets and liabilities for each major insurance product category. 94% of both assets and liabilities are derived from Hong Kong.

Statement of financial position of insurance subsidiaries by type of contract

	Life linked contracts[1] HK$m	*Life non-linked contracts*[2] HK$m	*Non-life insurance* HK$m	*Other Assets*[3] HK$m	*Total* HK$m
At 31 December 2009					
Financial assets:					
– financial assets designated at fair value	**23,689**	**16,996**	**274**	**2,741**	**43,700**
– derivatives	**9**	**154**	**–**	**–**	**163**
– financial investments	**–**	**107,550**	**1,498**	**6,528**	**115,576**
– other financial assets	**2,889**	**18,892**	**1,021**	**1,277**	**24,079**
Total financial assets	**26,587**	**143,592**	**2,793**	**10,546**	**183,518**
Reinsurance assets	**6,237**	**67**	**387**	**87**	**6,778**
PVIF[4]	**–**	**–**	**–**	**10,554**	**10,554**
Other assets	**5**	**1,647**	**168**	**2,146**	**3,966**
Total assets	**32,829**	**145,306**	**3,348**	**23,333**	**204,816**
Liabilities under investment contracts designated at fair value	**6,898**	**26,951**	**–**	**–**	**33,849**
Liabilities under insurance contacts	**25,846**	**116,449**	**2,633**	**–**	**144,928**
Deferred tax	**1**	**69**	**–**	**1,842**	**1,912**
Other liabilities	**–**	**–**	**–**	**2,621**	**2,621**
Total liabilities	**32,745**	**143,469**	**2,633**	**4,463**	**183,310**
Total equity	**–**	**–**	**–**	**21,506**	**21,506**
Total equity and liabilities	**32,745**	**143,469**	**2,633**	**25,969**	**204,816**

52 Risk Management *(continued)*

	Life linked contracts[1] HK$m	*Life non-linked contracts*[2] HK$m	*Non-life insurance* HK$m	*Other assets*[3] HK$m	*Total* HK$m
At 31 December 2008					
Financial assets:					
– financial assets designated at fair value	16,130	16,875	213	3,469	36,687
– derivatives	5	900	–	–	905
– financial investments	–	77,402	1,369	4,775	83,546
– other financial assets	2,365	20,211	914	1,276	24,766
Total financial assets	18,500	115,388	2,496	9,520	145,904
Reinsurance assets	7,334	144	361	101	7,940
PVIF[4]	–	–	–	7,638	7,638
Other assets	7	1,304	129	1,738	3,178
Total assets	25,841	116,836	2,986	18,997	164,660
Liabilities under investment contracts designated at fair value	5,707	25,083	–	–	30,790
Liabilities under insurance contacts	20,044	90,643	2,602	–	113,289
Deferred tax	52	115	–	1,229	1,396
Other liabilities	–	–	–	1,805	1,805
Total liabilities	25,803	115,841	2,602	3,034	147,280
Total equity	–	–	–	17,380	17,380
Total equity and liabilities	25,803	115,841	2,602	20,414	164,660

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

Underwriting strategy

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

Reinsurance strategy

The group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. The group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The group also utilises reinsurance to transfer out financial risk arising from guaranteeing minimum investment performance under a specific unit-linked insurance product, and uses reinsurance agreements with both affiliated and non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

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

52 Risk Management *(continued)*

Nature of risks covered

The following gives an assessment of the nature of risks inherent in the group’s main products:

(i) Insurance contracts – non-linked products

The basic feature of 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 may be provided. Discretionary participation features allow policyholders to participate in the profits of the life fund by means of annual bonuses. The group has complete contractual discretion on the bonuses declared. It is the group’s goal to maintain a smooth dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable.

(ii) Insurance contracts – unit-linked products

The group writes unit-linked life insurance policies, which typically provide policyholders with life insurance protection and choice of investment in a variety of funds. Premiums received are deposited into the chosen funds after deduction of premium fees. Other charges for the cost of insurance and administration are deducted from the funds accumulated. Where policyholders bear the market risk on linked products that enjoy no performance guarantees, the group manages the policyholders’ exposure to market risk in a manner consistent with any parameters set out in the policy documents. Where there is a performance guarantee, the risk is managed through reinsurance.

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

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

(iv) Investment contracts – unit-linked products

The group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the group does not bear investment risk for most of the funds. Although scheme members bear the market risk on the funds, the group manages 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 risk 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.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Concentrations 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, conflagration, 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 insurance 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, Macau, mainland China, Taiwan, Singapore, Malaysia, India and South Korea.

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 on page 188.

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 is 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. The liabilities for non-linked contracts are set by reference to a range of assumptions which mainly include interest rate and mortality levels. The process used to determine the assumptions is intended to result in stable and prudent estimates of future outcomes. This is achieved by adopting relatively conservative assumptions which can withstand a reasonable range of fluctuation of actual experience. An annual review of the relevant experience is performed to ensure a margin exists between the assumptions adopted and the most likely estimate of future outcome. By definition, the group is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 33. 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[1]

	2009	2008
	HK$m	HK$m
Accident and health	**1,291**	1,244
Fire and other damage	**235**	227
Motor	**262**	220
Liability	**141**	136
Marine, aviation and transport	**96**	116
Other (non-life)	**335**	287
Total net written insurance premiums	**2,360**	2,230

1 *Net written insurance premiums represent gross written premiums less gross written premiums ceded to reinsurers.*

52 Risk Management *(continued)*

Financial risks

Transactions in financial instruments may result in the group assuming financial risks. These include market risk, credit risk and liquidity risk. Each of these financial risks is described below, together with a summary of the ways in which the group manages these risks arising from underwriting insurance business.

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

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

Financial assets held by insurance manufacturing operations

	At 31 December 2009				
	Life linked contracts **HK$m**	*Life non-linked contracts* **HK$m**	*Non-life insurance* **HK$m**	*Other assets* **HK$m**	*Total* **HK$m**
Financial assets designated at fair value					
Debt securities	**277**	**13,032**	**274**	**2,741**	**16,324**
Equity securities	**23,412**	**3,964**	**–**	**–**	**27,376**
	23,689	**16,996**	**274**	**2,741**	**43,700**
Financial investments					
Held-to-maturity:					
Debt securities	**–**	**104,086**	**1,441**	**5,196**	**110,723**
	–	**104,086**	**1,441**	**5,196**	**110,723**
Available-for-sale:					
Treasury bills	**–**	**–**	**–**	**–**	**–**
Debt securities	**–**	**3,464**	**57**	**555**	**4,076**
Equity securities	**–**	**–**	**–**	**777**	**777**
	–	**3,464**	**57**	**1,332**	**4,853**
Derivatives	**9**	**154**	**–**	**–**	**163**
Other financial assets	**2,889**	**18,892**	**1,021**	**1,277**	**24,079**
	26,587	**143,592**	**2,793**	**10,546**	**183,518**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Financial assets held by insurance manufacturing operations

	At 31 December 2008				
	Life linked contracts HK$m	*Life non-linked contracts* HK$m	*Non-life insurance* HK$m	*Other assets* HK$m	*Total* HK$m
Financial assets designated at fair value					
Debt securities	196	13,301	213	3,469	17,179
Equity securities	15,934	3,574	–	–	19,508
	16,130	16,875	213	3,469	36,687
Financial investments					
Held-to-maturity:					
Debt securities	–	76,699	1,320	3,954	81,973
	–	76,699	1,320	3,954	81,973
Available-for-sale:					
Treasury bills	–	34	49	–	83
Debt securities	–	669	–	281	950
Equity securities	–	–	–	540	540
	–	703	49	821	1,573
Derivatives	5	900	–	–	905
Other financial assets	2,365	20,211	914	1,276	24,766
	18,500	115,388	2,496	9,520	145,904

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 14.5 per cent of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2009 (*2008: 12.7 per cent*). The table also shows that approximately 71.4 per cent of financial assets were invested in debt securities at 31 December 2009 (*2008: 68.6 per cent*) with 15.3 per cent (*2008: 13.7 per cent*) invested in equity securities.

Market risk

Market risk can be further sub-categorised into interest rate risk, equity risk and foreign currency risk. Each of these categories is discussed further below.

Interest rate risk

The group's exposure to interest rate risk arises mainly from its debt securities holdings. The held-to-maturity strategy accounts for a significant portion of the debt securities holdings and 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 mechanism.

52 Risk Management *(continued)*

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

	31 December 2009		31 December 2008	
	Impact on profit for the year	*Impact on net assets*	*Impact on profit for the year*	*Impact on net assets*
	HK$m	**HK$m**	HK$m	HK$m
+ 100 basis points shift in yield curves	**385**	**78**	384	370
– 100 basis points shift in yield curves	**(349)**	**(35)**	(227)	(213)

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

Equity risk

The portfolio of marketable equity securities, which the 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 industries, and concentrations in any one company or industry are limited by parameters established by senior management, as well as by statutory requirements.

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

	31 December 2009		31 December 2008	
	Impact on profit for the year	*Impact on net assets*	*Impact on profit for the year*	*Impact on net assets*
	HK$m	**HK$m**	HK$m	HK$m
10 per cent increase in equity prices	**67**	**141**	43	43
10 per cent decrease in equity prices	**(67)**	**(141)**	(43)	(43)

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 predominantly matching the assets with liabilities in the same currency, effectively reducing the foreign currency exchange rate exposure. Limits are set to ensure that the net foreign currency exposure is kept to an acceptable level. The group uses forward exchange contracts and swaps to manage its foreign currency risk.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Credit risk

The group's portfolio of fixed income securities, and to a lesser extent short-term and other investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place and limits are established to manage credit quality and concentration risk. The following table presents the analysis of the treasury bills, other eligible bills and debt securities within the group's insurance business. The definition of the four credit quality classifications are included on page 171. Only assets supporting non-linked liabilities are included in the table as financial risk on assets supporting linked liabilities is predominantly borne by the policyholders. 98.4 per cent (*2008: 98.7 per cent*) of the assets included in the table are invested in investments rated as 'Strong'.

	Neither past due nor impaired						
	Strong	*Medium*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
31 December 2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	**12,959**	**327**	**20**	–	–	–	**13,306**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	**12,959**	**327**	**20**	–	–	–	**13,306**
Financial investments	**107,316**	**1,732**	–	–	–	–	**109,048**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	**107,316**	**1,732**	–	–	–	–	**109,048**
Supporting shareholders funds[1]							
Financial assets designated at fair value	**2,733**	**8**	–	–	–	–	**2,741**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	**2,733**	**8**	–	–	–	–	**2,741**
Financial investments	**5,744**	**7**	–	–	–	–	**5,751**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	**5,744**	**7**	–	–	–	–	**5,751**
Total							
Financial assets designated at fair value	**15,692**	**335**	**20**	–	–	–	**16,047**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	**15,692**	**335**	**20**	–	–	–	**16,047**
Financial investments	**113,060**	**1,739**	–	–	–	–	**114,799**
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	**113,060**	**1,739**	–	–	–	–	**114,799**

52 Risk Management *(continued)*

31 December 2008	*Neither past due nor impaired* *Strong* HK$m	*Medium* HK$m	*Sub-standard* HK$m	*Past due not impaired* HK$m	*Impaired* HK$m	*Impairment allowances* HK$m	*Total* HK$m
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	12,694	820	–	–	–	–	13,514
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	12,694	820	–	–	–	–	13,514
Financial investments	78,361	410	–	–	–	–	78,771
– treasury and other eligible bills	83	–	–	–	–	–	83
– debt securities	78,278	410	–	–	–	–	78,688
Supporting shareholders funds[1]							
Financial assets designated at fair value	3,464	5	–	–	–	–	3,469
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	3,464	5	–	–	–	–	3,469
Financial investments	4,218	17	–	–	–	–	4,235
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	4,218	17	–	–	–	–	4,235
Total							
Financial assets designated at fair value	16,158	825	–	–	–	–	16,983
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	16,158	825	–	–	–	–	16,983
Financial investments	82,579	427	–	–	–	–	83,006
– treasury and other eligible bills	83	–	–	–	–	–	83
– debt securities	82,496	427	–	–	–	–	82,923

1 *Shareholders' funds comprise solvency and unencumbered assets.*

Notes on the Financial Statements (continued)

52 Risk Management *(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*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
31 December 2009							
Linked insurance contracts	**4**	**6,233**	**–**	**–**	**–**	**–**	**6,237**
Non-linked insurance contracts	**412**	**42**	**–**	**–**	**–**	**–**	**454**
Total	**416**	**6,275**	**–**	**–**	**–**	**–**	**6,691**
Reinsurance debtors	**15**	**11**	**–**	**61**	**–**	**–**	**87**
31 December 2008							
Linked insurance contracts	1	7,333	–	–	–	–	7,334
Non-linked insurance contracts	450	55	–	–	–	–	505
Total	451	7,388	–	–	–	–	7,839
Reinsurance debtors	17	2	–	82	–	–	101

The group has sold a unit-linked life insurance product which provides guaranteed minimum death benefits and guaranteed minimum accumulated benefits which are underwritten by the group but reinsured by a third party. The group has a credit risk exposure in respect of the third party's ability to meet its reinsurance obligation. At 31 December 2009, the exposure to the third party was HK$6,231 million (*2008: HK$7,333 million*).

Liquidity risk

There are three components of liquidity risk. The first of these arises in normal market conditions and is referred to as funding liquidity risk, specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, there is market liquidity risk where the size of a particular holding may be sufficiently large that a sale cannot be completed at or around the market price. Finally, there is standby liquidity risk which refers to the capacity to meet payment conditions in abnormal conditions.

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.

52 Risk Management *(continued)*

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

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year	*1-5 years*	*5-15 years*	*Over 15 years*	*Total*
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**
At 31 December 2009					
Non-life insurance	**1,573**	**720**	**276**	**64**	**2,633**
Life insurance (non-linked)	**9,151**	**62,212**	**115,826**	**115,823**	**303,012**
Life insurance (linked)	**1,733**	**9,752**	**14,296**	**37,705**	**63,486**
	12,457	**72,684**	**130,398**	**153,592**	**369,131**
At 31 December 2008					
Non-life insurance	1,551	831	221	–	2,603
Life insurance (non-linked)	7,814	46,947	112,193	87,843	254,797
Life insurance (linked)	8,561	4,596	12,543	32,126	57,826
	17,926	52,374	124,957	119,969	315,226

Remaining contractual maturity of investment contract liabilities

	Linked investment contracts	*Non-linked investment contracts*	*Investment contracts with DPF*	*Total*
At 31 December 2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Remaining contractual maturity				
– due within 1 year	**94**	**201**	**112**	**407**
– due between 1 and 5 years	**–**	**–**	**157**	**157**
– due between 5 and 10 years	**345**	**–**	**–**	**345**
– due after 10 years	**–**	**–**	**–**	**–**
– undated[1]	**6,459**	**26,750**	**–**	**33,209**
	6,898	**26,951**	**269**	**34,118**
At 31 December 2008				
Remaining contractual maturity				
– due within 1 year	59	235	4	298
– due between 1 and 5 years	–	165	256	421
– due between 5 and 10 years	–	237	–	237
– due after 10 years	82	327	–	409
– undated[1]	5,566	24,119	–	29,685
	5,707	25,083	260	31,050

1 *In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. The surrender values may be significantly lower than the amounts shown above.*

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

The group's life insurance business is accounted for using the embedded value approach, which, *inter alia*, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2009 was HK$10,554 million (*2008: HK$7,638 million*). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2009 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

52 Risk Management *(continued)*

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

	Impact on 2009 results **HK$m**	*Impact on 2008 results* HK$m
+ 100 basis points shift in risk-free rate	**1,296**	1,155
– 100 basis points shift in risk-free rate	**(773)**	(561)
+ 100 basis points shift in risk discount rate	**(640)**	(492)
– 100 basis points shift in risk discount rate	**734**	564
+ 100 basis points shift in expenses inflation	**(35)**	(24)
– 100 basis points shift in expenses inflation	**31**	21
+ 100 basis points shift in lapse rate	**1,444**	1,207
– 100 basis points shift in lapse rate	**(1,221)**	(1,181)

The effects on PVIF shown above are illustrative only and employ simplified scenarios. They do not incorporate actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

Non-economic assumptions

Non-economic assumptions including, for non-life manufacturers, claims costs and expense rates and, for life manufactures, mortality and/or morbidity, lapse rates and expense rates, are also used for the determination of the policyholder liabilities and PVIF. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2009 across all insurance underwriting subsidiaries is as follows:

	Impact on 2009 results		*Impact on 2008 results*	
	Profit after tax **HK$m**	*Net assets* **HK$m**	*Profit after tax* HK$m	*Net assets* HK$m
20 per cent increase in claims costs	**(177)**	**(177)**	(192)	(192)
20 per cent decrease in claims costs	**177**	**177**	192	192
10 per cent increase in mortality and/or morbidity rates	**(137)**	**(137)**	(123)	(123)
10 per cent decrease in mortality and/or morbidity rates	**130**	**130**	121	121
50 per cent increase in lapse rates	**586**	**586**	559	559
50 per cent decrease in lapse rates	**(422)**	**(422)**	(423)	(423)
10 per cent increase in expense rates	**(112)**	**(112)**	(92)	(92)
10 per cent decrease in expense rates	**112**	**112**	92	92

52 Risk Management *(continued)*

f *Capital management*

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

An annual capital plan is prepared by the group's ultimate holding company, HSBC Holdings plc, with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The group follows HSBC Group's policy to hold capital in a range of different forms and from diverse sources and all capital raising is agreed with major subsidiaries as part of their individual and the group's capital management process. The group raises its own non-equity core capital and subordinated debt in accordance with HSBC Group's guidelines regarding market and investor concentration, cost, market conditions, timing and maturity profile.

Each subsidiary 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, capital generated in excess of planned requirements is returned to the Bank, normally by way of dividends.

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 retention. 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, share premium account, other reserves, retained earnings, preference shares and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances.

Externally imposed capital requirements

The Hong Kong Monetary Authority supervises the group on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the group as a whole. Individual banking subsidiaries and branches 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 group migrated to the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures on 1 January 2009. From 30 March 2009, the group adopted an internal models approach to calculate its market risk in respect of specific risk for the interest rate risk category. Operational risk continues to be measured on a standardised approach.

During the year, the individual entities within the group and the group itself complied with all of the externally imposed capital requirements of the Hong Kong Monetary Authority.

Notes on the Financial Statements (continued)

53 Impact of market turmoil

a *Holdings of asset-backed securities*

The group has holdings of asset-backed securities ('ABSs'), including those represented by mortgage-backed securities ('MBSs') and by collateralised debt obligations ('CDOs').

The table below shows the group's exposure to ABSs issued by entities which are not consolidated by any HSBC Group entities. The carrying amounts of these exposures are measured at fair value.

Group

	Gross principal[1]	*CDS Gross protection*[2]	*Net principal exposure*[3]	*Carrying amount*[4]
2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Sub-prime residential mortgage related assets				
MBSs and MBS CDOs				
– high grade (AA or AAA rated)	**54**	–	**54**	**45**
– C to A rated	**562**	–	**562**	**74**
	616	–	**616**	**119**
US government-sponsored enterprises' mortgage related assets				
MBSs				
– high grade (AA or AAA rated)	**4,071**	–	**4,071**	**4,071**
Other residential mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	**3,366**	–	**3,366**	**3,142**
– C to A rated	**1**	–	**1**	**1**
– not publicly rated	**8**	–	**8**	**8**
	3,375	–	**3,375**	**3,151**
Commercial property mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	**705**	–	**705**	**636**
– C to A rated	**785**	–	**785**	**140**
– not publicly rated	–	–	–	–
	1,490	–	**1,490**	**776**
Leveraged finance-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**145**	–	**145**	**127**
Student loan-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**1,515**	–	**1,515**	**1,508**
Other assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**955**	–	**955**	**935**
– C to A rated	**249**	**(190)**	**59**	**18**
– not publicly rated	–	–	–	–
	1,204	**(190)**	**1,014**	**953**
	12,416	**(190)**	**12,226**	**10,705**

53 Impact of market turmoil *(continued)*

Group

2008	*Gross principal*[1] HK$m	*CDS Gross protection*[2] HK$m	*Net principal exposure*[3] HK$m	*Carrying amount*[4] HK$m
Sub-prime residential mortgage related assets				
MBSs and MBS CDOs				
– high grade (AA or AAA rated)	1,192	–	1,192	411
– C to A rated	2,439	–	2,439	36
	3,631	–	3,631	447
US government-sponsored enterprises' mortgage related assets				
MBSs				
– high grade (AA or AAA rated)	6,092	–	6,092	6,116
Other residential mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	4,770	–	4,770	4,266
– not publicly rated	13	–	13	–
	4,783	–	4,783	4,266
Commercial property mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	603	–	603	595
– C to A rated	25	–	25	25
– not publicly rated	3	–	3	–
	631	–	631	620
Leveraged finance-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	152	–	152	91
Student loan-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	2,037	–	2,037	1,934
– not publicly rated	7	–	7	–
	2,044	–	2,044	1,934
Other assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	1,168	–	1,168	1,116
– C to A rated	1,360	(1,352)	8	1
– not publicly rated	280	(232)	48	–
	2,808	(1,584)	1,224	1,117
	20,141	(1,584)	18,557	14,591

Notes on the Financial Statements (continued)

53 Impact of market turmoil *(continued)*

The table below shows the geographic distribution of the group's exposures to ABSs shown above.

	Gross principal[1]	*CDS Gross protection*[2]	*Net principal exposure*[3]	*Carrying amount*[4]
2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**
US	**7,249**	**–**	**7,249**	**5,982**
UK	**1,105**	**–**	**1,105**	**918**
Rest of the world	**4,062**	**(190)**	**3,872**	**3,805**
	12,416	**(190)**	**12,226**	**10,705**

	Gross principal[1]	*CDS Gross protection*[2]	*Net principal exposure*[3]	*Carrying amount*[4]
2008	HK$m	HK$m	HK$m	HK$m
US	11,962	–	11,962	8,539
UK	1,463	–	1,463	1,022
Rest of the world	6,716	(1,584)	5,132	5,030
	20,141	(1,584)	18,557	14,591

1 *The gross principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security.*
2 *A CDS is a credit default swap. CDS protection principal is the gross principal of the underlying instrument that is protected by CDSs.*
3 *Net principal exposure is the gross principal amount of assets that are not protected by CDSs. It includes assets that benefit from monoline protection, except where this protection is purchased with a CDS.*
4 *Carrying amount of the net principal exposure.*

b *Exposure to derivative transactions entered into with monoline insurers*

The group's principal exposure to monoline insurers is through a number of derivative transactions, primarily CDSs.

The table below sets out the fair value of the monoline derivative contracts at 31 December 2009, and hence the amount at risk, based on 31 December 2009 security prices, if the protection purchased were to be wholly ineffective because, for example, the monoline insurer was unable to meet its obligations. The 'Credit risk adjustment' column indicates the valuation adjustment taken against the net exposures, and reflects the estimated deterioration in creditworthiness of a monoline insurer during 2009. This adjustment has been charged to the income statement.

	Notional amount	*Net exposure Before credit risk adjustment*[1]	*Credit risk adjustment*[2]	*Net exposure after credit risk adjustment*
2009	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Derivative transactions with monoline insurers				
– investment grade	**190**	**–**	**–**	**–**
2008				
Derivative transactions with monoline insurers				
– investment grade	1,352	31	(3)	28

1 *Net exposure after legal netting and any other relevant credit mitigation prior to deduction of credit risk adjustment.*
2 *Fair value adjustment recorded against over-the-counter derivative counterparty exposures to reflect the credit worthiness of the counterparty.*

53 Impact of market turmoil *(continued)*

c *Special purpose entities (SPEs) consolidated by fellow Group companies*

In 2008 the group held commercial paper and medium-term notes issued by SPEs which have been established and are consolidated by other entities within the Group. The group no longer holds any such paper. The table below shows the group's holding of such instruments in 2008. The carrying amounts of these instruments are measured at fair value.

	2009		2008	
	Gross principal	**Carrying amount**	Gross principal	Carrying amount
	HK$m	**HK$m**	HK$m	HK$m
Medium-term notes				
– AAA rated	–	–	16,085	15,423
Commercial paper				
– A1/A1+ rated	–	–	57,137	57,129
	–	–	73,222	72,552

d *Leveraged finance commitments*

Leveraged finance commitments held by the group were HK$712 million at 31 December 2009 *(2008: HK$287 million)*, of which HK$545 million *(2008: HK$190 million)* was funded.

e *Other involvement with SPEs*

The group enters into certain transactions with customers in the ordinary course of business that involve the establishment of SPEs. The purposes for which the SPEs are established include facilitating the raising of funding for customers' business activities or to effect a lease. The use of SPEs is not a significant part of the group's activities and the group is not reliant on SPEs for any material part of its business operations or profitability.

54 Ultimate holding company

The ultimate holding company of the Bank is HSBC Holdings plc, which is incorporated in England.

The largest group in which the accounts of the Bank are consolidated is that headed by HSBC Holdings plc. The consolidated accounts of HSBC Holdings plc are available to the public on the Group's web site at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

55 Nature of business

The group provides domestic and international banking and related financial services, principally in the Asia-Pacific region.

56 Accounting standards issued but not yet effective

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

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

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;

Notes on the Financial Statements (continued)

56 Accounting standards issued but not yet effective *(continued)*

- changes in a parent's ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- an option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interests) in the entity either at fair value, or at the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired.

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

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

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

The HKICPA issued HKFRS 1 (Revised) 'First-time Adoption of Hong Kong Financial Reporting Standards' in December 2008, which is applicable for annual periods beginning on or after 1 July 2009. The revised version has an improved structure but does not contain any technical changes. The group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

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

The HKICPA issued 'Improvements to HKFRSs' in May 2009, which comprises a collection of necessary, but not urgent, amendments to HKFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2010, with earlier application permitted. As a consequence of the amendment to HKAS 17 'Leases' amongst these improvements to HKFRSs, the HKICPA issued revised HK Interpretation 4 'Leases – Determination of the Length of Lease Term in respect of Hong Kong Land Leases' in December 2009. On application of the amendment to HKAS 17 'Leases' and the revised Interpretation, the group will reclassify interests in leasehold land held under long leases, previously recorded as operating leases, as finance leases. At present, these leases are recorded at original cost and amortised over the term of the lease. When these leases are reclassified as finance leases, they will be carried at valuation and included under 'Property, Plant and Equipment', with the difference between the amortised cost and valuation recognised in equity. If this amendment to HKAS 17 had been applied in 2009, the carrying value of the property at 31 December 2009 would have increased by approximately HK$19 billion and the amount credited to property revaluation reserve, net of deferred tax, would have increased by approximately HK$16 billion. An additional depreciation charge of approximately HK$215 million would have been recognised in the income statement during 2009. The group does not expect adoption of the other amendments to have a significant effect on the consolidated financial statements.

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

56 Accounting standards issued but not yet effective *(continued)*

The HKICPA issued Amendments to HKFRS 1 'First-time Adoption of Hong Kong Financial Reporting Standards' – 'Additional Exemptions for First-time Adopters' in August 2009, which are effective for annual periods beginning on or after 1 January 2010. The amendments address the retrospective application of HKFRSs to particular situations and are aimed at ensuring that entities applying HKFRSs will not face undue cost or effort in the transition process. The group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

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

HKFRS 9 'Financial Instruments' ('HKFRS 9') was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2013 with earlier application permitted. Under HKFRS 9, financial assets are classified into two measurement categories: amortised cost or fair value. These two categories replace the four categories under the current HKAS 39 'Financial Instruments: Recognition and Measurement'. Under HKFRS 9, financial assets are classified on the basis of both an entity's business model for managing groups of financial assets and the contractual cash flow characteristics of the individual assets.

The group is presently studying the implications of applying HKFRS 9. It is impracticable to quantify the impact of HKFRS9 as at the date of publication of these 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 an Amendment to HKFRS 1 'First-time Adoption of Hong Kong Financial Reporting Standards' – 'Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters' in February 2010. The amendment relieves first-time adopters of HKFRSs from providing the additional disclosures introduced in March 2009 by Amendments to HKFRS 'Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments'.

57 Events after the balance sheet date

On 19 January 2010, the group, through its subsidiary, HSBC Insurance (Asia-Pacific) Holdings Limited, increased its shareholding in Bao Viet Holdings to 18 per cent from 10 per cent through the purchase of additional shares for a cash consideration of VND1.88 trillion (or approximately US$101.8 million). Bao Viet Holdings will be accounted for as an associate as of 19 January 2010.

58 Approval of accounts

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

Independent auditor's report to the shareholders of The Hongkong and Shanghai Banking Corporation Limited (incorporated in the Hong Kong SAR with limited liability)

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited set out on pages 27 to 205, which comprise the consolidated and the Bank's statements of financial position as at 31 December 2009, and the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors of the Bank are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the state of the affairs of the Bank and the group as at 31 December 2009 and of the profit and cash flows of the group for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants
8th Floor, Prince's Building
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Central
Hong Kong

1 March 2010

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