The Hongkong and Shanghai Banking Corporation Limited

Annual Report and Accounts 2013

HSBC

Annual Report and Accounts 2013

Contents

Certain defined terms

This document comprises the *Annual Report and Accounts 2013* for The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group'). References to 'HSBC', 'the Group' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'. The abbreviations 'HK$m' and 'HK$bn' represent millions and billions (thousands of millions) of Hong Kong dollars respectively.

Cautionary statement regarding forward-looking statements

This *Annual Report and Accounts* contains certain forward-looking statements with respect to the financial condition, results of operations and business of the group.

Statements that are not historical facts, including statements about the Bank's beliefs and expectations, are forward-looking statements. Words such as 'expects', 'anticipates', 'intends', 'plans', 'believes', 'seeks', 'estimates', 'potential' and 'reasonably possible', variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement.

Chinese translation

A Chinese translation of the *Annual Report and Accounts* is available upon request from: 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 website at www.hsbc.com.hk .

本《*年報及賬* 》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 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氏

Financial Highlights

	2013 HK$m	2012 HK$m
For the year		
Net operating income before loan impairment charges	**202,596**	162,267
Profit before tax	**144,756**	108,729
Profit attributable to shareholders	**119,009**	83,008
At the year-end		
Shareholders' equity	**480,809**	437,399
Total equity	**522,224**	473,078
Total capital base	**378,110**	272,892
Customer accounts	**4,254,752**	3,874,884
Total assets	**6,439,355**	6,065,327
Ratios	**%**	%
Return on average shareholders' equity	**25.9**	21.9
Post-tax return on average total assets	**2.08**	1.54
Cost efficiency ratio	**33.9**	42.4
Net interest margin	**1.94**	1.96
Capital ratios		
– Common equity tier 1 capital	**14.1**	–
– Tier 1 capital	**14.1**	–
– Total capital	**15.2**	–
– Core capital	–	13.7
– Capital adequacy	–	14.3

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 Hong Kong and one of Hong Kong's three note-issuing banks.

Serving the financial and wealth management needs of an international customer base, the group provides a range of personal, commercial and corporate banking and related financial services in 20 countries and territories in Asia-Pacific, with the largest network of any international financial institution in the region. Employing some 67,000 people, of whom 36,000 work for the Bank itself, the group had consolidated assets at 31 December 2013 of HK$6,439bn.

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 an international network covering 75 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America.

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
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Report of the Directors

Principal Activities

The group provide a comprehensive range of domestic and international banking and related financial services, principally in the Asia-Pacific region.

Asia Strategy

HSBC Group's aim is to be the world's leading international bank. As a subsidiary of the HSBC Group, the group applies a disciplined approach in managing its portfolio of businesses to focus on areas where it has a clear and competitive advantage. The group has set three interconnected priorities to deliver its strategy: (i) grow the business, focusing on its priority countries; (ii) streamline processes and procedures and restructure businesses to improve efficiency and achieve sustainable cost savings; and (iii) implement Global Standards, including Risk and Compliance, to support its long-term growth objectives for the benefit of customers, regulators, employees and shareholders.

The group's strong presence across the Asia-Pacific region will help maintain its competitive advantage in connecting business opportunities within the region, as well as between Asia-Pacific and other parts of the world.

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 77 to 227.

Share Capital

The Bank cancelled at its option 1,045m cumulative irredeemable preference shares at par value of US$1.00 each with repayment of the total par value on 20 March 2013. The Bank also cancelled at its option a total of 2,700m non-cumulative irredeemable preference shares at par value of US$1.00 each with repayment of the total par value on 28 March, 26 April and 21 June 2013. To fund the acquisition of the private banking business of HSBC Private Bank (Suisse) SA, Hong Kong branch and Singapore branch, the Bank increased its authorised ordinary share capital by the creation of 8,000m ordinary shares to 40,000m ordinary shares on 31 October 2013. On the same date 7,750m ordinary shares at par value of HK$2.50 each were issued to the existing shareholder, HSBC Asia Holdings BV ("HAHB"). To improve the Common Equity Tier 1 capital ratio, on 19 December 2013 the Bank redeemed 400.5m cumulative redeemable preference shares of par value USD900m, which was funded by the allotment of 2,790m ordinary shares at par value of HK$2.50 each to HAHB on the same date.

Reserves and Dividends

Profits attributable to shareholders, before dividends, of HK$119,009m have been transferred to reserves. During the year, a surplus of HK$4,738m, net of the related deferred taxation effect, arising from professional valuations of premises 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 the Bank Statement of Changes in Equity. The interim dividends paid in respect of 2013 are set out in note 9 to the financial statements. The Directors do not recommend the payment of a final dividend.

Report of the Directors (continued)

Directors

The names of the Directors at the date of this report are set out below:

Stuart T Gulliver, *Chairman*
Peter Wong Tung Shun, *Deputy Chairman & Chief Executive*
Laura Cha May Lung*, GBS, *Deputy Chairman*
Zia Mody*, *Deputy Chairman*
Graham John Bradley*
Dr Christopher Cheng Wai Chee*, GBS, OBE
Dr Raymond Ch'ien Kuo Fung*, GBS, CBE
Naina L Kidwai
Irene Lee Yun-lien*
Rose Lee Wai Mun
Victor Li Tzar Kuoi*
Christopher D Pratt*
James Riley*
Andreas Sohmen-Pao*
Kevin Anthony Westley*
Dr Rosanna Wong Yick-ming*, DBE
Marjorie Yang Mun Tak*, GBS
Tan Sri Dr Francis Yeoh Sock Ping*, CBE

* *independent non-executive Director*

All the Directors served throughout the year save for Dr Christopher Cheng Wai Chee, Kevin Anthony Westley and Irene Lee Yun-lien who were appointed on 1 May, 9 May and 1 October 2013 respectively. William Fung Kwok Lun and T Brian Stevenson retired on 20 May 2013.

Directors' Interests in Contracts

No contracts of significance to which the Bank, its holding companies, its subsidiaries or any fellow subsidiary 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

To help align the interests of employees with shareholders, Executive Directors are eligible to be granted conditional awards over ordinary shares in HSBC Holdings plc by that company (being the ultimate holding company) under the HSBC Share Plan 2011, including the Group Performance Share Plan ('GPSP') and the HSBC International Employee Share Purchase Plan.

The GPSP was developed to incentivise senior executives to deliver sustainable long-term business performance. A key feature of the GPSP is that participants are required to hold the shares once the awards have vested, until retirement, thereby enhancing the alignment of interests between the senior executives of HSBC Group and shareholders. The GPSP is a long-term incentive plan under the HSBC Share Plan 2011. The award levels of GPSP are determined by considering performance up to the date of grant against enduring performance measures set out in the long-term performance scorecard. The GPSP award is subject to a five year vesting period during which the Group Remuneration Committee has the authority to claw back all or part of the award. The vesting of conditional awards over shares in HSBC Holdings plc granted to Executive Directors under the HSBC Share Plan 2011, and its predecessor the HSBC Share Plan, are generally subject to the individual remaining an employee on the vesting date.

Generally, the vesting period of conditional share awards is staggered over three years. However, the deferred element of variable pay and annual incentive awards in respect of 2013 for the Executive Directors will vest no earlier than five years from grant subject to satisfactory completion of the Group's Deferred Prosecution Agreements reached with US authorities.

The HSBC International Employee Share Purchase Plan is a new employee share purchase plan offered to employees in Hong Kong in 2013 that will be extended to further countries in the HSBC Group from 2014. For every three shares in HSBC Holdings plc purchased by an employee ('Investment Shares'), a conditional award to acquire one share is granted ('Matching Shares'). The employee becomes entitled to the Matching Shares subject to continued employment with HSBC and retention of the Investment Shares until the third anniversary of the start of the relevant plan year.

There will be no further invitations to employees under The HSBC Holdings Savings-Related Share Option Plans.

Share options have previously been granted to Executive Directors under the HSBC Holdings Group Share Option Plan ('GSOP'). No options have been granted under the GSOP since 26 May 2005 and the exercise period of the last option will end in 2015.

During the year, Stuart T Gulliver, Naina L Kidwai, Rose Lee Wai Mun and Peter Wong Tung Shun acquired or were awarded shares in HSBC Holdings plc under the terms of the HSBC Share Plan 2011.

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

Donations

Donations made by the Bank and its subsidiaries during the year amounted to HK$184m (2012: HK$208m).

Compliance with the Banking (Disclosure) Rules

The Directors are of the view that the Accounts and Supplementary Notes for the year ended 31 December 2013, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance.

Auditor

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

On 2 August 2013, HSBC Group announced its intention to appoint PricewaterhouseCoopers LLP ('PwC') as auditor for the year ended 31 December 2015. It is expected that the Audit Committee will be invited to consider a recommendation for PwC to be appointed as auditor for the group for the year ended 31 December 2015.

Corporate Governance

The Bank is committed to high standards of corporate governance. As an Authorised Institution, the Bank is subject to and complies with the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'. During 2013, the Group introduced a 'comply or explain' Corporate Governance Code for HSBC Group companies (the 'Code') that has been implemented by the Bank. The Code is being implemented by the Bank's subsidiaries. The corporate governance report is included within pages 5 to 9 of the Report of the Directors.

Board of Directors

The Board, led by the Chairman, provides entrepreneurial leadership of the Bank within a framework of prudent and effective controls which enables risks to be assessed and managed. The Directors are collectively responsible for the long-term success of the Bank and delivery of sustainable value to shareholders. The Board sets the strategy and risk appetite for the group and approves capital and operating plans presented by management for the achievement of the strategic objectives it has set.

Directors

The Bank has a unitary Board. The authority of each Director is exercised in Board meetings where the Board acts collectively. At 24 February 2014, the Board comprised the Chairman, Deputy Chairman and Chief Executive, two Deputy Chairmen who are independent non-executive Directors, two other Directors with executive responsibilities for the Bank's or a subsidiary's operations and twelve independent non-executive Directors.

Independence of non-executive Directors

Non-executive Directors are not HSBC employees and do not participate in the daily business management of the Bank; they bring an external perspective, constructively challenge and help develop proposals on strategy, scrutinize the performance of management in meeting agreed goals and objectives, and monitor the risk profile and reporting of performance of the Bank. The non-executive Directors bring experience from a number of industries and business sectors, including the leadership of large complex multinational enterprises. The Board has considered the independence of each of the non-executive Directors and determined that each non-executive Director is independent in character and judgement and that there are no relationships or circumstances likely to affect their judgement, with any relationships or circumstances that could appear to do so not considered to be material.

Report of the Directors (continued)

Chairman and Chief Executive

The roles of Chairman and Chief Executive are separate and held by experienced full-time employees of the HSBC Group. There is a clear division of responsibilities between leading the Board and the executive responsibility for running the Bank's business.

The Chairman provides leadership to the Board and is responsible for the overall effective functioning of the Board. The Chairman is responsible for the development of strategy and the oversight of implementation of Board approved strategies and direction. The Chief Executive is responsible for ensuring implementation of the strategy and policy as established by the Board and the day-to-day running of operations. The Chief Executive is chairman of the Executive Committee and the Asset and Liability Management Committee. Each Asia-Pacific Global Business and Global Function head reports to the Chief Executive.

Board Committees

The Board has established various committees consisting of Directors and senior management. The Board and each Board committee have terms of reference to document their responsibilities and governance procedures. The key roles of the committees are described in the paragraphs below. The chairman of each Board committee reports to each subsequent Board meeting when presenting the meeting minutes of the relevant committee.

Executive Committee

The Executive Committee meets monthly and is responsible for the exercise of all of the powers, authorities and discretions of the Board in so far as they concern the management, operations and day-to-day running of group, in accordance with such policies and directions as the Board may from time to time determine, with power to sub-delegate. A schedule of items that require the approval of the Board is maintained.

The Bank's Deputy Chairman and Chief Executive, Peter Wong Tung Shun, is Chairman of the Committee. The current members of the Committee are: Raymond Cheng Siu Hong *(Chief Operating Officer Asia-Pacific*), Rhydian H Cox *(Chief Risk Officer*), Gordon William French *(Head of Global Banking and Markets Asia-Pacific)*, Anita Fung Yuen Mei *(Chief Executive Officer Hong Kong)*, Guy D Harvey-Samuel *(Chief Executive Officer Singapore)*, Mukhtar M Hussain *(Chief Executive Officer Malaysia)*, Sarah C Legg *(Chief Financial Officer)*, Kevin Ross Martin *(Regional Head of Retail Banking and Wealth Management Asia-Pacific)*, Stuart P Milne *(Chief Executive Officer India)*, Noel P Quinn *(Regional Head of Commercial Banking Asia-Pacific)*, J Rikhye *(Head of Strategy Planning, Asia-Pacific and Head of International Asia-Pacific)*, Donna Wong Ka Yuk *(Head of Human Resources Asia-Pacific)*, Helen Wong Pik Kuen *(Chief Executive Officer China)*. P A Stafford *(Corporation Secretary)* is the Committee Secretary. In attendance are: P M Chan *(Head of Regulatory Compliance Asia-Pacific)*, M Wallis *(Head of Communications Asia-Pacific)*, K S Y Ng *(Regional General Counsel Asia-Pacific)*, B J Rennell *(Chief Executive Officer, Private Bank North Asia and Global Head Private Wealth Solutions)*, S E Williamson *(Head of Financial Crime Compliance, Asia-Pacific)* and W S M Tam *(Deputy Secretary)*.

Asset and Liability Management Committee

The Asset and Liability Management Committee is chaired by the Deputy Chairman and Chief Executive and is responsible for providing direction on and monitoring the group's balance sheet composition and capital, liquidity and funding structure, and structural exposures under normal and stressed conditions. The Committee consists of senior executives of the Bank, most of whom are members of the Executive Committee.

Risk Management Committee

The Risk Management Committee is chaired by the Chief Risk Officer and is responsible for the executive oversight of the risk management framework of the group. The Committee consists of senior executives of the Bank, most of whom are members of the Executive Committee.

Audit Committee

The Audit Committee meets at least four times a year and has non-executive responsibility for oversight of and advice to the Board on matters relating to financial reporting.

The current members of the Committee, all being independent non-executive directors, are James Riley (Chairman of the Committee), Graham John Bradley, Irene Lee Yun-lien and Kevin Anthony Westley.

Governance structure

The Audit Committee monitors the integrity of the financial statements and oversees the internal control systems over financial reporting, including reviewing their effectiveness. The Committee reviews the financial statements before submission to the Board. It also monitors and reviews the effectiveness of the internal audit function and reviews the Bank's financial and accounting policies and practices. The Committee advises the Board on the appointment of the external auditor and is responsible for oversight and remuneration of the external auditor. As part of the monitoring process, the Committee reviews the minutes of meetings of subsidiaries' Audit Committees and the Asset and Liability Management Committee.

Risk Committee

The Risk Committee meets at least four times a year and has non-executive responsibility for oversight of and advice to the Board on high-level risk-related matters and risk governance. The current members of the Committee, all being independent non-executive directors, are Kevin Anthony Westley (Chairman of the Committee), Graham John Bradley, Dr Christopher Cheng Wai Chee, Zia Mody and James Riley.

Risk governance and culture

All of the Bank's activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combination of risks. The Board, advised by the Risk Committee, requires and encourages a strong risk governance culture which shapes the Bank's attitude to risk.

The Bank's risk governance is supported by a clear policy of risk ownership and accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by the governance structure, experience and mandatory learning, helps to foster a disciplined and constructive culture of risk management and control throughout the group.

Risk management

The Board and the Risk Committee oversee the maintenance and development of a strong risk management framework by continually monitoring the risk environment, top and emerging risks facing the group and mitigating actions planned and taken. The Risk Committee monitors the effectiveness of the Bank's risk management and internal controls, other than controls over financial reporting, which are monitored by the Audit Committee. The Committee regularly monitors the group's risk appetite and risk profile against key performance/risk indicators, the top and emerging risks facing the group and the risk profiles for separate categories of risk within the group's business, as well as reviews the mitigating actions proposed by management.

Reports on these items are presented at each meeting of the Committee. Regular reports from the Risk Management Committee, which is the executive body responsible for overseeing risk, are also presented.

In carrying out its responsibilities the Committee is closely supported by the Chief Risk Officer. The Committee also receives regular presentations from the Head of Internal Audit, the Chief Financial Officer and other business, function and risk heads.

Risk appetite

Risk appetite is set out in the group's Risk Appetite Statement ('RAS'), which describes the types and levels of risk that the group is prepared to accept in executing its strategy. It is approved by the Board on the advice of the Risk Committee, and is a key component of our risk management framework. The Risk Management Committee, through their risk management oversight role, coordinates the process of aligning risk appetite and risk strategy with business strategy, oversees monitoring, reporting and governance around the risk appetite process, agrees remedial action should the risk profile fall outside agreed parameters and communicates risk appetite. The risk appetite is defined as an expression of the types and quantum of risks (both tangible and intangible) which the group is willing to accept in order to achieve its medium and long-term strategic goals. Across the group, each country and regional Global Business is required to prepare a RAS. The regional Risk function tracks the RAS development and performance across sites on a regular basis.

Report of the Directors (continued)

Quantitative and qualitative metrics are assigned to primary categories including: earnings, capital, liquidity and funding, cost of risk, intra-group lending, risk categories and risk diversification and concentration. Measurement against these metrics serves to:

- guide underlying business activity, ensuring it is aligned to RASs;
- determine risk-adjusted remuneration;
- enable the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and
- promptly identify business decisions needed to mitigate risks.

Top and emerging risks

The Board and the Risk Committee oversee the maintenance and development of a strong risk management framework by the continual monitoring of the risk environment and top and emerging risks facing the Bank, and mitigating actions planned and taken.

The Bank's businesses are exposed to a variety of risk factors that could potentially affect the results of operations or financial condition. The approach to identifying and monitoring top and emerging risks is informed by the risk factors. Certain risks are classified as 'top' or 'emerging'. A 'top risk' is defined as a current, emerged risk which has arisen across any risk category, region or global business and has the potential to have a material impact on the Bank's financial results or reputation and the sustainability of the long-term business model, and which may form and crystallise within a one year horizon. An 'emerging risk' is considered to be one which has large uncertain outcomes which may form and crystallise beyond a one-year horizon and, if it were to crystallise, could have a material effect on long term strategy. Our top and emerging risk framework enables us to focus on current and forward looking aspects of our risk exposures and ensure our risk profile remains in line with our risk appetite and that our appetite remains appropriate. Top and emerging risks fall under the following three broad categories:

- macro-economic and geopolitical risk;
- macro-prudential, regulatory and legal risks to the Bank's business model; and
- risks related to business operations, governance and internal control systems.

Stress testing

The stress testing and scenario analysis programme is central to the monitoring of top and emerging risks. The Bank conducts a range of Group stress-testing scenarios including, but not limited to, severe global economic downturn, country, sector and counterparty failures and a variety of projected major operational risk events. As a major HSBC subsidiary, the Bank also conducts regular macroeconomic and event-driven scenario analyses specific to Asia Pacific. The outcomes of the stress tests are used to assess the potential impacts on the Bank. The Bank also participates, where appropriate, in scenario analyses requested by regulatory bodies.

Stress testing is used across risk categories such as market risk, liquidity and funding risk and credit risk to evaluate the potential impact of stress scenarios on portfolio values, structural long-term funding positions, income or capital.

The Bank also conducts reverse stress testing. Reverse stress testing is a process of working backwards from the non-viability of the business to identify scenarios that could bring the Bank to that point. Non-viability might occur before the Bank's capital is depleted, and could result from a variety of events. These include idiosyncratic, systemic or combinations of events, and/or could imply failure of the Bank or one of its major subsidiaries and does not necessarily mean the simultaneous failure of all the major subsidiaries.

The Bank uses reverse stress testing as part of our risk management process to strengthen resilience.

Nomination Committee

The Nomination Committee meets at least twice a year and is responsible for leading the process for Board appointments and for identifying and nominating, for the approval of the Board, candidates for appointment to the Board. Appointments to the Board are subject to the approval of the HKMA. The Committee considers plans for orderly succession to the Board and the appropriate balance of skills and experience on the Board.

The current members of the Committee, being a majority of independent non-executive directors, are Stuart T Gulliver (Chairman of the Committee), Laura Cha May Lung and Majorie Yang Mun Tak. Peter Wong Tung Shun attends each meeting of the Committee.

Acquisitions and Disposals Committee

The Acquisitions and Disposals Committee is responsible for the approval of acquisitions and disposals that arise between scheduled Board meetings where the transaction exceeds the authority delegated by the Board to the Chairman. All Directors are members of the Committee.

Remuneration Committee

The Board of the Bank's ultimate parent company, HSBC Holdings plc, has established a Group Remuneration Committee comprising independent non-executive directors. The Committee is responsible for determining and approving the Group's remuneration policy. The Committee also determines the remuneration of Directors, other senior Group employees, employees in positions of significant influence and employees whose activities have or could have an impact on the Bank's risk profile and in doing so takes into account the pay and conditions across the HSBC Group. Having a Group Remuneration Committee is consistent with the principles set out in the HKMA Supervisory Policy Manual CG-5 'Guideline on a Sound Remuneration System'.

Remuneration policy

A global reward strategy for the HSBC Group, approved by the Group Remuneration Committee and applicable to the Bank aims to reward success, not failure, and to be properly aligned with the risk management framework and risk outcomes. In order to ensure alignment between remuneration and business strategy, individual remuneration is determined through assessment of performance, delivered against both annual and long-term objectives summarised in performance scorecards, as well as adherence to HSBC Values. Altogether, performance is judged not only on what is achieved over the short and long term, but also on how it is achieved, as the latter contributes to the sustainability of the organisation. The financial and non-financial measures incorporated in the annual and long-term scorecards are carefully considered to ensure alignment with the long-term strategy of the HSBC Group.

An annual review of the Bank's remuneration strategy and its operation is commissioned externally and carried out independently of management. The review confirms that the Bank's remuneration policy is consistent with the principles set out in the HKMA Supervisory Policy Manual CG-5 'Guideline on a Sound Remuneration System'.

In accordance with the 'Guideline on a Sound Remuneration System', details of the remuneration strategy are contained within the Annual Report and Accounts 2013 and Capital and Risk Management Pillar 3 Disclosures as at 31 December 2013 of HSBC Holdings plc.

On behalf of the Board
Stuart T Gulliver, *Chairman*
24 February 2014

Financial Review

Summary of Financial Performance

Results for 2013

Profit attributable to shareholders for 2013 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') increased by HK$36,027m, or 33%, to HK$144,756m.

Profit before tax

	2013 **HK$m**	2012 HK$m
Hong Kong	**59,791**	56,499
Rest of Asia-Pacific	**84,965**	52,230
Total	**144,756**	108,729

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 geographical region and by global business. 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 influential in determining performance across the different types of business activity carried out in the region. Therefore, the provision of segmental 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 global businesses.

- Retail Banking and Wealth Management (RBWM) serves personal customers. We take deposits and provide transactional banking services to enable customers to manage their day to day finances and save for the future. We selectively offer credit facilities to assist customers in their short or longer-term borrowing requirements; and we provide financial advisory, broking, insurance and investment services to help them manage and protect their financial futures.
- Commercial Banking (CMB) is segmented into Corporate, to serve both corporate and mid-market companies with more sophisticated financial needs, and Business Banking, to serve small and medium-sized enterprises (SMEs), enabling differentiated coverage of our target customers. This allows us to provide continuous support to companies as they grow both domestically and internationally, and ensures a clear focus on internationally aspirant customers.
- Global Banking and Markets (GB&M) provides tailored financial solutions to major government, corporate and institutional clients worldwide. GB&M operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs.
- Global Private Banking (GPB) provides investment management and trustee solutions to high net worth individuals and their families. We aim to meet the needs of our clients by providing excellent customer service, leveraging our global footprint and offering a comprehensive suite of solutions.

Geographical Regions *(continued)*

Profit before tax by geographical region

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2013				
Net interest income	**45,682**	**41,729**	**(46)**	**87,365**
Net fee income	**28,794**	**15,129**	**(77)**	**43,846**
Net trading income	**11,156**	**5,375**	**46**	**16,577**
Net income from financial instruments designated at fair value	**2,008**	**467**	**–**	**2,475**
Gains less losses from financial investments	**323**	**119**	**–**	**442**
Dividend income	**1,165**	**10**	**–**	**1,175**
Net earned insurance premiums	**47,173**	**6,490**	**–**	**53,663**
Net gain on reclassification of associates	**–**	**8,157**	**–**	**8,157**
Gain on sale of Ping An	**–**	**34,070**	**–**	**34,070**
Other operating income	**13,803**	**2,186**	**(4,571)**	**11,418**
Total operating income	**150,104**	**113,732**	**(4,648)**	**259,188**
Net insurance claims incurred and movement in liabilities to policyholders	**(50,960)**	**(5,632)**	**–**	**(56,592)**
Net operating income before loan impairment charges and other credit risk provisions	**99,144**	**108,100**	**(4,648)**	**202,596**
Loan impairment charges and other credit risk provisions	**(1,032)**	**(2,500)**	**–**	**(3,532)**
Net operating income	**98,112**	**105,600**	**(4,648)**	**199,064**
Operating expenses	**(38,845)**	**(34,531)**	**4,648**	**(68,728)**
Operating profit	**59,267**	**71,069**	**–**	**130,336**
Share of profit in associates and joint ventures	**524**	**13,896**	**–**	**14,420**
Profit before tax	**59,791**	**84,965**	**–**	**144,756**
2012				
Net interest income	40,155	42,271	(7)	82,419
Net fee income	24,670	15,220	–	39,890
Net trading income	9,892	9,315	7	19,214
Net income from financial instruments designated at fair value	3,799	814	–	4,613
Gains less losses from financial investments	2,510	124	–	2,634
Dividend income	489	33	–	522
Net earned insurance premiums	46,304	6,317	–	52,621
Other operating income	14,991	4,632	(4,286)	15,337
Total operating income	142,810	78,726	(4,286)	217,250
Net insurance claims incurred and movement in liabilities to policyholders	(49,401)	(5,582)	–	(54,983)
Net operating income before loan impairment charges and other credit risk provisions	93,409	73,144	(4,286)	162,267
Loan impairment charges and other credit risk provisions	(603)	(2,975)	–	(3,578)
Net operating income	92,806	70,169	(4,286)	158,689
Operating expenses	(36,947)	(36,109)	4,286	(68,770)
Operating profit	55,859	34,060	–	89,919
Share of profit in associates and joint ventures	640	18,170	–	18,810
Profit before tax	56,499	52,230	–	108,729

Financial Review (continued)

Geographical Regions *(continued)*

Hong Kong

Hong Kong reported pre-tax profits of HK$59,791m compared with HK$56,499m in 2012, an increase of 6%. This reflected higher revenue, driven by balance sheet growth, and increased net fees from unit trusts and debt issuance.

In RBWM, we grew our average mortgage balances by 8% with average loan-to-value ratios of 44% on new mortgage drawdowns and an estimated 32% on the portfolio as a whole. We continued to develop our digital capabilities and launched our mobile banking application. We also developed our Wealth Management capabilities, growing revenue by more than 10%. In addition, we enhanced our wealth management systems, simplified the product range and implemented the Global Wealth Incentive Plan to better align customer and business interests.

In CMB, we further strengthened the collaboration with GB&M, raising financing for our clients of over US$14bn from the debt capital markets ('DCM') and nearly US$4bn from the equity capital markets ('ECM'), including the largest IPO in Hong Kong for a mainland Chinese consumer company. In addition, we were awarded 'Best Trade Finance Bank in Hong Kong' by *Global Finance*.

In GB&M, we continued to lead the market in Hong Kong dollar bond issuance and are now one of the top five houses for both ECM and mergers and acquisitions. We were voted 'Best Debt House in Hong Kong' in the *Euromoney 2013 Awards for Excellence* and were involved in seven of the ten largest IPOs in Hong Kong this year.

We led the market in offshore renminbi ('RMB') bond issuance, including the RMB3bn government bond issue in December 2013 by mainland China's Ministry of Finance, and were voted 'Best provider of offshore renminbi products and services' for the second year running by *Asiamoney*. We also won the award for 'RMB House of the Year' from *Asia Risk*.

In November 2013, we acquired the Private Banking ('GPB') business of HSBC Private Bank (Suisse) SA, Hong Kong branch. We announced the sale of our shareholding in Bank of Shanghai in 2013, a transaction which is expected to complete in the first half of 2014.

Net interest income rose by HK$5,527m compared with 2012, led by RBWM and supported by GB&M and CMB. The increase was mainly due to higher average lending and deposit balances, wider spreads on mortgages in RBWM reflecting lower funding costs, and growth in the insurance debt securities portfolio.

There was strong loan growth in both CMB and GB&M, driven by trade-related lending in the first half of 2013 and an increase in commercial real estate and other property-related lending in the second half of the year, though the benefit of this growth was partly offset by spread compression reflecting competition and increased liquidity in the markets. Mortgage lending in RBWM also increased, although the rate of growth began to slow during 2013 as transaction volumes in the property market reduced.

Average deposit balances increased, in part reflecting new Premier customers in RBWM and increased Payments and Cash Management balances in CMB, though the benefit of this growth was more than offset by narrower deposit spreads due to a fall in short-term interbank interest rates.

Net fee income rose by HK$4,124m in 2013, primarily in RBWM. Strong customer demand and favourable market sentiment led to higher fees from unit trusts and increased brokerage income. Fee income increased due to a rise in debt and equity underwriting and corporate finance activity compared with 2012, in part reflecting collaboration between GB&M and CMB. Fee income also rose in CMB as trade and Payments and Cash Management volumes increased.

Geographical Regions *(continued)*

Net trading income rose by HK$1,264m in 2013. Rates revenue rose due to greater client activity, increased holdings of debt securities and a net favourable movement in respect of the valuation adjustments on derivatives compared with a net charge in 2012. Equities revenues rose from warrant market making as volumes increased, while Foreign Exchange revenue grew due to improved margins and higher customer trading volumes.

Net income from financial instruments designated at fair value was HK$2,008m compared with HK$3,799m in 2012, primarily due to lower net investment returns on assets held by the insurance business reflecting weaker equity markets and falling bond prices. To the extent that these investment returns were attributed to policyholders holding unit-linked insurance policies and insurance contracts with discretionary participation features, there was a corresponding movement in Net insurance claims incurred and movement in liabilities to policyholders.

Gains less losses from financial investments were HK$323m in 2013 compared with HK$2,510m in 2012, largely due to the non-recurrence of the gain on sale of our shares in four Indian banks in 2012.

Dividend income was HK$1,165m compared with HK$489m in 2012, mainly due to the dividend from Industrial Bank following its reclassification as a financial investment during the year.

Net earned insurance premiums grew by 2% due to increased renewals of deferred annuity and unit-linked insurance contracts, partly offset by the absence of non-life insurance premiums following the disposal of the HSBC and Hang Seng Bank general insurance businesses in 2012 and lower new business premiums. The growth in premiums resulted in a corresponding increase in Net insurance claims incurred and movement in liabilities to policyholders.

Other operating income was HK$1,188m lower than in 2012 due to the non-recurrence of the gains on sale of Global Payments Asia-Pacific Limited and the non-life insurance businesses in 2012, totalling HK$2,906m. This more than offset higher revaluation and disposal gains on investment properties, which in part reflected the strong commercial property market, and a larger increase in the PVIF asset. The latter arose in 2013 due to favourable interest rate assumption updates, although this was more than offset in Net insurance claims incurred and movement in liabilities to policyholders.

Loan impairment charges were HK$429m higher due to a revision to the assumptions used in our collective assessment models in RBWM and a rise in individual impairment charges in CMB, although these remained low. This was partly offset by collective provision releases in CMB from lower historical loss rates and individual impairment releases in GB&M.

Operating expenses rose by HK$1,898m in 2013, reflecting higher marketing spend, costs relating to the introduction of updated payment cards and information technology platforms, as well as increased property rental and maintenance costs. In addition, staff costs increased from changes to the measurement of pension costs.

Share of profit in associates and joint ventures was HK$116m lower, primarily due to the effect of the disposal of our interest in Global Payments Asia-Pacific Ltd in 2012.

Financial Review (continued)

Geographical Regions *(continued)*

Hong Kong profit before tax by global business

	Retail Banking and Wealth Management HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Global Private Banking HK$m	Other HK$m	Intra-segment elimination HK$m	Hong Kong Total HK$m
2013							
Net interest income/(expense)	**24,687**	**13,406**	**10,380**	**116**	**(2,690)**	**(217)**	**45,682**
Net fee income	**15,749**	**7,473**	**5,405**	**105**	**62**	**–**	**28,794**
Net trading income	**1,045**	**1,417**	**8,334**	**78**	**66**	**216**	**11,156**
Net income/(expense) from financial instruments designated at fair value	**1,965**	**–**	**56**	**–**	**(14)**	**1**	**2,008**
Gains less losses from financial investments	**–**	**–**	**323**	**–**	**–**	**–**	**323**
Dividend income	**1**	**7**	**47**	**–**	**1,110**	**–**	**1,165**
Net earned insurance premiums	**43,530**	**3,659**	**–**	**–**	**–**	**(16)**	**47,173**
Other operating income	**4,799**	**706**	**591**	**–**	**9,856**	**(2,149)**	**13,803**
Total operating income	**91,776**	**26,668**	**25,136**	**299**	**8,390**	**(2,165)**	**150,104**
Net insurance claims incurred and movement in liabilities to policyholders	**(46,730)**	**(4,230)**	**–**	**–**	**–**	**–**	**(50,960)**
Net operating income before loan impairment charges and other credit risk provisions	**45,046**	**22,438**	**25,136**	**299**	**8,390**	**(2,165)**	**99,144**
Loan impairment (charges)/releases and other credit risk provisions	**(1,065)**	**(122)**	**154**	**–**	**1**	**–**	**(1,032)**
Net operating income	**43,981**	**22,316**	**25,290**	**299**	**8,391**	**(2,165)**	**98,112**
Operating expenses	**(15,501)**	**(5,955)**	**(10,084)**	**(224)**	**(9,246)**	**2,165**	**(38,845)**
Operating profit/(loss)	**28,480**	**16,361**	**15,206**	**75**	**(855)**	**–**	**59,267**
Share of profit in associates and joint ventures	**518**	**2**	**4**	**–**	**–**	**–**	**524**
Profit/(loss) before tax	**28,998**	**16,363**	**15,210**	**75**	**(855)**	**–**	**59,791**
2012							
Net interest income/(expense)	22,194	12,636	8,436	–	(3,744)	633	40,155
Net fee income	13,723	6,594	4,255	–	98	–	24,670
Net trading income	1,270	1,278	7,822	–	157	(635)	9,892
Net income/(expense) from financial instruments designated at fair value	4,098	(412)	177	–	(66)	2	3,799
Gains less losses from financial investments	(8)	–	18	–	2,500	–	2,510
Dividend income	1	7	36	–	445	–	489
Net earned insurance premiums	41,074	5,132	98	–	–	–	46,304
Other operating income	5,518	1,965	738	–	8,853	(2,083)	14,991
Total operating income	87,870	27,200	21,580	–	8,243	(2,083)	142,810
Net insurance claims incurred and movement in liabilities to policyholders	(44,650)	(4,676)	(75)	–	–	–	(49,401)
Net operating income before loan impairment charges and other credit risk provisions	43,220	22,524	21,505	–	8,243	(2,083)	93,409
Loan impairment (charges)/releases and other credit risk provisions	(754)	21	129	–	1	–	(603)
Net operating income	42,466	22,545	21,634	–	8,244	(2,083)	92,806
Operating expenses	(14,127)	(5,621)	(9,952)	–	(9,330)	2,083	(36,947)
Operating profit/(loss)	28,339	16,924	11,682	–	(1,086)	–	55,859
Share of profit in associates and joint ventures	347	49	25	–	219	–	640
Profit/(loss) before tax	28,686	16,973	11,707	–	(867)	–	56,499

Geographical Regions *(continued)*

Rest of Asia-Pacific

Rest of Asia-Pacific reported pre-tax profits of HK$84,965m compared with HK$52,230m in 2012.

The increase in profits was mainly due to the net gain on disposal of our shareholding in Ping An of HK$30,747m and an accounting gain of HK$8,454m on the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties.

Excluding these gains, profit before tax reduced from lower revenues and lower income from associates, partly offset by reduced operating expenses and loan impairment charges.

The implementation of our strategy to reduce fragmentation across the region continued, leading to the disposal of non-core insurance businesses in Vietnam, South Korea, Taiwan and Singapore. We announced the closure of a retail brokerage in India and our retail banking operations in South Korea. We also completed the sale of our investment in Ping An. In November 2013, we acquired the GPB business of HSBC Private Bank (Suisse) SA, Singapore branch.

In mainland China, where we continued to expand our branch network, we had 162 HSBC outlets, 23 HSBC rural bank outlets and 48 Hang Seng Bank outlets at the end of the year. We expanded our wealth management capabilities and were one of the first foreign banks to be approved to distribute domestic funds to retail investors. We were the market leader in mainland China's state-owned enterprise bond issuances and we were awarded 'Best Foreign Commercial Bank in China' by *FinanceAsia*.

We continued to promote the internationalisation of the RMB as regulations developed. We were the first foreign bank in mainland China to implement a customised RMB cross-border centralised settlement solution and were also the first foreign bank to complete a two-way cross-border RMB lending transaction.

In India, we revised our wealth management product offering to ensure customers' needs were being met and to improve customer satisfaction levels. In Payments and Cash Management, we were awarded the 'Best Domestic Cash Management Bank' in 2013 by *Euromoney*. Our strength in DCM continued, acting as a joint lead manager and bookrunner for the largest US dollar-denominated single tranche bond issuance by an Indian corporate in 2013.

In Singapore, we led the market in foreign currency DCM issuance, continuing to demonstrate our ability to structure DCM transactions. In CMB, we began to offer a RMB settlement service.

We continued to develop our Payments and Cash Management product offering across the region and were awarded the 'Best Cash Management House in Asia' by *Euromoney*. We also strengthened our Project and Export Finance capabilities and were named the 'Best Project Finance House in Asia' by *Euromoney* for the third consecutive year. Our strength in DCM continued and we were the No.1 bookrunner in Asia ex-Japan bonds. We were awarded the 'Domestic Bond House of the Year' by *IFR Asia.*

Net interest income reduced by HK$542m as balance sheet growth was more than offset by spread compression in many countries from competition and increased liquidity.

Average residential mortgage balances grew, primarily in mainland China and Australia, as we focused on secured lending, and in Singapore reflecting lending growth in 2012. Term and trade-related lending in CMB rose, notably in mainland China, Singapore and Indonesia, from continued client demand. Increased average loan balances were broadly offset by lending spread compression, notably on trade finance lending, reflecting competitive pressures and increased liquidity in the market.

We grew average deposit balances in both Payments and Cash Management and RBWM, though the benefit of this growth was partly offset by narrower liability spreads in many countries following central bank interest rate cuts and increased liquidity.

Net fee income fell by HK$91m, primarily in RBWM, notably in India, from lower Wealth Management sales as we revised our product offerings. This was partly offset in GB&M from increased activity in bond sales in Singapore and in CMB from increased credit facilities, notably in mainland China.

Financial Review (continued)

Geographical Regions *(continued)*

Net trading income was HK$3,940m lower, in part from further adverse fair value movements on the Ping An contingent forward sale contract of HK$3,323m, compared with HK$2,694m in 2012. Rates revenues decreased largely from reduced bond holdings in a number of countries and revaluation losses as bond yields rose, notably in mainland China. Foreign Exchange revenues also fell as 2012 market conditions were not repeated.

Net income from financial instruments designated at fair value was HK$467m compared with HK$814m in 2012 from lower gains on assets held by the insurance business in Singapore driven by rising bond yields. To the extent that these investment returns were attributed to policyholders holding unit-linked insurance policies and insurance contracts with discretionary participation features, there was a corresponding movement in Net insurance claims incurred and movement in liabilities to policyholders.

We recorded an accounting gain of HK$8,454m on the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties. This was partly offset by a loss of HK$297m on the reclassification of Yantai Bank as a financial investment.

There was a gross gain of HK$34,070m on the disposal of our investment in Ping An, which was partly offset by the adverse fair value movement of HK$3,323m on the contingent forward sale contract included in 'Net trading income' noted above.

Other operating income fell by HK$2,446m in 2013. There was a gain on the disposal of our investment in Bao Viet Holdings of HK$810m and losses on the disposal of our Taiwan life insurance business and Singapore group term life and group medical insurance businesses totalling HK$339m. We recorded a gain on the disposal of Hana HSBC Life Insurance Company Limited of HK$214m, though this was after a write-down of HK$558m recorded in 'Operating expenses'. In 2012, we reported gains totalling HK$2,340m on the sale of our RBWM business in Thailand, our GPB business in Japan and our interest in a property company in the Philippines.

Loan impairment charges decreased by HK$475m as a result of the non-recurrence of a large individually assessed impairment of a corporate exposure in Australia in 2012, as well as an impairment release in GB&M in Bahrain in 2013. This was partly offset by an increase in individually assessed impairments in GB&M and CMB in a number of countries across the region.

Operating expenses decreased by HK$1,578m. There was a partial write back of a litigation provision in Singapore and Australia compared with a charge in 2012. In addition, there were lower restructuring and other related costs, including termination benefits, than in 2012, and the non-recurrence of costs following the sale or closure of operations. These decreases were partly offset by a rise in mainland China from wage inflation, higher staff numbers and branch expansion.

Share of profit in associates and joint ventures reduced by HK$4,274m following the reclassification of Industrial Bank as a financial investment and an impairment charge of HK$819m on our banking associate in Vietnam. Excluding these factors, income from associates rose, primarily in Bank of Communications as a result of balance sheet growth and increased fee income, partly offset by higher operating expenses and a rise in loan impairment charges.

Geographical Regions *(continued)*

Rest of Asia-Pacific profit before tax by global business

	Retail Banking and Wealth Management HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Global Private Banking HK$m	Other HK$m	Intra-segment elimination HK$m	Rest of Asia-Pacific Total HK$m
2013							
Net interest income	**13,328**	**10,660**	**14,926**	**159**	**1,606**	**1,050**	**41,729**
Net fee income/(expense)	**5,411**	**4,304**	**5,398**	**143**	**(127)**	**–**	**15,129**
Net trading income/(expense)	**617**	**1,467**	**7,811**	**44**	**(3,514)**	**(1,050)**	**5,375**
Net income from financial instruments designated at fair value	**460**	**2**	**–**	**–**	**5**	**–**	**467**
Gains less losses from financial investments	**(8)**	**4**	**117**	**–**	**6**	**–**	**119**
Dividend income	**3**	**1**	**–**	**–**	**6**	**–**	**10**
Net earned insurance premiums	**5,053**	**1,452**	**–**	**1**	**–**	**(16)**	**6,490**
Net gain on reclassification of associates	**–**	**–**	**–**	**–**	**8,157**	**–**	**8,157**
Gain on sale of Ping An	**–**	**–**	**–**	**–**	**34,070**	**–**	**34,070**
Other operating income	**1,119**	**44**	**626**	**3**	**923**	**(529)**	**2,186**
Total operating income	**25,983**	**17,934**	**28,878**	**350**	**41,132**	**(545)**	**113,732**
Net insurance claims incurred and movement in liabilities to policyholders	**(4,531)**	**(1,113)**	**–**	**(1)**	**–**	**13**	**(5,632)**
Net operating income before loan impairment charges and other credit risk provisions	**21,452**	**16,821**	**28,878**	**349**	**41,132**	**(532)**	**108,100**
Loan impairment (charges)/releases and other credit risk provisions	**(1,635)**	**(970)**	**103**	**–**	**2**	**–**	**(2,500)**
Net operating income	**19,817**	**15,851**	**28,981**	**349**	**41,134**	**(532)**	**105,600**
Operating expenses	**(16,405)**	**(7,938)**	**(9,580)**	**(227)**	**(913)**	**532**	**(34,531)**
Operating profit	**3,412**	**7,913**	**19,401**	**122**	**40,221**	**–**	**71,069**
Share of profit in associates and joint ventures	**1,782**	**10,323**	**1,956**	**–**	**(165)**	**–**	**13,896**
Profit before tax	**5,194**	**18,236**	**21,357**	**122**	**40,056**	**–**	**84,965**
2012							
Net interest income	13,859	10,822	18,000	137	911	(1,458)	42,271
Net fee income/(expense)	6,379	3,870	4,933	91	(53)	–	15,220
Net trading income/(expense)	699	1,437	8,477	10	(2,766)	1,458	9,315
Net income/(expense) from financial instruments designated at fair value	844	7	(24)	–	(13)	–	814
Gains less losses from financial investments	(6)	9	(74)	(1)	196	–	124
Dividend income	3	–	–	–	30	–	33
Net earned insurance premiums	4,411	1,905	–	1	–	–	6,317
Other operating income	1,630	500	580	499	1,985	(562)	4,632
Total operating income	27,819	18,550	31,892	737	290	(562)	78,726
Net insurance claims incurred and movement in liabilities to policyholders	(4,057)	(1,524)	–	(1)	–	–	(5,582)
Net operating income before loan impairment charges and other credit risk provisions	23,762	17,026	31,892	736	290	(562)	73,144
Loan impairment (charges)/releases and other credit risk provisions	(1,815)	(1,133)	(24)	1	(4)	–	(2,975)
Net operating income	21,947	15,893	31,868	737	286	(562)	70,169
Operating expenses	(17,133)	(7,702)	(9,695)	(256)	(1,885)	562	(36,109)
Operating profit/(loss)	4,814	8,191	22,173	481	(1,599)	–	34,060
Share of profit in associates and joint ventures	2,110	11,416	4,638	–	6	–	18,170
Profit/(loss) before tax	6,924	19,607	26,811	481	(1,593)	–	52,230

Financial Review (continued)

Net interest income

Net interest income increased as a result of loan and deposit growth, notably in Hong Kong, partly offset by a reduction in the net interest margin.

Average interest-earning assets increased by HK$312,990m or 7.5% compared with 2012. Average customer lending increased 11%, with notable growth in both mortgages and trade-related lending, while financial investments increased by 7%.

	2013 HK$m	2012 HK$m
Average interest-earning assets	**4,512,319**	4,199,329

Net interest margin fell by two basis points to 1.94% compared with 2012. Central bank rate cuts and liquidity easing measures reduced deposit spreads, while competitive pressures reduced asset spreads, notably on trade-related lending. Net interest spread decreased by four basis points to 1.81%, whilst the contribution from net free funds increased by two basis point to 13 basis points.

Net interest margin (%)

	2013 %	2012 %
Spread	**1.81**	1.85
Contribution from net free funds	**0.13**	0.11
Total	**1.94**	1.96

Net interest margin (%)

	2013 %	2012 %
Hong Kong:		
The Bank	**1.34**	1.46
Hang Seng Bank	**2.13**	2.10
Rest of Asia-Pacific	**2.06**	2.14

In **Hong Kong,** the Bank recorded a decrease in net interest margin of 12 basis points to 1.34%. Asset spreads on customer loans reduced, notably on trade-related lending, though remained broadly stable on mortgages and term lending, while deposit spreads were lower as short-term interest rates reduced. The net interest margin was also reduced by an increase in the commercial surplus following the purchase of the GPB business from HSBC Private Bank (Suisse) SA.

At **Hang Seng Bank,** the net interest margin increased by three basis points to 2.13% and the net interest spread increased by three basis points to 2.03%. The spread on customer lending improved, notably on mortgages, as the cost of funds reduced. This was partly offset by lower deposit spreads as short-term interest rates reduced.

In the **Rest of Asia-Pacific,** the net interest margin was 2.06%, eight basis points lower than 2012. Central bank rate cuts and liquidity easing measures reduced deposit spreads, while competitive pressures and our focus on secured lending reduced asset spreads.

Net fee income

Net fee income increased by HK$3,956m, or 10% compared with 2012.

Fees from unit trusts and brokerage rose due to strong customer demand and favourable investment sentiment, notably in Hong Kong. This was partly offset by lower wealth management sales in India as we revised our product offerings.

Card fees also rose from higher spending in Hong Kong, partly offset by Thailand following the sale of the business in 2012 and balance reductions in the Philippines, India and Indonesia.

Fee income from remittances was higher from increased business volumes in Hong Kong.

Credit facility fees increased in 2013 from more mandates arranged during the year, notably in Hong Kong and Singapore.

Underwriting fees increased due to our participation in many debt and equity market transactions, primarily in Hong Kong.

Fees from insurance increased from distribution agreements following the sale of our general insurance business, though this corresponds with a reduction in net earned general insurance premiums.

Other fee income rose compared with 2012, in part due to growth in the mandatory provident funds business in Hong Kong, as well as increased participation in corporate and project finance advisory activity in Hong Kong.

	2013 HK$m	2012 HK$m
Brokerage	**7,344**	6,824
Cards	**7,146**	6,858
Unit trusts	**5,672**	4,523
Import/export	**4,986**	5,115
Funds under management	**4,114**	4,089
Remittances	**3,364**	3,066
Credit facilities	**3,176**	2,797
Account services	**2,782**	2,772
Underwriting	**1,908**	1,689
Insurance	**1,401**	1,042
Other	**8,294**	7,446
Fee income	**50,187**	46,221
Fee expense	**(6,341)**	(6,331)
Net fee income	**43,846**	39,890

Net trading income

Net trading income decreased by HK$2,637m, or 14% compared with 2012.

Included within trading income were further adverse fair value movements on the Ping An contingent forward sale contract of HK$3,323m, compared with HK$2,694m in 2012.

Dealing profits were lower in a number of countries in Asia Pacific, with a decline in Rates revenues from revaluation losses on trading bonds as yields rose. Foreign Exchange revenues also decreased as market conditions in 2012 were not repeated. Dealing profits in Hong Kong rose from higher Equities revenues as volumes increased from market making in warrants, as well as higher Foreign Exchange income due to improved margins and higher customer trading volumes. Rates trading income also benefited from more volume and a net favourable movement in respect of the valuation adjustments on derivatives compared with a net charge in 2012.

Net interest income on trading assets and liabilities decreased in 2013 from reduced bond holdings in a number of countries, partly offset by an increase in Hong Kong.

	2013 HK$m	2012 HK$m
Dealing profits	**15,104**	16,633
Loss from hedging activities	**(37)**	(31)
Net interest income	**3,859**	4,520
Dividend income from trading securities	**974**	786
Ping An contingent forward sale contract	**(3,323)**	(2,694)
Net trading income	**16,577**	19,214

Financial Review (continued)

Gains less losses from financial investments

We recorded a gross gain on the sale of our shareholding in Ping An of HK$34,070m, which was partly offset by the adverse fair value movement of HK$3,323m on the contingent forward sale contract included in 'Net trading income', leading to a net gain of HK$30,747m.

Gains on disposal of financial investments in 2012 included the gain of HK$2,441m on the sale of our shares in four Indian banks.

	2013 HK$m	2012 HK$m
Gain on sale of Ping An	**34,070**	–
Gains on disposal of available-for-sale securities	**470**	2,809
Impairment of available-for-sale equity investments	**(28)**	(175)
Gains less losses from financial investments	**442**	2,634

Other operating income

We recorded an accounting gain of HK$8,454m on the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties.

We recorded an accounting loss of HK$297m on the reclassification of Yantai Bank as a financial investment following an increase in its registered share capital to enable a private placement of additional share capital to a third party.

Other operating income decreased by HK$3,919m in 2013. There was a gain on the disposal of our investment in Bao Viet Holdings of HK$810m and losses on the sale of our Taiwan life insurance business and Singapore group term life and group medical insurance businesses totalling HK$339m. We also recorded a gain on the disposal of Hana HSBC Life Insurance Company Limited of HK$214m, though this was after write-downs of HK$558m earlier in the year and HK$395m in 2012, recorded in operating expenses.

In 2012 we reported gains totalling HK$5,246m on the disposals of our RBWM business in Thailand, our GPB business in Japan, the general insurance businesses in Hong Kong, Global Payments Asia-Pacific Ltd and our interest in a property company in the Philippines.

There was a larger increase in the present value of in-force ('PVIF') asset in 2013 due to favourable interest rate assumption updates, though this was more than offset in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Gains on investment properties rose by HK$555m following revaluations, in part reflecting the strong commercial property market. There were also gains on disposals of properties of HK$269m during the year.

	2013 HK$m	2012 HK$m
Gain on reclassification of Industrial Bank	**8,454**	–
Loss on reclassification of Yantai Bank	**(297)**	–
Net gain on reclassification of associates	**8,157**	–
Movement in PVIF	**4,735**	4,432
Gains on investment properties	**1,389**	834
Gain on disposal of property, plant and equipment, and assets held for sale	**299**	30
Gain on disposal of subsidiaries, associates and business portfolios	**758**	5,246
Rental income from investment properties	**312**	216
Other	**3,925**	4,579
Other operating income	**11,418**	15,337

Insurance income

Net interest income increased by 11% as funds under management grew, reflecting net inflows from new and renewal insurance business.

Net income from financial instruments designated at fair value was HK$2,426m compared with HK$4,538m in 2012, reflecting weaker equity markets and falling bond prices. To the extent that revaluation is attributed to policyholders, there is an offsetting movement reported under 'Net insurance claims incurred and movement in liabilities to policyholders'.

Net insurance premiums rose by 2% as a result of increased renewals of existing deferred annuity and unit-linked policies, partly offset by the absence of general insurance premiums following the disposal of these businesses in 2012 and lower new business premiums. The growth in premiums resulted in a corresponding increase in 'Net insurance claims incurred and movement in liabilities to policyholders'.

The movement in PVIF increased by HK$303m, largely due to favourable interest rate assumption updates in Hong Kong, though this was more than offset in 'Net insurance claims incurred and movement in liabilities to policyholders'. The PVIF increase was partly offset by a lower value of new business compared with 2012, reflecting lower new business premiums.

Other operating income includes the gains on sale of our interests in Bao Viet Holdings and Hana HSBC Life Insurance Company Limited of HK$810m and HK$214m respectively, offset by losses on the sale of our Taiwan life insurance business and Singapore group term life and group medical insurance businesses totalling HK$339m.

Insurance income

	2013 **HK$m**	2012 HK$m
Net interest income	**8,702**	7,864
Net fee income	**1,864**	1,216
Net trading income/(loss)	**(349)**	56
Net income from financial instruments designated at fair value	**2,426**	4,538
Net earned insurance premiums	**53,663**	52,621
Movement in PVIF	**4,735**	4,432
Other operating income	**1,052**	1,308
	72,093	72,035
Net insurance claims incurred and movement in liabilities to policyholders	**(56,592)**	(54,983)
Net operating income	**15,501**	17,052

Financial Review (continued)

Loan impairment charges and other credit risk provisions

Loan impairment charges and other credit risk provisions decreased by HK$46m in 2013.

The charge for individually assessed impairments rose due to charges against a number of CMB customers in Hong Kong and a number of countries across Asia Pacific. These were partly offset by the non-recurrence of an impairment charge on a corporate exposure in Australia, as well as individually assessed impairment charges in India, both in 2012. There were higher releases in 2013, notably in Hong Kong and Bahrain.

The charge for collectively assessed impairments was broadly unchanged compared with 2012, with an increase in RBWM reflecting a revision to the assumptions used in our collective assessment model, largely offset by higher collective provision releases in CMB from lower historical loss rates.

The charge for other credit risk provisions decreased by HK$127m due to the non-recurrence of a charge in 2012 against a corporate exposure in Australia as noted above.

Loan impairment charges by region

	2013 HK$m	2012 HK$m
Hong Kong	**1,017**	658
Rest of Asia-Pacific	**2,394**	2,672
Total	**3,411**	3,330

Loan impairment charges and other credit risk provisions

	2013 HK$m	2012 HK$m
Individually assessed impairment charges:		
New charges	**2,433**	2,201
Releases	**(1,426)**	(1,230)
Recoveries	**(198)**	(237)
	809	734
Collectively assessed impairment charges	**2,602**	2,596
	3,411	3,330
Other credit risk provisions	**121**	248
Loan impairment charges and other credit risk provisions	**3,532**	3,578

Operating Expenses

Employee compensation and benefits were broadly unchanged compared with 2012.

Wages and salaries decreased by HK$472m in 2013, in part due to lower termination benefits than 2012 in a number of countries.

Excluding termination benefits, wages and salaries were lower from reduced average staff numbers, partly offset by wage inflation across a number of countries and the acquisition of the GPB businesses in Hong Kong and Singapore in November 2013. The decrease also reflected lower performance-related pay, primarily from share-based payment expenses as fewer shares were granted during the year.

Retirement benefit costs increased from changes to the measurement of defined benefit pension costs in 2013 following the adoption of Amendments to HKAS 19 'Employee Benefits'.

Staff numbers by region (full time equivalent)

	At 31 December	
	2013	2012
Hong Kong:		
The bank and wholly owned subsidiaries	**20,189**	18,966
Hang Seng Bank Hong Kong	**7,945**	7,746
Total Hong Kong	**28,134**	26,712
Rest of Asia-Pacific:		
Australia	**1,654**	1,675
Mainland China	**8,711**	8,444
Malaysia	**4,694**	4,523
India	**4,961**	5,347
Indonesia	**5,773**	5,113
Singapore	**3,048**	2,656
Taiwan	**2,249**	2,557
Sri Lanka	**1,404**	1,488
Others	**6,393**	7,078
Total Rest of Asia-Pacific	**38,887**	38,881
Total	**67,021**	65,593

General and administrative expenses increased by HK$116m in 2013.

Rental expenses rose in 2013, primarily in Hong Kong from higher property rental prices and in mainland China from branch expansion.

Other premises and equipment expenses rose marginally, reflecting higher property maintenance charges in Hong Kong. This was partly offset by the non-recurrence of restructuring costs in 2012 relating to the sale of our RBWM business in Thailand and our GPB business in Japan.

Marketing and advertising expenses decreased, from reduced activity in a few countries across Rest of Asia-Pacific, partly offset by higher card awards and increased promotions in Hong Kong.

Other administrative expenses were broadly unchanged. Expenses reduced from the partial write back of a litigation provision in Singapore and Australia compared with a charge in 2012 and lower restructuring and other related costs, as well as the non-recurrence of costs following the sale or closure of operations.

These reductions were offset by increases in Hong Kong, reflecting growth in professional, legal and data processing costs, increased use of the global services centres and costs relating to the introduction of updated payment cards and information technology platforms. In addition, we recorded a write-down of Hana HSBC Life Insurance Company Limited of HK$558m in 2013 compared with HK$395m in 2012.

	2013	2012
	%	%
Cost efficiency ratio	**33.9**	42.4

Excluding the gain on disposal of our shareholding in Ping An and the accounting gain on the reclassification of Industrial Bank, the cost efficiency ratio is 42.1% in 2013.

Operating expenses

	2013	2012
	HK$m	HK$m
Employee compensation and benefits	**36,938**	37,021
General and administrative expenses	**26,127**	26,011
Depreciation of property plant and equipment	**3,988**	4,014
Amortisation of intangible assets	**1,675**	1,724
Total	**68,728**	68,770
Of which: restructuring costs	**662**	1,166

Financial Review (continued)

Share of profit in associates and joint ventures

Share of profit in associates and joint ventures reduced by HK$4,390m following the reclassification of Industrial Bank as a financial investment and an impairment charge of HK$819m on our banking associate in Vietnam. Excluding these factors, income from associates rose, principally in Bank of Communications ('BoCom') as a result of balance sheet growth and increased fee income, partly offset by higher operating expenses and a rise in loan impairment charges.

At 31 December 2013, we performed an impairment review of our investment in BoCom and concluded that it was not impaired at the year end, based on our value in use calculation (see note 24 for further details). In future years, the value in use will remain relatively stable if the current calculation assumptions remain broadly unchanged. However, it is expected that the carrying amount will increase in 2014 due to retained profits earned by BoCom. At the point where the carrying amount exceeds the value in use, the carrying amount would be reduced to equal value in use, with a corresponding reduction in income, unless the market value has increased to a level above the carrying amount.

	2013 HK$m	2012 HK$m
Share of profit in associates and joint ventures	**14,420**	18,810

Tax expense

The effective rate of tax for 2013 was 10.8% compared with 16.6% in 2012, reflecting the non-taxable gains on the reclassification of Industrial Bank as a financial investment and the Ping An disposal.

	2013 %	2012 %
Effective tax rate	**10.8**	16.6

Assets

In November 2013 we acquired the Hong Kong and Singapore branches of HSBC Private Bank (Suisse) SA, including customer loans of HK$54bn and HK$28bn respectively, largely in other personal lending. Excluding this, loans and advances to customers in Hong Kong and Rest of Asia-Pacific increased by HK$167bn, or 13%, and HK$71bn, or 7%, respectively.

The increase in Hong Kong was largely attributable to growth in corporate and commercial lending of HK$122bn, reflecting higher demand primarily in international trade and other property-related lending.

In the Rest of Asia-Pacific, growth was offset by foreign exchange translation effects of HK$52bn. The underlying increase of HK$123bn was mainly from growth in corporate and commercial lending of HK$57bn, notably in Singapore and mainland China. Residential mortgage lending increased by HK$27bn, notably in mainland China and Australia. Total financial lending increased by HK$38bn following a change in the way GB&M manages repo and reverse repo activities, which were previously being managed in a trading environment. During the year, these activities were organised into trading and non-trading portfolios, which resulted in an increase in the amount of reverse repos classified as 'Loans and advances to customers' and a decline in the amount classified as 'Trading assets' at 31 December 2013, compared with previous reporting periods.

Assets 2013[1]

	HK$m	**%**
Cash and short-term funds	**1,132,719**	**18.1**
Placings with banks maturing after one month and certificates of deposit	**305,177**	**4.9**
Trading assets	**311,400**	**5.0**
Loans and advances to customers	**2,669,238**	**42.7**
Financial investments	**765,866**	**12.3**
Other	**1,059,401**	**17.0**
Total	**6,243,801**	**100.0**

Assets 2012[1]

	HK$m	%
Cash and short-term funds	1,111,199	18.9
Placings with banks maturing after one month and certificates of deposit	277,796	4.7
Trading assets	419,697	7.1
Loans and advances to customers	2,349,043	39.9
Financial investments	626,042	10.6
Other	1,105,286	18.8
Total	5,889,063	100.0

1 *Excluding Hong Kong Government certificates of indebtedness.*

Customer accounts

Customer accounts increased by HK$380bn, or 10%, during 2013, of which HK$151bn and HK$77bn respectively were attributable to the acquisition of the Hong Kong and Singapore branches of HSBC Private Bank (Suisse) SA. Excluding this, customer accounts in Hong Kong increased by HK$155bn, or 6%. In the Rest of Asia-Pacific, customer accounts decreased by HK$3bn due to the depreciation of many Asian currencies against the Hong Kong dollar, offset by growth notably in mainland China, Australia and India.

Customer accounts by region

	2013	2012
	HK$m	HK$m
Hong Kong excluding Hang Seng Bank	**2,068,380**	1,805,417
Hang Seng Bank Hong Kong	**769,399**	726,207
Rest of Asia-Pacific	**1,416,973**	1,343,260
Total	**4,254,752**	3,874,884

The group's advances-to-deposits ratio increased to 62.7% at 31 December 2013, from 60.6% at 31 December 2012, as more of the commercial surplus was deployed to customer lending.

	2013	2012
	%	%
Advances-to-deposits ratio	**62.7**	60.6

Customer accounts by type

	2013	2012
	HK$m	HK$m
Current accounts	**862,138**	831,256
Savings accounts	**2,246,618**	2,063,565
Other deposit accounts	**1,145,996**	980,063
Total	**4,254,752**	3,874,884

Equity

Equity increased by HK$49bn, or 10%, to HK$522bn. The increase came from retained profits, the issue of additional share capital and an increase in the property revaluation reserve. This was offset by the impact of the acquisition of the Hong Kong and Singapore branches of HSBC Private Bank (Suisse) SA, where the premium paid in excess of the net assets acquired was charged to reserves.

Risk Report

Risk management *(Unaudited)*

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. In addition, internal audit is responsible for the independent review of risk management and the control environment.

Description of risks - banking operations
(Audited)

Risks	Arising from	Measurement, monitoring and management of risk
Credit risk		
The risk of financial loss if a customer or counterparty fails to meet an obligation under a contract.	· Credit risk arises principally from direct lending, trade finance and leasing business, but also from certain other products such as guarantees and derivatives.	Credit risk: · is measured as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark to market value of the contract and the expected potential change in that value over time caused by movements in market rates; · is monitored within limits approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the group could be subjected should the customer or counterparty fail to perform its contractual obligations; and · is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.
Liquidity and funding risk		
The risk that we do not have sufficient financial resources to meet our obligations as they fall due or that we can only do so at excessive cost.	· Liquidity risk arises from mismatches in the timing of cash flows. · Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.	Liquidity and funding risk: · is measured using internal metrics including stressed operational cash flow projections, coverage ratio and advances to core funding ratios; · is monitored against the Group's liquidity and funding risk framework and overseen by regional Asset and Liability Management Committees ('ALCO's), Group ALCO and the Risk Management Meeting; and · is managed on a stand-alone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established market practice.
Market risk		
The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.	Exposure to market risk is separated into two portfolios: · Trading portfolios comprise positions arising from market-making and warehousing of customer derived positions. · Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from our insurance operations.	Market risk: · is measured in terms of value at risk, which is used to estimate potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence, augmented with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables; · is monitored using measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to the market risk positions within each risk type; and · is managed using risk limits approved by the Risk Management Committee for the group. These units are allocated across business lines and to the group's operating entities.

Risks	Arising from	Measurement, monitoring and management of risk
Operational risk		
The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk (along with accounting, tax, security and fraud, people, systems, projects, operations and organisational change risk).	Operational risk arises from day to day operations or external events, and is relevant to every aspect of our business.	Operational risk: · is measured using both the top risk analysis process and the risk and control assessment process, which assess the level of risk and effectiveness of controls; · is monitored using key indicators and other internal control activities; and · is primarily managed by global business and functional managers. They identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls using the operational risk management framework. The Global Operational Risk function is responsible for the framework and for overseeing the management of operational risks within businesses and functions.
Other material risks		
Reputational risk		
The risk that illegal, unethical or inappropriate behaviour by the group itself, members of staff or clients or representatives of the group will damage our reputation, leading, potentially, to a loss of business, fines or penalties.	Reputational risk encompasses negative reaction not only to activities which may be illegal or against regulations, but also to activities that may be counter to societal standards, values and expectations. It arises from a wide variety of causes, including how we conduct our business and the way in which clients to whom we provide financial services, and bodies who represent us, conduct themselves.	Reputational risk: · is measured by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees; · is monitored through a reputational risk management framework, taking into account the results of the compliance risk monitoring activity; and · is managed by every member of staff and is covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk, including the Group Reputational Risk Policy Committee and regional/business equivalents.
Pension risk		
The risk that contributions from group companies and members fail to generate sufficient funds to meet the cost of accruing benefits for the future service of active members, and the risk that the performance of assets held in pension funds is insufficient to cover existing pension liabilities.	Pension risk arises from investments delivering an inadequate return, economic conditions leading to corporate failures or adverse changes in interest rates or inflation. Pension risk includes operational risks listed above.	Pension risk: · is measured in terms of the schemes' ability to generate sufficient funds to meet the cost of their accrued benefits; · is monitored through the specific risk appetite that has been developed at both Group and regional levels; and · is managed locally through the appropriate pension risk governance structure and globally through the Risk Management Meeting.

Our insurance manufacturing subsidiaries are separately regulated from our banking operations. Risks in the insurance entities are managed using methodologies and processes appropriate to insurance manufacturing operations, but remain subject to oversight at group level. Our insurance operations are also subject to the operational and other material risks presented in relation to the banking operations, and these are covered by the group's respective risk management processes.

Risk Report (continued)

Description of risks - insurance manufacturing operations

Risks	Arising from	Measurement, monitoring and management of risk
Insurance risk		
The risk that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income.	The cost of claims and benefits 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.	Insurance risk: · is measured in terms of life insurance liabilities; · is monitored by the Risk Management Committee of the Insurance operations, which checks the risk profile against the risk appetite for insurance business approved by the group; and · is managed both centrally and locally using product design, underwriting, reinsurance and claims-handling procedures.
Financial risks		
Our ability to effectively match the liabilities arising under insurance contracts with the asset portfolios that back them are contingent on the management of financial risks such as market, credit and liquidity risks, and the extent to which these risks are borne by the policyholders. *Liabilities to policyholders under unit-linked contracts move in line with the value of the underlying assets, and as such the policyholder bears the majority of the financial risks.* *Contracts with discretionary participating features share the performance of the underlying assets between policyholders and the shareholder in line with the type of contract and the specific contract terms.*	Exposure to financial risks arises from: · market risk of changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices; · credit risk and the potential for financial loss following the default of third parties in meeting their obligations; and · liquidity risk of entities not being able to make payments to policyholders as they fall due as there are insufficient assets that can be realised as cash.	Financial risks: · are measured separately for each type of risk: - market risks are measured in terms of exposure to fluctuations in key financial variables; - credit risk is measured as the amount which could be lost if counterparty fails to make repayments; and - liquidity risk is measured using internal metrics including stressed operational cash flow projections; · are monitored within limits approved by individuals within a framework of delegated authorities; · are managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers. Subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates and equity prices to the extent that the market exposure cannot be managed by using any discretionary participation (or bonus) features within the policy contracts they issue; and · can be mitigated through sharing of risk with policyholders under the discretionary participation features for participating products.

Stress testing *(Unaudited)*

Our stress testing and scenario analysis programme is central to our risk management. We conduct stress-testing scenarios across the group and for individual subsidiaries which reflect our business strategy and resultant risk exposures. These scenarios include, but are not limited to, adverse macro-economic events; country, sector and counterparty failures; and a variety of projected major operational risk events. The results of the stress tests are used to assess the potential demand for regulatory capital under the various scenarios. We also participate, where appropriate, in scenario analyses requested by regulatory bodies including the Hong Kong Monetary Authority ('HKMA') and other regional regulators.

We examined several scenarios in the course of 2013. These included a severe Asian-led global recession scenario; a worsening Eurozone crisis and a US-fiscal cliff scenario. The results of these stress tests demonstrated that the group would remain satisfactorily capitalised after taking account of assumed management actions.

Exposure to risks arising from the business activities of global businesses (Unaudited)

The chart below provides a high level guide to how the group's business activities are reflected in our risk measures and in our balance sheet.

The assets and liabilities indicate the contribution each business makes to the balance sheet, while risk weighted assets ('RWAs') illustrate the relative size of the risks incurred in respect of each business.

The Hongkong and Shanghai Banking Corporation Limited — **Other**

Global business	**RBWM**	**CMB**	**GB&M**	**GPB**	**Other**
Business activities	• Deposits • Accounts services • Credit and lending • Asset management • Wealth solutions and financial planning • Broking • Life insurance manufacturing	• Deposits • Payments and cash management • Credit and lending • Global trade and receivables finance • Global markets (via GB&M) • Capital financing (via GB&M) • Insurance and investments	• Deposits • Payments and cash management • Balance sheet management • Credit and lending • Asset and trade finance • Corporate finance • Markets • Securities services	• Deposits • Account services • Credit and lending • Asset management • Financial advisory • Broking • Corporate finance (via GB&M) • Alternative investments	• The Bank's central operations
Balance sheet[1]	HK$bn • Assets 1,226 • Customer accounts 2,159	HK$bn • Assets 1,140 • Customer accounts 1,101	HK$bn • Assets 3,919 • Customer accounts 751	HK$bn • Assets 100 • Customer accounts 242	HK$bn • Assets 54 • Customer accounts 3
RWAs	HK$bn • Credit risk 224 • Operational risk 60	HK$bn • Credit risk 708 • Operational risk 54	HK$bn • Credit risk 782 • Counterparty credit risk 95 • Operational risk 145 • Market risk 134	HK$bn • Credit risk 20 • Operational risk 6	HK$bn • Credit risk 245 • Operational risk 10
Risk profile	Liquidity and funding risk, Pension risk, Reputational risk and Insurance risk. The latter is predominantly in RBWM and CMB.				

1 *The sum of balances presented does not agree to the consolidated amounts, because balances between global businesses are not eliminated here.*

Credit Risk

(Audited)

Credit risk generates the largest regulatory capital requirement of the risks we incur. 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 which are consistent with the Group credit policy 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 group's 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.

RMC has the responsibility for risk approval authorities 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 the risk management framework.

The Executive Committee ('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.

The Risk Committee also has responsibility for oversight and advice to the Board on risk matters. The key responsibilities of the Risk Committee in this regard include preparing advice to the Board on the overall risk appetite tolerance and strategy within the group and seeking such assurance as it may deem appropriate that account has been taken of the current and prospective macroeconomic and financial environment. The Risk Committee is also responsible for the periodic review of the effectiveness of the internal control and risk management frameworks and advising the Board on all high level risk matters. The Risk Committee approves the appointment and removal of the group Chief Risk Officer.

(i) Credit exposure

Maximum exposure to credit risk

(Audited)

Our credit exposure is spread across a broad range of asset classes, including derivatives, trading assets, loans and advances to customers, loans and advances to banks and financial investments.

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (unless such credit enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Maximum exposure to credit risk before collateral held or other credit enhancements

The group	**2013 HK$m**	2012 HK$m
Cash and short-term funds	**1,132,719**	1,111,199
Items in the course of collection from other banks	**16,346**	23,079
Placings with banks maturing after one month	**216,970**	184,711
Certificates of deposit	**88,207**	93,085
Hong Kong Government certificates of indebtedness	**195,554**	176,264
Trading assets	**279,760**	389,296
Debt securities	**150,145**	176,757
Treasury bills and other eligible bills	**109,174**	155,464
Other	**20,441**	57,075
Financial assets designated at fair value	**19,900**	17,421
Debt securities	**19,871**	17,001
Other	**29**	420
Derivatives	**388,727**	398,956
Loans and advances to customers	**2,669,238**	2,349,043
Personal	**963,372**	857,670
Corporate and commercial	**1,580,540**	1,426,700
Financial (non-bank financial institutions)	**125,326**	64,673
Financial investments: Debt securities	**731,070**	618,671
Amounts due from Group companies	**161,975**	176,004
Other assets	**77,895**	80,105
Acceptances and endorsements	**34,239**	31,965
Other	**43,656**	48,140
Financial guarantees and other credit-related contingent liabilities	**83,647**	59,065
Loan commitments and other credit-related commitments[1]	**1,944,536**	1,820,719
At 31 December	**8,006,544**	7,497,618

1 *Includes both revocable and irrevocable commitments.*

The Bank	**2013 HK$m**	2012 HK$m
Cash and short-term funds	**763,529**	761,187
Items in the course of collection from other banks	**10,922**	17,355
Placings with banks maturing after one month	**92,945**	80,200
Certificates of deposit	**10,012**	20,150
Hong Kong Government certificates of indebtedness	**195,554**	176,264
Trading assets	**204,069**	254,323
Debt securities	**111,588**	125,372
Treasury bills and other eligible bills	**82,003**	116,214
Other	**10,478**	12,737
Financial assets designated at fair value: debt securities	**1,561**	1,432
Derivatives	**377,183**	391,839
Loans and advances to customers	**1,503,251**	1,282,720
Personal	**538,117**	447,209
Corporate and commercial	**894,880**	790,414
Financial (non-bank financial institutions)	**70,254**	45,097
Financial investments: Debt securities	**319,849**	257,804
Amounts due from Group companies	**366,889**	321,600
Other assets	**37,255**	45,231
Acceptances and endorsements	**19,845**	21,191
Other	**17,410**	24,040
Financial guarantees and other credit-related contingent liabilities	**41,783**	32,317
Loan commitments and other credit-related commitments[1]	**1,282,148**	1,167,024
At 31 December	**5,206,950**	4,809,446

1 *Includes both revocable and irrevocable commitments.*

Total exposure to credit risk remained broadly unchanged in 2013 with loans and advances remaining the largest element. Whilst the total exposure to credit risk remained broadly stable, there was an increase in the amount of reverse repos classified as ‘Loans and advances to customers’, and a decline in the amount classified as ‘Trading assets’. This followed a change in GB&M’s management model relating to repo and reverse repo agreements to reflect the continued change in the use of such arrangements for funding, rather than solely trading purposes. The change was applied prospectively during the year from which point new repo and reverse repo transactions identified as being entered for funding purposes were recognised at amortised cost in the balance sheet, in accordance with the accounting policies set out in note 3(j) on the Financial Statements.

(ii) Credit quality of financial instruments
(Audited)

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 the granular level, except insofar as both fall within one of the four classifications.

	Debt securities/ other bills	**Wholesale lending and derivatives**		**Retail lending**	
Quality Classification	**External rating**	**Internal credit rating**	**Probability of default %**	**Internal credit rating**	**Expected loss %**
Strong	**A– and above**	**CRR 1 to CRR 2**	**0 – 0.169**	**EL 1 to EL 2**	**0 – 0.999**
Medium	**B+ to BBB+, and unrated**	**CRR 3 to CRR 5**	**0.170 – 4.914**	**EL 3 to EL 5**	**1.000 – 19.999**
Sub-standard	**B and below**	**CRR 6 to CRR 8**	**4.915 – 99.999**	**EL 6 to EL 8**	**20.000 – 99.999**
Impaired	**Impaired**	**CRR 9 to CRR 10**	**100**	**EL 9 to EL 10**	**100+ or defaulted[1]**

1 *The EL percentage is derived through a combination of PD and LGD, and may exceed 100% in circumstances where the LGD is above 100%, reflecting the cost of recoveries.*

Quality classification definitions
(Audited)

- 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 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 3(e) and 3(h) on the Financial Statements. An analysis of impairment allowances as at 31 December 2013 and the movement of such allowances during the year are disclosed in note 19.

Granular risk rating scales
(Audited)

The CRR ('Customer Risk Rating') 10-grade scale summarises to a more granular underlying 23-grade scale of obligor probability of default ('PD'). All HSBC wholesale customers are rated using the 10 or 23-grade scale, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

The EL 10-grade scale for retail business summarises a more granular underlying EL scale for these customer segments; this combines obligor and facility/product risk factors in a composite measure. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures.

The basis of reporting reflects risk rating systems under the HSBC Group's Basel II programme and extends 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.

(iii) Collateral and other credit enhancements
(Audited)

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the group's general practice to lend on the basis of the customer's ability to meet their obligations out of their cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. However, for other lending a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default the bank may use the collateral as a source of repayment.

Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk. The tables below provide a quantification of the value of fixed charges we hold over a borrower's specific asset (or assets) where we have a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and where the collateral is cash or can be realised by sale in an established market. The collateral valuation in the tables below excludes any adjustments for obtaining and selling the collateral.

We may also manage our risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised may benefit from such credit mitigants.

Personal lending

(Audited)

Residential mortgages including loan commitments by level of collateral

	At 31 December	
	2013	2012
	HK$m	HK$m
Unimpaired loans		
Not collateralised	**665**	70
Fully collateralised	**762,451**	745,291
– Less than 25% LTV	**98,986**	96,375
– 25% to 50% LTV	**331,186**	328,793
– 51% to 75% LTV	**266,496**	248,670
– 76% to 90% LTV	**53,004**	62,520
– 91% to 100% LTV	**12,779**	8,933
Partially collateralised		
– Greater than 100% LTV (A)	**2,807**	2,846
– Collateral value on A	**2,379**	2,450
	765,923	748,207
Impaired loans		
Not collateralised	**22**	9
Fully collateralised	**1,978**	2,398
– Less than 25% LTV	**248**	251
– 25% to 50% LTV	**532**	857
– 51% to 75% LTV	**746**	778
– 76% to 90% LTV	**380**	400
– 91% to 100% LTV	**72**	112
Partially collateralised		
– Greater than 100% LTV (B)	**129**	83
– Collateral value on B	**34**	63
	2,129	2,490
Total residential mortgages	**768,052**	750,697

The above table shows residential mortgage lending including off-balance sheet loan commitments by level of collateral. The collateral included in the table above consists of fixed first charges on real estate.

The loan-to-value ('LTV') ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The methodologies for obtaining residential property collateral values vary throughout the group, but are typically determined through a combination of professional appraisals, house price indices or statistical analysis. Valuations must be updated on a regular basis and, as a minimum, at intervals of every three years. Valuations are conducted more frequently when market conditions or portfolio performance are subject to significant change or where a loan is identified and assessed as impaired.

Other personal lending

Other personal lending consists primarily of personal loans, overdrafts and credit cards, all of which are generally unsecured.

Corporate, commercial and financial (non-bank financial institutions) lending
(Audited)

Collateral held is analysed below separately for commercial real estate and for other corporate, commercial and financial (non-bank) lending. This reflects the difference in collateral held on the portfolios. In each case, the analysis includes off-balance sheet loan commitments, primarily undrawn credit lines.

Commercial real estate loans and advances including loan commitments by level of collateral

	At 31 December	
	2013	2012
	HK$m	HK$m
Rated CRR/EL 1 to 7	**324,558**	314,079
Not collateralised	**109,827**	111,895
Fully collateralised	**196,301**	181,832
Partially collateralised (A)	**18,430**	20,352
– collateral value on A	**13,089**	12,735
Rated CRR/EL 8 to 10	**230**	878
Not collateralised	**81**	–
Fully collateralised	**93**	486
– Less than 25% LTV	**1**	12
– 25% to 50% LTV	**19**	437
– 51% to 75% LTV	**48**	17
– 76% to 90% LTV	**20**	9
– 91% to 100% LTV	**5**	11
Partially collateralised (B)	**56**	392
– collateral value on B	**43**	115
Total commercial real estate loans and advances	**324,788**	314,957

The collateral included in the table above consists of fixed first charges on real estate and charges over cash for the commercial real estate sector. The table includes lending to major property developers which is typically secured by guarantees or is unsecured.

The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of collateral valuations for commercial real estate, local valuation policies determine the frequency of review based on local market conditions. Revaluations are sought with greater frequency where, as part of the regular credit assessment of the obligor, material concerns arise in relation to the transaction which may reflect on the underlying performance of the collateral, or in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation (i.e. the obligor's credit quality classification indicates it is at the lower end e.g. sub-standard, or approaching impaired).

Other corporate, commercial and financial (non-bank) loans and advances rated CRR/EL 8 to 10 only, including loan commitments, by level of collateral
(Audited)

	At 31 December 2013 HK$m	At 31 December 2012 HK$m
Rated CRR/EL 8 to 10		
Not collateralised	**7,432**	6,447
Fully collateralised	**1,641**	1,784
– Less than 25% LTV	**182**	113
– 25% to 50% LTV	**561**	515
– 51% to 75% LTV	**195**	547
– 76% to 90% LTV	**468**	278
– 91% to 100% LTV	**235**	331
Partially collateralised (A)	**2,543**	2,591
– collateral value on A	**1,202**	1,011
Total	**11,616**	10,822

The collateral used in the assessment of the above primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector and charges over cash and marketable financial instruments in the financial sector. Government sector lending is typically unsecured.

It should be noted that the table above excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer's business. While such mitigants have value, often providing rights in insolvency, their assignable value is insufficiently certain. They are assigned no value for disclosure purposes.

As with commercial real estate the value of real estate collateral included in the table above is generally determined through a combination of professional and internal valuations and physical inspection. The frequency of revaluation is undertaken on a similar basis to commercial real estate loans and advances; however, for financing activities in corporate and commercial lending that are not predominantly commercial real estate-oriented, collateral value is not as strongly correlated to principal repayment performance. Collateral values will generally be refreshed when an obligor's general credit performance deteriorates and it is necessary to assess the likely performance of secondary sources of repayment should reliance upon them prove necessary. For this reason, the table above reports values only for customers with CRR 8 to 10, reflecting that these loans and advances generally have valuations which are of comparatively recent vintage. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

Loans and advances to banks
(*Audited*)

Loans and advances to banks, including loan commitments, by level of collateral

	At 31 December 2013 HK$m	At 31 December 2012 HK$m
Rated CRR/EL 1 to 8		
Not collateralised	**565,854**	492,106
Fully collateralised	**80,853**	61,702
Partially collateralised (A)	**34,753**	20,661
– collateral value on A	**32,657**	20,054
Total loans and advances to banks	**681,460**	574,469

The collateral used in the assessment of the above lending relates primarily to cash and marketable securities. Loans and advances to banks are typically unsecured. Certain products such as reverse repurchase agreements and stock borrowing are effectively collateralised and have been included in the above as fully or partially collateralised.

Derivatives

(Audited)

The International Swaps and Derivatives Association ('ISDA') Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of 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 another pre-agreed termination event occurs. It is common, and our preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institution clients.

Other credit risk exposures

(Audited)

In addition to collateralised lending described above, other credit enhancements are employed and methods used to mitigate credit risk arising from financial assets. These are described in more detail below.

Government, bank and other financial institution issued securities may benefit from additional credit enhancement, notably through government guarantees that reference these assets. Corporate issued debt securities are primarily unsecured. Debt securities issued by banks and financial institutions include asset-backed securities ('ABS's) and similar instruments, which are supported by underlying pools of financial assets. Credit risk associated with ABSs is reduced through the purchase of credit default swap ('CDS') protection.

Trading assets include loans and advances held with trading intent, the majority of which consist of reverse repos and stock borrowing which by their nature are collateralised. Collateral accepted as security that the group is permitted to sell or repledge under these arrangements is described in note 44 'Assets pledged as security for liabilities and collateral accepted as security for assets'.

The group's maximum exposure to credit risk includes financial guarantees and similar arrangements that it issues or enters into, and loan commitments to which it is irrevocably committed. Depending on the terms of the arrangement, the bank may have recourse to additional credit mitigation in the event that a guarantee is called upon or a loan commitment is drawn and subsequently defaults. Further information about these arrangements is provided in note 43 'Contingent liabilities and commitments'.

The carrying amount of assets obtained by taking possession of collateral held as security, or calling upon other credit enhancements, is as follows:

(Audited)	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**53**	115	**20**	21
Commercial and industrial properties	**16**	26	**15**	23
Other assets	**3**	3	**–**	–
	72	144	**35**	44

Repossessed assets are made available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. 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 own business use.

Risk Report (continued)

(iv) Distribution of financial instruments by credit quality (Audited)

The group

31 December 2013	Neither past due nor impaired: 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	**14,515**	**1,829**	**2**	–	–	–	**16,346**
Trading assets	**230,974**	**48,032**	**754**	–	–	–	**279,760**
– treasury and other eligible bills	**95,145**	**13,994**	**35**	–	–	–	**109,174**
– debt securities	**124,035**	**25,391**	**719**	–	–	–	**150,145**
– loans and advances to banks	**8,956**	**2,941**	–	–	–	–	**11,897**
– loans and advances to customers	**2,838**	**5,706**	–	–	–	–	**8,544**
Financial assets designated at fair value	**16,809**	**3,091**	–	–	–	–	**19,900**
– debt securities	**16,809**	**3,062**	–	–	–	–	**19,871**
– loans and advances to customers	–	**29**	–	–	–	–	**29**
Derivatives	**328,218**	**60,236**	**273**	–	–	–	**388,727**
Loans and advances to customers held at amortised cost	**1,303,525**	**1,299,677**	**29,756**	**32,646**	**13,135**	**(9,501)**	**2,669,238**
– personal	**857,139**	**82,358**	**535**	**21,425**	**4,078**	**(2,163)**	**963,372**
– corporate and commercial	**415,314**	**1,126,065**	**28,540**	**9,280**	**8,450**	**(7,109)**	**1,580,540**
– financial (non-bank financial institutions)	**31,072**	**91,254**	**681**	**1,941**	**607**	**(229)**	**125,326**
Loans and advances to banks held at amortised cost	**566,113**	**96,376**	**2,537**	**86**	–	–	**665,112**
Financial investments	**1,223,652**	**118,552**	**2,765**	–	**6**	–	**1,344,975**
– treasury and other eligible bills	**493,213**	**32,157**	**328**	–	–	–	**525,698**
– debt securities	**730,439**	**86,395**	**2,437**	–	**6**	–	**819,277**
Other assets	**23,708**	**52,813**	**1,105**	**217**	**53**	–	**77,895**
– endorsements and acceptances	**6,393**	**26,823**	**1,006**	**15**	**2**	–	**34,239**
– other	**17,315**	**25,990**	**99**	**201**	**51**	–	**43,656**
Total	**3,707,514**	**1,680,606**	**37,192**	**32,949**	**13,194**	**(9,501)**	**5,461,953**

1 *Includes HK$103,258m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

31 December 2012	Neither past due nor impaired: 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	21,044	2,035	–	–	–	–	23,079
Trading assets	288,274	99,986	1,036	–	–	–	389,296
– treasury and other eligible bills	131,405	23,926	133	–	–	–	155,464
– debt securities	131,588	44,312	857	–	–	–	176,757
– loans and advances to banks	21,001	1,190	–	–	–	–	22,191
– loans and advances to customers	4,280	30,558	46	–	–	–	34,884
Financial assets designated at fair value	14,705	2,716	–	–	–	–	17,421
– debt securities	14,705	2,296	–	–	–	–	17,001
– loans and advances to customers	–	420	–	–	–	–	420
Derivatives	334,877	63,793	286	–	–	–	398,956
Loans and advances to customers held at amortised cost	1,320,255	968,777	23,642	33,126	13,014	(9,771)	2,349,043
– personal	764,839	69,756	356	20,143	4,586	(2,010)	857,670
– corporate and commercial	534,606	856,938	22,787	11,869	7,584	(7,084)	1,426,700
– financial (non-bank financial institutions)	20,810	42,083	499	1,114	844	(677)	64,673
Loans and advances to banks held at amortised cost	472,123	72,026	2,682	77	–	–	546,908
Financial investments	1,133,090	110,743	2,816	–	5	–	1,246,654
– treasury and other eligible bills	512,674	21,661	563	–	–	–	534,898
– debt securities[1]	620,416	89,082	2,253	–	5	–	711,756
Other assets	31,901	47,101	774	228	101	–	80,105
– endorsements and acceptances	8,624	22,759	580	2	–	–	31,965
– other	23,277	24,342	194	226	101	–	48,140
Total	3,616,269	1,367,177	31,236	33,431	13,120	(9,771)	5,051,462

1 *Includes HK$108,872m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

Risk Report (continued)

The Bank

31 December 2013	Neither past due nor impaired: 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	9,485	1,435	2	–	–	–	10,922
Trading assets	161,204	42,682	183	–	–	–	204,069
– treasury and other eligible bills	68,009	13,994	–	–	–	–	82,003
– debt securities	88,506	22,899	183	–	–	–	111,588
– loans and advances to banks	1,862	110	–	–	–	–	1,972
– loans and advances to customers	2,827	5,679	–	–	–	–	8,506
Financial assets designated at fair value:							
– debt securities	555	1,006	–	–	–	–	1,561
Derivatives	321,165	55,814	204	–	–	–	377,183
Loans and advances to customers held at amortised cost	722,946	740,601	22,445	15,346	7,119	(5,206)	1,503,251
– personal	482,802	47,036	245	7,441	1,620	(1,027)	538,117
– corporate and commercial	218,475	647,770	21,687	5,998	4,906	(3,956)	894,880
– financial (non-bank financial institutions)	21,669	45,795	513	1,907	593	(223)	70,254
Loans and advances to banks held at amortised cost	272,597	45,406	89	86	–	–	318,178
Financial investments	665,990	89,450	126	–	6	–	755,572
– treasury and other eligible bills	395,977	29,734	–	–	–	–	425,711
– debt securities	270,013	59,716	126	–	6	–	329,861
Other assets	8,472	27,906	804	53	17	–	37,255
– endorsements and acceptances	4,524	14,568	736	15	2	–	19,845
– other	3,948	13,338	68	41	15	–	17,410
Total	2,162,414	1,004,300	23,853	15,485	7,142	(5,206)	3,207,991

1 *Includes HK$86,110m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

	Neither past due nor impaired						
31 December 2012	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	15,546	1,809	–	–	–	–	17,355
Trading assets	190,792	63,255	276	–	–	–	254,323
– treasury and other eligible bills	92,288	23,926	–	–	–	–	116,214
– debt securities	91,255	33,887	230	–	–	–	125,372
– loans and advances to banks	3,513	501	–	–	–	–	4,014
– loans and advances to customers	3,736	4,941	46	–	–	–	8,723
Financial assets designated at fair value:							
– debt securities	576	856	–	–	–	–	1,432
Derivatives	330,679	61,023	137	–	–	–	391,839
Loans and advances to customers held at amortised cost	722,756	527,615	15,175	16,175	6,548	(5,549)	1,282,720
– personal	407,730	30,990	225	7,420	1,673	(829)	447,209
– corporate and commercial	303,096	464,927	14,702	7,730	4,057	(4,098)	790,414
– financial (non-bank financial institutions)	11,930	31,698	248	1,025	818	(622)	45,097
Loans and advances to banks held at amortised cost	208,565	37,414	49	76	–	–	246,104
Financial investments	613,227	83,922	145	–	5	–	697,299
– treasury and other eligible bills	398,367	20,978	–	–	–	–	419,345
– debt securities	214,860	62,944	145	–	5	–	277,954
Other assets	18,370	26,278	509	62	12	–	45,231
– endorsements and acceptances	6,482	14,350	359	–	–	–	21,191
– other	11,888	11,928	150	62	12	–	24,040
Total	2,100,511	802,172	16,291	16,313	6,565	(5,549)	2,936,303

1 *Includes HK$94,465m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

(v) *Ageing analysis of past due but not yet impaired financial instruments (Audited)*

The amounts in the following table reflect exposures designated as past due but not impaired. Examples of exposures designated as past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment and 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.

Risk Report (continued)

The group

	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
31 December 2013						
Loans and advances to customers held at amortised cost[1]	**25,921**	**4,968**	**1,504**	**160**	**93**	**32,646**
– personal	**16,405**	**3,899**	**1,074**	**46**	**1**	**21,425**
– corporate and commercial	**7,873**	**773**	**430**	**114**	**90**	**9,280**
– financial (non-bank financial institutions)	**1,643**	**296**	**–**	**–**	**2**	**1,941**
Loans and advances to banks held at amortised cost	**86**	**–**	**–**	**–**	**–**	**86**
Other assets	**131**	**24**	**25**	**24**	**12**	**216**
	26,138	**4,992**	**1,529**	**184**	**105**	**32,948**
31 December 2012						
Loans and advances to customers held at amortised cost[1]	26,799	4,874	1,353	81	19	33,126
– personal	15,442	3,520	1,176	5	–	20,143
– corporate and commercial	10,802	799	177	76	15	11,869
– financial (non-bank financial institutions)	555	555	–	–	4	1,114
Loans and advances to banks held at amortised cost	77	–	–	–	–	77
Other assets	96	37	38	31	26	228
	26,972	4,911	1,391	112	45	33,431

The Bank

	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
31 December 2013						
Loans and advances to customers held at amortised cost[1]	**12,067**	**2,407**	**758**	**92**	**22**	**15,346**
– personal	**5,562**	**1,510**	**369**	**–**	**–**	**7,441**
– corporate and commercial	**4,888**	**609**	**389**	**92**	**20**	**5,998**
– financial (non-bank financial institutions)	**1,617**	**288**	**–**	**–**	**2**	**1,907**
Loans and advances to banks held at amortised cost	**86**	**–**	**–**	**–**	**–**	**86**
Other assets	**32**	**5**	**10**	**4**	**5**	**56**
	12,185	**2,412**	**768**	**96**	**27**	**15,488**
31 December 2012						
Loans and advances to customers held at amortised cost[1]	13,111	2,518	509	21	16	16,175
– personal	5,684	1,367	369	–	–	7,420
– corporate and commercial	6,948	609	140	21	12	7,730
– financial (non-bank financial institutions)	479	542	–	–	4	1,025
Loans and advances to banks held at amortised cost	76	–	–	–	–	76
Other assets	23	9	3	10	17	62
	13,210	2,527	512	31	33	16,313

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

(vi) Impaired loans and advances
(Audited)

The group's policy for recognising and measuring impairment allowances on both individually assessed loans and advances and those which are collectively assessed on a portfolio basis is described in note 3(e).

Analyses of impairment allowances at 31 December 2013, and the movement of such allowances during the year, are disclosed in note 19.

Impaired loans and advances are those that meet any of the following criteria:

- wholesale loans and advances classified as CRR 9 or CRR 10. These grades are assigned when the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse to security, or when the customer is past due 90 days or more on any material credit obligation to the group;
- retail loans and advances:
  - classified as EL 9 or EL 10; or
  - classified as EL 1 to EL 8 with 90 days and over past due; or
  - have been restructured with 90 days and over past due or with economic loss incurred by the bank irrespective of the delinquency status
- renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment. For loans that are assessed for impairment on a collective basis, the evidence to support reclassification as no longer impaired typically comprises a history of payment performance against the original or revised terms, depending on the nature and volume of renegotiation and the credit risk characteristics surrounding the renegotiation. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case by case basis.

(vii) Impairment assessment
(Audited)

It is the group's policy that each operating entity in the group creates impairment allowances for impaired loans promptly and appropriately.

For details of our impairment policies on loans and advances and financial investments, see notes 3(e) and 3(h) on the Financial Statements.

Impairment and credit risk mitigation

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. When we no longer expect to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for an impairment allowance. No impairment allowance is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans. Two methods are used to calculate allowances on a collective basis: a roll rate methodology or a more basic formulaic approach based on historical losses. In 2013 we reviewed the impairment allowance methodology used for retail banking and small business portfolios across the group to ensure that the assumptions used in our collective assessment models continue to appropriately reflect the period of time between a loss event occurring and the account proceeding to delinquency and eventual write-off.

- The historical loss methodology is typically used to calculate collective impairment allowances for secured, or low default portfolios, until the point at which they are individually identified and assessed as impaired. For loans which are collectively assessed using historical loss methodology, the historical loss rate is derived from the average contractual write-off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after the realisation of collateral and receipt of recoveries.
- A roll rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models.

The nature of the collective allowance assessment prevents individual collateral values or LTV ratios from being included within the calculation. However, the loss rates used in the collective assessment are adjusted for the collateral realisation experiences which will vary depending on the LTV composition of the portfolio.

For wholesale collectively assessed loans and secured personal lending, historical loss methodologies are applied to estimate impairment losses which have been incurred but not individually identified. Loss rates are derived from the observed contractual write-off net of recoveries over a defined period of at least 60 months. The net contractual write-off rate is the actual amount of loss experienced after realisation of collateral and receipt of recoveries. These historical loss rates are adjusted by an economic factor which adjusts the historical averages to better represent current economic conditions affecting the portfolio. In order to reflect the likelihood of a loss event not being identified and assessed an emergence period assumption is applied. This reflects the period between a loss occurring and its identification. The emergence period is estimated by the group, and in some cases by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. A fixed range for the period between a loss occurring and its identification is not defined across the group and as it is assessed empirically on a periodic basis, it may vary over time as these factors change. Given that credit management policies require all customers to be reviewed at least annually, we expect this estimated period would be at most 12 months.

Liquidity and Funding Risk

(Audited)

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities, in compliance with the Group's liquidity and funding risk framework ('LFRF') and with practices and limits set by the Group Management Board ('GMB') through the Risk Management Meeting and approved by the Board. These limits vary according to the depth and liquidity of the markets in which the entities operate. Our general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of the HSBC Group's Asset, Liability and Capital Management ('ALCM') structure, we have established Asset and Liability Management Committees ('ALCOs') at the group and operating entity level. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

The primary responsibility for managing liquidity and funding within the Group's framework and risk appetite resides with the local operating entity ALCO. All operating entities are overseen by the group ALCO, with appropriate escalation of significant issues to the HSBC Group ALCO and the Risk Management Meeting.

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding. Typically, an operating entity will be defined as a single branch or legal entity. However, to take account of the situation where operations in a country are booked across multiple subsidiaries or branches:

- an operating entity may be defined as a wider sub-consolidated group of legal entities if they are incorporated in the same country, liquidity and funding are freely fungible between the entities and permitted by local regulation, and the definition reflects how liquidity and funding are managed locally; or
- an operating entity may be defined more narrowly as a principal office (branch) of a wider legal entity operating in multiple countries, reflecting the local country management of liquidity and funding.

The Board is ultimately responsible for determining the types and magnitude of liquidity risk that the group is able to take and ensuring that there is an appropriate organisation structure for managing this risk. Under authorities delegated by the Board, the group ALCO is responsible for managing all ALCM issues including liquidity and funding risk management.

The group ALCO delegates to the group Tactical Asset and Liability Management Committee ('TALCO') the task of reviewing various analyses of the group pertaining to site liquidity and funding. TALCO's primary responsibilities include but are not limited to:

- reviewing the funding structure of operating entities and the allocation of liquidity among them;
- reviewing operating entities' list of liquid securities and documented proof that a deep and liquid market exists; and
- monitoring liquidity and funding limit breaches and to providing direction to those operating entities that have not been able to rectify breaches on a timely basis.

Compliance with liquidity and funding requirements is monitored by local ALCO who report to the group ALCO on a regular basis. This process includes:

- maintaining compliance with relevant regulatory requirements of the operating entity;
- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to core funding ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined limits;
- 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.

Liquidity ratio under the Hong Kong Banking Ordinance
(Audited)

The Banking Ordinance requires banks operating in Hong Kong to maintain a minimum liquidity ratio of 25%, calculated in accordance with the provisions of the Fourth Schedule of the Banking Ordinance. This 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.

The average liquidity ratios for the year are as follows:
(Unaudited)

	2013	2012
	%	%
Hong Kong branches of the Bank	**36.5**	38.3

The management of liquidity and funding risk
(Audited)

Inherent liquidity risk categorisation

We place our operating entities into one of three categories (low, medium and high) to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the host country and factors specific to the operating entities themselves, such as the local market, market share and balance sheet strength. The categorisation involves management judgement and is based on the perceived liquidity risk of an operating entity relative to other entities in the group. The categorisation is intended to reflect the possible impact of a liquidity event, not the probability of an event. The categorisation is part of our risk appetite and is used to determine the prescribed stress scenario that we require our operating entities to be able to withstand and manage.

Core deposits

A key assumption of our internal framework is the classification of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during periods of liquidity stress. This characterisation takes into account the inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics.

The three filters considered in assessing whether a deposit in any operating entity is core are:

- price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;
- size: depositors with total funds above certain monetary thresholds are excluded. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and
- line of business: the element of any deposit remaining after the application of the price and size filter is assessed on the basis of the line of business to which the deposit is associated. The proportion of any customer deposit that can be considered core under this filter is between 35% and 90%.

Repo transactions and bank deposits cannot be categorised as core deposits.

Advances to core funding ratio

Our liquidity and funding risk management framework employs two key measures to define, monitor and control the liquidity and funding risk of each of our operating entities. The advances to core funding ratio is used to monitor the structural long-term funding position, and the stressed coverage ratio, incorporating Group-defined stress scenarios, is used to monitor the resilience to severe liquidity stresses.

Core customer deposits are an important source of funds to finance lending to customers, and mitigate against reliance on short-term wholesale funding. Limits are placed on operating entities to restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long-term debt funding with a residual maturity beyond one year. This measure is referred to as the ‘advances to core funding’ ratio.

Advances to core funding ratio limits are set by the Risk Management Meeting for the most significant operating entities, and by the group ALCO for smaller operating entities, and are monitored by ALCM teams. The ratio describes current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. In general, customer loans are assumed to be renewed and are included in the numerator of the advances to core funding ratio, irrespective of the contractual maturity date. Reverse repurchase arrangements are excluded from the advances to core funding ratio.

Stressed coverage ratios

Stressed coverage ratios tabulated below are derived from stressed cash flow scenario analyses and express the stressed cash inflows as a percentage of stressed cash outflows over one-month and three-month time horizons.

The stressed cash inflows include:

· inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and

· contractual cash inflows from maturing assets that are not already reflected as a use of liquid assets.

In line with the approach adopted for the advances to core funding ratio, customer loans are, in general, assumed not to generate any cash inflows under stress scenarios and are therefore excluded from the numerator of the stressed coverage ratios, irrespective of the contractual maturity date.

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow under the stress scenario being monitored. Group operating entities are required to maintain a ratio of 100% or greater out to three months under the combined market-wide and HSBC-specific stress scenario defined by the inherent risk categorisation of the operating entity concerned.

Advances to core funding ratios and the stressed one-month and three-month coverage ratios for the group are provided in the following table based on month end figures:

	Advances to core funding ratio		Stressed one month coverage ratio		Stressed three month coverage ratio	
	2013	2012	**2013**	2012	**2013**	2012
	%	%	**%**	%	**%**	%
Year-end	**77.8**	79.0	**122.1**	131.9	**116.3**	127.3
Maximum	**83.1**	80.7	**131.9**	134.1	**127.3**	127.3
Minimum	**77.1**	78.3	**115.7**	123.3	**110.8**	117.4
Average	**79.8**	79.2	**121.2**	128.9	**115.5**	122.2

Stressed scenario analysis

We use a number of standard Group stress scenarios designed to model:

· combined market-wide and HSBC-specific liquidity crisis scenarios; and

· market-wide liquidity crisis scenarios.

These scenarios are modelled by all operating entities. The appropriateness of the assumptions for each scenario is reviewed regularly and formally approved by the Risk Management Meeting and the Board annually as part of the liquidity and funding risk appetite approval process.

Stressed cash outflows are determined by applying a standard set of prescribed stress assumptions to the Group’s cash flow model. Our framework prescribes the use of two market-wide scenarios and three further combined market-wide and HSBC-specific stress scenarios of increasing severity. In addition to our standard stress scenarios, individual operating entities are required to design their own scenarios to reflect specific local market conditions, products and funding bases.

The three combined market-wide and HSBC-specific scenarios model a more severe scenario than the two market-wide scenarios. The relevant combined market-wide and HSBC-specific stress scenario that an operating entity manages to is based upon its inherent liquidity risk categorisation.

Liquid assets
(Unaudited)

Stressed scenario analysis and the numerator of the coverage ratio include the assumed cash inflows that would be generated from the realisation of liquid assets, after applying the appropriate stressed haircut. These assumptions are made based on management's expectation of when an asset is deemed to be realisable.

Liquid assets are unencumbered assets that meet the Group's definition of liquid assets and are either held outright or as a consequence of a reverse repo transaction with a residual contractual maturity beyond the time horizon of the stressed coverage ratio being monitored.

Our framework defines the asset classes that can be assessed locally as high quality and realisable within one month and between one month and three months. Each local ALCO has to be satisfied that any asset which may be treated as liquid in accordance with the Group's liquid asset policy will remain liquid under the stress scenario being managed to.

Inflows from the utilisation of liquid assets within one month can generally only be based on confirmed withdrawable central bank deposits, gold or the sale or repo of government and quasi-government exposures generally restricted to those denominated in the sovereign's domestic currency. High quality ABSs (predominantly US MBSs) and covered bonds are also included but inflows assumed for these assets are capped.

Inflows after one month are also reflected for high quality non-financial and non-structured corporate bonds and equities within the most liquid indices.

Internal categorisation	**Cash inflow recognised**	**Asset classes**	**Eligibility criteria**
Level 1	· Within one month	· Central government · Central bank (including confirmed withdrawable reserves) · Supranationals · Multilateral Development Banks · Coins and banknotes	· 0% and 20% risk weighted
Level 2	· Within one month but capped	· Local and regional government · Public sector entities · Secured covered bonds and pass-through ABSs · Gold	· 20% risk weighted
Level 3	· From one to three months	· Unsecured non-financial entity securities · Equities listed on recognized exchanges and within liquid indices	· Internally rated 2.2 CRR or better

Any entity owned and controlled by central or local/regional government but not explicitly guaranteed is treated as a public sector entity.

Any exposure explicitly guaranteed is reflected as an exposure to the ultimate guarantor.

The table below shows the estimated liquidity value (before assumed haircuts) of assets categorised as liquid used for the purposes of calculating the three-month stressed coverage ratios, as defined under the LFRF.

Any unencumbered asset held as a consequence of a reverse repo transaction with a residual contractual maturity within the stressed coverage ratio time period and unsecured interbank loans maturing within three months are not included in liquid assets, as these assets are reflected as contractual cash inflows.

Liquid assets are held and managed on a standalone operating entity basis. Most of the liquid assets shown are held directly by each operating entity's Balance Sheet Management function, primarily for the purpose of managing liquidity risk, in line with the LFRF.

	At 31 December	
	2013	2012
	HK$m	HK$m
Liquid assets of the group		
Level 1	**1,238,471**	1,277,741
Level 2	**80,726**	78,575
Level 3	**67,874**	43,338
	1,387,071	1,399,654

All assets held within the liquid asset portfolio are unencumbered.

Liquid assets held by the group decreased, mainly on account of the ring fencing of Level 1 securities to meet the new intraday liquidity requirement in 2013, partially offset by an increase in core deposits exceeding the increase in loans and advances to customers, which was deployed into liquid assets.

Wholesale debt monitoring
(Unaudited)

Where wholesale debt term markets are accessed to raise funding, ALCO is required to establish cumulative rolling three-month and 12-month debt maturity limits to ensure no concentration of maturities within these timeframes.

Sources of funding
(Unaudited)

Our primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice.

We also access wholesale funding markets by issuing senior secured and unsecured debt securities (publicly and privately) and borrowing from the secured repo markets against high quality collateral, in order to obtain funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local wholesale market.

Liquidity behaviouralisation
(Audited)

Liquidity behaviouralisation is applied to reflect our assessment of the expected period for which we are confident that we will have access to our liabilities, even under a severe liquidity stress scenario, and the expected period for which we must assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour. Liquidity behaviouralisation is reviewed and approved by local ALCOs in compliance with policies set by the Risk Management Meeting.

Contingent liquidity risk
(Audited)

Operating entities provide customers with committed and standby facilities. These facilities increase the funding requirements of the group when customers drawdown. The liquidity risk associated with the potential drawdown on non-cancellable committed facilities is factored into our stressed scenarios and limits are set for these facilities.

Management of cross-currency liquidity and funding risk
(Audited)

Our liquidity and funding risk framework also considers the ability of each entity to continue to access foreign exchange markets under stress when a surplus in one currency is used to meet a deficit in another currency, for example, by the use of the foreign currency swap markets. Where appropriate, operating entities are required to monitor stressed coverage ratios and advances to core funding ratios for non-local currencies.

Encumbered and unencumbered assets
(Unaudited)

An asset is defined as encumbered, from a liquidity perspective, if it has been pledged as collateral against an existing liability, and as a result is no longer available to the bank to secure funding, satisfy collateral needs or be sold to reduce the funding requirement. An asset is therefore categorised as unencumbered if it has not been pledged against an existing liability.

The disclosure is not designed to identify assets which would be available to meet the claims of creditors or to predict assets that would be available to creditors in the event of a resolution or bankruptcy.

The table below presents an analysis of on-balance sheet holdings only, and shows the amounts of balance sheet assets that are encumbered. The table therefore excludes any available off-balance sheet holdings received in respect of reverse repo, stock borrowing or derivatives.

Risk Report (continued)

Analysis of on-balance sheet encumbered and unencumbered assets

	Encumbered	Unencumbered		Unencumbered- cannot be pledged as collateral		
	Assets pledged as collateral HK$m	Readily realisable assets HK$m	Other realisable assets HK$m	Reverse repo/stock borrowing receivables & derivative assets HK$m	Cannot be pledged as collateral and amounts due from Group companies HK$m	Total HK$m
31 December 2013						
Cash and balances at central banks	–	158,878	–	–	1	158,879
Items in the course of collection from other banks	–	–	–	–	16,346	16,346
Hong Kong Government certificates of indebtedness	–	–	–	–	195,554	195,554
Trading assets	18,144	272,818	20,430	8	–	311,400
– treasury and other eligible bills	4,759	104,415	–	–	–	109,174
– debt securities	11,402	138,743	–	–	–	150,145
– equity securities	1,983	29,657	–	–	–	31,640
– loans and advances to banks	–	–	11,897	–	–	11,897
– loans and advances to customers	–	3	8,533	8	–	8,544
Financial assets designated at fair value	–	1,561	–	–	88,585	90,146
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	1,561	–	–	18,310	19,871
– equity securities	–	–	–	–	70,246	70,246
– loans and advances to banks	–	–	–	–	–	–
– loans and advances to customers	–	–	–	–	29	29
Derivatives	–	–	–	388,727	–	388,727
Loans and advances to banks	–	92	430,196	100,590	134,234	665,112
Loans and advances to customers	2,392	10,775	2,592,861	50,275	12,935	2,669,238
Financial investments	50,912	1,090,433	7,458	–	230,968	1,379,771
– treasury and other eligible bills	31,005	492,944	–	–	1,749	525,698
– debt securities	19,907	570,095	126	–	229,149	819,277
– equity securities	–	27,394	7,332	–	70	34,796
Asset held for sale	–	–	4,476	–	–	4,476
Other assets	–	13,267	47,637	–	62,049	122,953
Current tax assets	–	–	–	–	2,034	2,034
Prepayments and accrued income	–	–	–	–	19,476	19,476
Interest in associates and joint ventures	–	3	105,816	–	2,033	107,852
Goodwill and intangible assets	–	–	–	–	41,882	41,882
Property, plant and equipment	–	605	94,164	–	6,471	101,240
Deferred tax	–	–	–	–	2,294	2,294
Amounts due from Group companies	–	–	–	–	161,975	161,975
	71,448	1,548,432	3,303,038	539,600	976,837	6,439,355

Additional contractual obligations

(Unaudited)

Under the terms of our current collateral obligations under derivative contracts (which are ISDA compliant CSA contracts), and based on the positions at 31 December 2013, we estimate that we could be required to post additional collateral of up to HK$364m in the event of a one-notch downgrade in credit ratings, which would increase to HK$530m in the event of a two-notch downgrade.

Liquidity regulation

(Unaudited)

In December 2010, the Basel Committee published the 'International framework for liquidity risk measurement, standards and monitoring'. The framework comprises two liquidity metrics: the liquidity coverage ratio ('LCR') and the net stable funding ratio ('NSFR'). The ratios are subject to an observation period that began in 2011, and are expected to become established standards by 2015 and 2018, respectively.

In January 2013, the Basel Committee announced several changes to the calibration of the LCR which included reducing the outflow applied to non-operational non-financial corporate deposits from 75% to 40% and reducing the outflow applied to committed liquidity facilities from 100% to 30%. In response to the updated Basel standard on liquidity, the HKMA's consultation in respect of the LCR has been completed. It is expected that legislation will be introduced in 2014.

In January 2014, the Basel Committee issued a further consultation paper in respect of the NSFR.

Market Risk

(Audited)

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. Wholesale Credit and Market Risk, an independent unit within the Risk function, 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.

There were no material changes to our policies and practices for the management of market risk in 2013, apart from the introduction of Model Oversight Committees ('MOC's) to govern model risk at the regional and global levels of Wholesale Credit and Market Risk. They have direct oversight and approval responsibility for all traded risk models used for risk measurement and management and stress testing. The Committees prioritise the development of models, methodologies and practices used for traded risk management within the group and ensure that they remain within our risk appetite and business plans.

Risk types	**Global businesses**
Trading risk · Foreign exchange and commodities · Interest rate · Equities · Credit spread	· GB&M including Balance Sheet Management ('BSM')
Non-trading risk · Foreign exchange (structural) · Interest rate · Credit spread	· GB&M including BSM, RBWM, CMB and GPB

The market risk for insurance operations is reported separately in the 'Insurance risk' section of the 'Risk Report'.

Market risk reporting measures

The following table provides an overview of the reporting of risks within this section:

Overview of risk reporting

	Portfolio	
Risk type	**Trading**	**Non-trading**
Foreign exchange and commodity	**VAR**	**VAR**
Interest rate	**VAR**	**VAR/ Sensitivity**
Equity	**VAR**	**Sensitivity**
Credit spread	**VAR**	**VAR**
Structural foreign exchange	**N/A**	**Sensitivity**

Value at risk ('VAR')
(Audited)

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. The use of VAR is integrated in the risk management of market risk in the group and VAR is calculated for all trading-intent positions regardless of how we capitalise those exposures. Where there is not an approved internal model, we use the appropriate local rules to capitalise exposures. Our models are based predominantly on historical simulation. VAR is calculated at a 99% confidence level for a one-day holding period. 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
- 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.

Market risk linkages to the accounting balance sheet
(Unaudited)

Trading assets and liabilities

The group's trading assets and liabilities are in substantially all cases originated by GB&M. As described in note 3(f), assets and liabilities are classified as held for trading if they have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These assets and liabilities are treated as traded risk for the purposes of market risk management, other than a limited number of exceptions, primarily in Global Banking where the short-term acquisition and disposal of the assets are linked to other non-trading related activities such as loan origination.

Financial assets designated at fair value

Financial assets designated at fair value within the group are predominantly held within the insurance entities. The majority of these assets are linked to policyholder liabilities for either unit-linked or insurance and investment contracts with DPF. Further information in respect of these assets is given in note 3(g). The risks of these assets largely offset the market risk on the liabilities under the policyholder contracts, and are risk managed on a non-trading basis. Market risk for insurance operations is covered in the Insurance risk section of the Risk Report.

Financial liabilities designated at fair value

Financial liabilities designated at fair value within the group are primarily liabilities to customers under investment contracts, where the liabilities on unit-linked contracts are based on the fair value of assets within the unit-linked funds. The exposures on these funds are treated as non-traded risk and the principal risks are those of the underlying assets in the funds.

Derivative assets and liabilities

As described in note 17 on the Financial Statements the group undertakes derivative activity for three primary purposes: to create risk management solutions for clients, to manage the portfolio risks arising from client business and to manage and hedge the group's own risks. Most of the group's derivative exposures arise from sales and trading activities within GB&M and are treated as traded risk for market risk management purposes. Within derivative assets and liabilities there are portfolios of derivatives which are not risk managed on a trading intent basis and are treated as non-traded risk for VAR measurement purposes. These arise when the derivative was entered into in order to manage risk arising from non-traded exposures. These include non-qualifying hedging derivatives, and derivatives qualifying for fair value and cash flow hedge accounting. The use of non-qualifying hedges whose primary risks relate to interest rate and foreign exchange exposure is described in note 3(k). Details of derivatives in fair value and cash flow hedge accounting relationships are given in note 17 on the Financial Statements. The group's primary risks in respect of these instruments relate to interest rate and foreign exchange risks.

Loans and advances to customers

The primary risk on assets within loans and advances to customers is the credit risk of the borrower. The risk of these assets is treated as non-trading risk for market risk management purposes.

Financial investments

Financial investments include assets held on an available-for-sale and held-to-maturity basis. An analysis of the group's holdings of these securities by accounting classification and issuer type is shown in note 21. The majority of these securities are held within Balance Sheet Management in GB&M. The positions which are originated in order to manage structural interest rate and liquidity risk are treated as non-trading risk for the purposes of market risk management. Available-for-sale security holdings within insurance entities are treated as non-trading risk and are largely held to back non-linked insurance policyholder liabilities. Market risk for insurance operations is covered in the Insurance risk section of the Risk Report. The other main holdings of available-for-sale assets are the ABSs within GB&M's legacy credit business, which are treated as non-trading risk for market risk management purposes, the principal risk being the credit risk of the obligor. The group's held-to-maturity securities are principally held within the Insurance business. Risks of held-to-maturity assets are treated as non-trading for risk management purposes.

Trading
(Audited)

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 Wholesale 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.

Daily market risk revenues
(Unaudited)

	2013 HK$m	2012 HK$m
Average daily revenue	**112**	117
Standard deviation	**71**	58
Ranges of most frequent:		
– daily revenues	**80-100**	80-100
– daily occurrences	**43 times**	47 times
Days of negative revenue	**4 days**	1 day
Highest daily revenue	**562**	417

The total trading VAR for Global Markets were as follows:
(Audited)

	The group	
	2013 HK$m	2012 HK$m
Total trading VAR		
Year end	**107**	134
Average	**107**	136
Maximum	**189**	232
Minimum	**61**	89
Interest rate trading VAR		
Year end	**79**	95
Average	**91**	110
Maximum	**120**	159
Minimum	**57**	68
Foreign exchange trading VAR		
Year end	**33**	43
Average	**39**	38
Maximum	**88**	85
Minimum	**13**	23
Credit spread trading VAR		
Year end	**28**	39
Average	**27**	47
Maximum	**49**	98
Minimum	**13**	29
Equity trading VAR		
Year end	**18**	26
Average	**22**	27
Maximum	**42**	54
Minimum	**8**	14

Non-trading portfolios
(Audited)

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

(Unaudited)

The group's structural foreign exchange exposures are represented by the net asset value of the group's foreign currency investments in subsidiaries, branches, joint ventures and associates with non-HK dollar functional currencies.

The group's structural foreign currency exposures are managed by the group's ALCO with the primary objective of ensuring, where practical, that the 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$293,163m (61% of shareholders' funds) at 31 December 2013, a decrease of HK$31,641m from HK$324,804m (74% of shareholders' funds) at 31 December 2012. Gains or losses on structural foreign currency exposures are taken to reserves.

The group had the following structural foreign currency exposures that were not less than 10% of the total net structural foreign currency position:

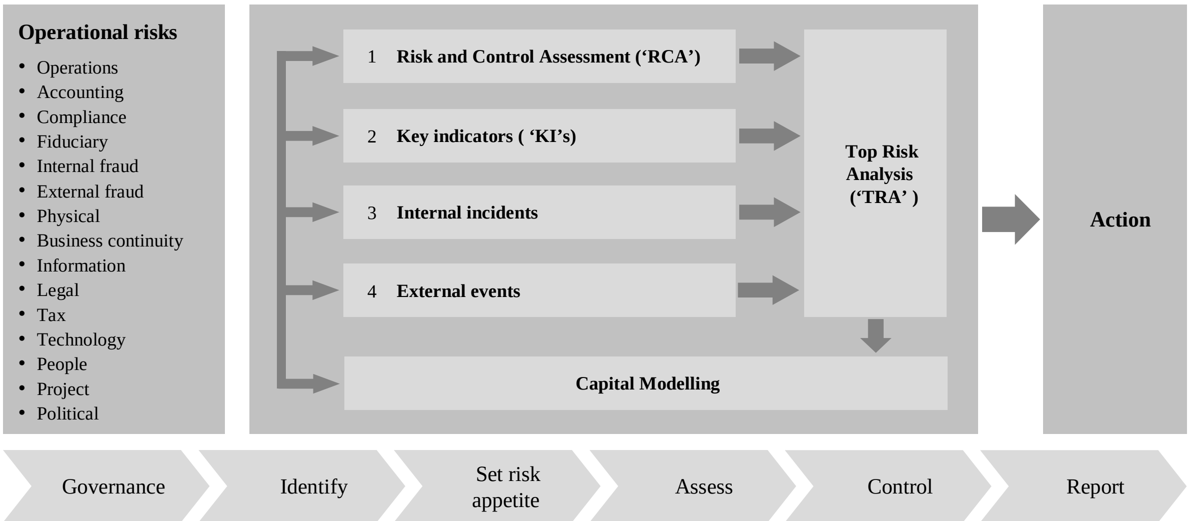
	The group	
	LCYm	**HK$m**
At 31 December 2013		
Chinese renminbi	**135,713**	**172,594**
At 31 December 2012		
Chinese renminbi	153,638	189,446

Operational Risk

(Audited)

Operational risk management framework

The Group Operational Risk function and the operational risk management framework ('ORMF') assist business management in discharging their responsibilities. The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the group.



- *RCAs are used to inform the evaluation of the effectiveness of controls over top risks.*
- *KIs are used to help monitor the risks and controls.*
- *TRAs (scenarios) provide management with a quantified view of our top and emerging operational risks.*
- *Internal incidents are used to forecast expected losses.*
- *External sources (e.g. IBM/Algo and ORX databases) are used to inform the assessment of extreme TRAs.*

Articulating our risk appetite for material operational risks helps business understand the level of risk our organisation is willing to accept. Monitoring operational risk exposure against risk appetite on a regular basis and implementing our risk acceptance process drives risk awareness in a more forward-looking manner. It assists management in determining whether further action is required.

In addition, an enhanced Top Risk Analysis process is being implemented across the Bank to improve the quantification and management of material risks through scenario analysis.

The incidence of regulatory proceedings and other adversarial proceedings against financial service firms is increasing. Proposed changes relating to capital and liquidity requirements, remuneration and/or taxes could increase our cost of doing business, reducing future profitability. Various regulators and competition authorities around the world are also investigating and reviewing certain past submissions made by panel banks and the process for making submissions in connection with the setting of benchmark interest and foreign exchange rates. In response, we have undertaken a number of initiatives which seek to address the issues identified, including creating a global management structure, enhancing our governance and oversight, increasing our compliance function resource, emphasising HSBC Values and designing and implementing new global standards.

Other featured operational risks (Unaudited)

- *Challenges to achieving our strategy in a downturn*: businesses and countries have prioritised strategy and annual operating plans to reflect current economic conditions amid increased geo-political risk. Performance against plan is monitored through a number of means including the use of risk consideration and performance reporting at all relevant management committees.
- *Fraud risks*: the threat of fraud perpetrated by or against our customers, especially in retail and commercial banking, may increase during adverse economic conditions. We have increased monitoring, root cause analysis and review of internal controls to enhance our defences against external attacks and reduce the level of loss in these areas. In addition, Group Security and Fraud Risk is working closely with the global businesses to continually assess these threats as they evolve and adapt our controls to mitigate these risks.
- *Level of change creating operational complexity*: the Risk function is engaged with business management in business transformation initiatives to ensure robust internal controls are maintained, including through participation in all relevant management committees. The Global Transactions Team has developed an enhanced risk management framework to be applied to the management of disposal risks.
- *Information security*: the security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and the HSBC brand. A failure of our defences against such attacks could result in financial loss, loss of customer data and other sensitive information which could undermine both our reputation and our ability to retain the trust of our customers.
- *People Risk*: attracting and retaining staff with appropriate skills and expertise across the markets in which we operate remains a challenge. Significant investment is made in training and management development initiatives to equip our staff for the business changes we face and for the implementation of global standards.

Insurance Risk

(Audited)

Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the insurer. The principal insurance risk faced by the group is that, over time, the combined cost of claims, benefits, administration and acquisition of the contracts may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has discretionary participation features, the performance of the assets held to support the liabilities. The severity of the claims and benefits, as well as the timing, is therefore uncertain. Contracts under which the transfer of insurance risk from the policyholder to the group is not significant are classified as investment contracts.

The group manages its insurance risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set limits, risk diversification, pricing guidelines, reinsurance and monitoring of emerging issues, taking into account where appropriate local market conditions and any regulatory requirements that apply.

All insurance products, whether internally manufactured or provided by a third party manufacturer, are reviewed by the Product Management 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.

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. Insurance events are, by their nature, incorporated with a certain degree of randomness and the actual number of events during any one year may vary from those estimated using established statistical techniques.

Asset and 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, cash flow matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return within acceptable parameters. The Investment Committee reviews and approves strategic asset allocation on a periodic basis and establishes investment guidelines. The asset and liability management process is also overseen by the Asset and Liability Management Committee of the group’s insurance business.

Risk Report (continued)

The group establishes asset portfolios for each major insurance product category consistent with local regulatory requirements. The investment policy defines the asset allocation and restrictions with the aim of achieving the target investment return in the long term.

The following table shows the composition of assets and liabilities for each major insurance product category. 93% of both assets and liabilities are derived from Hong Kong.

Statement of financial position of insurance manufacturing 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 2013					
Financial assets:					
– financial assets designated at fair value	**44,061**	**43,980**	**–**	**515**	**88,556**
– derivatives	**2**	**11**	**–**	**41**	**54**
– financial investments	**–**	**188,397**	**83**	**17,042**	**205,522**
– other financial assets	**1,527**	**30,776**	**49**	**1,929**	**34,281**
Total financial assets	**45,590**	**263,164**	**132**	**19,527**	**328,413**
Reinsurance assets	**1,700**	**2,917**	**7**	**–**	**4,624**
PVIF[4]	**–**	**–**	**–**	**28,916**	**28,916**
Other assets	**5**	**6,462**	**–**	**1,934**	**8,401**
Total assets	**47,295**	**272,543**	**139**	**50,377**	**370,354**
Liabilities under investment contracts designated at fair value	**7,527**	**29,159**	**–**	**–**	**36,686**
Liabilities under insurance contracts	**39,269**	**236,783**	**128**	**–**	**276,180**
Deferred tax	**–**	**93**	**–**	**4,906**	**4,999**
Other liabilities	**–**	**–**	**–**	**2,886**	**2,886**
Total liabilities	**46,796**	**266,035**	**128**	**7,792**	**320,751**
Total equity	**–**	**–**	**–**	**49,603**	**49,603**
Total equity and liabilities	**46,796**	**266,035**	**128**	**57,395**	**370,354**
At 31 December 2012					
Financial assets:					
– financial assets designated at fair value	36,837	30,376	–	413	67,626
– derivatives	7	1,017	–	2	1,026
– financial investments	–	175,773	81	12,246	188,100
– other financial assets	963	37,035	324	1,196	39,518
Total financial assets	37,807	244,201	405	13,857	296,270
Reinsurance assets	3,103	1,389	–	1,101	5,593
PVIF[4]	–	–	–	24,425	24,425
Other assets	2	3,941	1	5,595	9,539
Total assets	40,912	249,531	406	44,978	335,827
Liabilities under investment contracts designated at fair value	7,038	29,182	–	–	36,220
Liabilities under insurance contracts	33,948	210,853	120	–	244,921
Deferred tax	–	196	–	4,610	4,806
Other liabilities	–	–	–	4,761	4,761
Total liabilities	40,986	240,231	120	9,371	290,708
Total equity	–	–	–	45,119	45,119
Total equity and liabilities	40,986	240,231	120	54,490	335,827

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 achieve 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 outcomes.

Reinsurance strategy

The group reinsures a portion of the insurance risks it underwrites in order to mitigate its exposures to losses and protect capital resources. The group uses reinsurance to manage financial risk arising from guaranteeing minimum investment performance under a unit-linked insurance product and a traditional non-participating insurance product. Although reinsurance provides a means of managing insurance risk, it exposes the group to credit risk arising from default by the reinsurers. Management of such credit risk exposure is described on page 64.

Nature of risks covered

The following gives an assessment of the nature of risks inherent in the group's main manufactured products:

(i) Insurance contracts – non-linked products

The basic feature of non-linked insurance business is to provide guaranteed death benefits 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 stable 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 a choice of investment in a variety of funds. Premiums received are deposited into the chosen funds. Charges for the cost of insurance and administration are deducted from the funds accumulated. Where there is a performance guarantee, the risk is managed through reinsurance.

(iii) Investment contracts – retirement funds with guarantees

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 in which to place their contributions, on which the group provides an investment return or capital protection guarantee for some specific funds. Investment strategy is set with the objective of providing a return that is sufficient to meet at least the minimum guarantee.

(iv) Investment contracts – retirement funds without guarantees

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 in which to place their contributions. The group bears no investment risk under this type of investment contract.

(v) Non-life insurance contracts

The group assumes the risk of loss from persons and organisations relating to property, liability, 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, pricing guidelines, reinsurance and monitoring of emerging issues. Following the disposals of the majority of non-life businesses during 2013, this risk is minimal.

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 number of related small contracts, and relate to circumstances where a large claim from a single or multiple contracts 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 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.

The policyholders of the insurance contracts issued by the group and its joint venture are mainly residents of Hong Kong, Macau, mainland China, Singapore, Malaysia and India, with the majority in Hong Kong.

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the group. Total loss is estimated based on the chosen stress level. Details of the group's reinsurance strategy are disclosed on page 59.

Life business is generally long term in nature and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore an appropriate overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies and 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 assess the adequacy of margins that exist between the assumptions adopted and the most likely estimate of future outcome. Since the group is not exposed to significant insurance risk on investment contracts, they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 34.

Financial risks

Managing financial assets backing insurance liabilities 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. 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 invest in fixed income securities and adopt a matching approach whereby assets held are managed to meet the liabilities to policyholders. 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, a provision is established to provide additional coverage.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries at 31 December 2013 by type of liability, and provides a view of the exposure to financial risk:

Financial assets held by insurance manufacturing subsidiaries

	At 31 December 2013				
	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	**13**	**17,782**	**–**	**515**	**18,310**
– Equity securities	**44,048**	**26,198**	**–**	**–**	**70,246**
	44,061	**43,980**	**–**	**515**	**88,556**
Financial investments					
Held-to-maturity:					
– Debt securities	**–**	**162,858**	**–**	**16,608**	**179,466**
Available-for-sale:					
– Treasury bills	**–**	**–**	**–**	**–**	**–**
– Debt securities	**–**	**25,539**	**83**	**365**	**25,987**
– Equity securities	**–**	**–**	**–**	**69**	**69**
	–	**25,539**	**83**	**434**	**26,056**
Derivatives	**2**	**11**	**–**	**41**	**54**
Other financial assets	**1,527**	**30,776**	**49**	**1,929**	**34,281**
	45,590	**263,164**	**132**	**19,527**	**328,413**

	At 31 December 2012				
	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	10	15,146	–	413	15,569
– Equity securities	36,827	15,230	–	–	52,057
	36,837	30,376	–	413	67,626
Financial investments					
Held-to-maturity:					
– Debt securities	–	151,818	–	12,001	163,819
Available-for-sale:					
– Treasury bills	–	–	–	–	–
– Debt securities	–	23,952	81	191	24,224
– Equity securities	–	3	–	54	57
	–	23,955	81	245	24,281
Derivatives	7	1,017	–	2	1,026
Other financial assets	963	37,035	324	1,196	39,518
	37,807	244,201	405	13,857	296,270

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 13.9% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2013 (2012: 12.8%). The table also shows that approximately 68.1% of financial assets were invested in debt securities at 31 December 2013 (2012: 68.7%) with 21.4% (2012: 17.6%) invested in equity securities.

Market risk

Market risk can be sub-categorised into interest rate risk, equity and other price risks and foreign currency risk. Each of these categories is discussed further below.

Interest rate risk

The exposure of the group's insurance business to interest rate risk arises mainly from its debt securities holdings and the uncertainty of the achievable interest rate when reinvesting the future net cash flows. The held-to-maturity category 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 can also be mitigated through sharing of risk with policyholders under the discretionary participation mechanism.

A shift in interest yield curves as at 31 December 2013 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 2013		31 December 2012	
	Impact on profit for the year HK$m	**Impact on net assets HK$m**	Impact on profit for the year HK$m	Impact on net assets HK$m
+ 100 basis points shift in yield curves	**1,179**	**(1,308)**	1,096	(1,238)
– 100 basis points shift in yield curves	**(1,343)**	**1,263**	(1,424)	1,032

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 reflect the established investment risk sharing mechanism with policyholders for participating products but do not incorporate other actions that could be taken by management to mitigate the impact of the effect of the interest rate movements, nor do they take account of any resultant changes in policyholder behaviour.

Equity and other price risks

The portfolio of securities, including equities and other assets, 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, portfolio diversification and sharing the risk with policyholders through the discretionary participation feature. Portfolio characteristics are analysed regularly and these risks are regularly reviewed. The group's investment portfolios are diversified across industries and asset classes, with concentrations in any one company, industry or asset class limited by parameters established by senior management, as well as by statutory requirements.

The following table illustrates the impact on the profit for the year and net assets of a 10% variance in equity prices:

	31 December 2013		31 December 2012	
	Impact on profit for the year HK$m	**Impact on net assets HK$m**	Impact on profit for the year HK$m	Impact on net assets HK$m
10% increase in equity prices	**948**	**948**	515	515
10% decrease in equity prices	**(780)**	**(780)**	(518)	(518)

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not allow for the effect of other management actions which may mitigate the impact of the equity price decline, nor for any resultant changes 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, Hong Kong dollars and United States dollars. The group adopts a policy of predominantly matching the liabilities with assets 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 also uses forward exchange contracts and swaps to manage its foreign currency risk.

Credit risk

The group's portfolios 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 financial loss 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 is included on page 32. 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. 88.4% (2012:88.4%) of the assets included in the table are invested in investments rated as 'Strong'.

	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
At 31 December 2013							
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	**15,806**	**1,976**	**–**	**–**	**–**	**–**	**17,782**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**15,806**	**1,976**	**–**	**–**	**–**	**–**	**17,782**
Financial investments	**165,971**	**22,509**	**–**	**–**	**–**	**–**	**188,480**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**165,971**	**22,509**	**–**	**–**	**–**	**–**	**188,480**
Supporting shareholders funds[1]							
Financial assets designated at fair value	**448**	**67**	**–**	**–**	**–**	**–**	**515**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**448**	**67**	**–**	**–**	**–**	**–**	**515**
Financial investments	**15,472**	**1,501**	**–**	**–**	**–**	**–**	**16,973**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**15,472**	**1,501**	**–**	**–**	**–**	**–**	**16,973**
Total							
Financial assets designated at fair value	**16,254**	**2,043**	**–**	**–**	**–**	**–**	**18,297**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**16,254**	**2,043**	**–**	**–**	**–**	**–**	**18,297**
Financial investments	**181,443**	**24,010**	**–**	**–**	**–**	**–**	**205,453**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**181,443**	**24,010**	**–**	**–**	**–**	**–**	**205,453**

Risk Report (continued)

At 31 December 2012	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	13,755	1,391	–	–	–	–	15,146
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,755	1,391	–	–	–	–	15,146
Financial investments	154,799	21,052	–	–	–	–	175,851
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	154,799	21,052	–	–	–	–	175,851
Supporting shareholders funds[1]							
Financial assets designated at fair value	374	39	–	–	–	–	413
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	374	39	–	–	–	–	413
Financial investments	10,960	1,232	–	–	–	–	12,192
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	10,960	1,232	–	–	–	–	12,192
Total							
Financial assets designated at fair value	14,129	1,430	–	–	–	–	15,559
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	14,129	1,430	–	–	–	–	15,559
Financial investments	165,759	22,284	–	–	–	–	188,043
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	165,759	22,284	–	–	–	–	188,043

1 *Shareholders' funds comprise solvency and unencumbered assets.*

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 amounts 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 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
At 31 December 2013							
Linked insurance contracts	**3**	**1,692**	–	–	–	–	**1,695**
Non-linked insurance contracts ...	**2,834**	**2**	–	–	–	–	**2,836**
Total	**2,837**	**1,694**	–	–	–	–	**4,531**
Reinsurance debtors	**45**	**7**	–	**41**	–	–	**93**
At 31 December 2012							
Linked insurance contracts	2	3,101	–	–	–	–	3,103
Non-linked insurance contracts ...	1,389	–	–	–	–	–	1,389
Total	1,391	3,101	–	–	–	–	4,492
Reinsurance debtors	23	1,020	–	58	–	–	1,101

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 this third party's ability to meet its reinsurance obligation. At 31 December 2013, the exposure to the third party was HK$1,694m (2012: HK$3,101m).

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 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 surrender penalties and market adjustment clauses are used to defray the costs of unexpected cash requirements.

Risk Report (continued)

The following table shows the expected maturity of insurance contract liabilities at 31 December 2013:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year HK$m	**1-5 years HK$m**	**5-15 years HK$m**	**Over 15 years HK$m**	**Total HK$m**
At 31 December 2013					
Non-life insurance	**127**	**–**	**–**	**–**	**127**
Life insurance (non-linked)	**28,201**	**84,543**	**197,109**	**226,343**	**536,196**
Life insurance (linked)	**2,196**	**8,078**	**45,963**	**89,836**	**146,073**
	30,524	**92,621**	**243,072**	**316,179**	**682,396**
At 31 December 2012					
Non-life insurance	98	22	1	–	121
Life insurance (non-linked)	28,558	86,803	168,809	203,753	487,923
Life insurance (linked)	4,213	8,073	42,297	84,029	138,612
	32,869	94,898	211,107	287,782	626,656

Remaining contractual maturity of investment contract liabilities

At 31 December 2013	**Linked investment contracts HK$m**	**Non-linked investment contracts HK$m**	**Investment contracts with DPF HK$m**	**Total HK$m**
Remaining contractual maturity				
– due within 1 year	**119**	**45**	**–**	**164**
– due between 1 and 5 years	**–**	**–**	**–**	**–**
– due between 5 and 10 years	**–**	**–**	**–**	**–**
– undated[1]	**7,408**	**29,114**	**–**	**36,522**
	7,527	**29,159**	**–**	**36,686**
At 31 December 2012				
Remaining contractual maturity				
– due within 1 year	115	25	29	169
– due between 1 and 5 years	–	–	–	–
– due between 5 and 10 years	–	–	–	–
– undated[1]	6,923	29,156	–	36,079
	7,038	29,181	29	36,248

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 2013 was HK$28,916m (2012: HK$24,425m), representing the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

The valuation of the PVIF asset includes explicit risk margins for non-economic risks in the projection assumptions and explicit allowances for financial options and guarantees using stochastic methods. Risk discount rates are set on active basis with reference to market risk free yields.

PVIF can be stress-tested to assess the sensitivity of the value of life business to adverse movements of different risk factors. The following table shows the effect on the PVIF as at 31 December 2013 of changes in the main economic assumption:

	Impact on results	
	2013	2012
	HK$m	HK$m
+ 100 basis points shift in risk-free rate	**1,392**	1,111
– 100 basis points shift in risk-free rate	**(1,515)**	(1,153)

The effects on PVIF shown above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

Non-economic assumptions

Non-economic assumptions including, mortality and/or morbidity, lapse rates and expense rates, are also used for the determination of the policyholder liabilities and PVIF, subject to any relevant local regulatory requirements. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2013 across all insurance manufacturing subsidiaries is as follows:

	Impact on 2013 results		Impact on 2012 results	
	Profit after tax	**Net assets**	Profit after tax	Net assets
	HK$m	**HK$m**	HK$m	HK$m
20% increase in claims costs	**(3)**	**(3)**	(3)	(3)
20% decrease in claims costs	**3**	**3**	3	3
10% increase in mortality and/or morbidity rates	**(291)**	**(291)**	(362)	(362)
10% decrease in mortality and/or morbidity rates	**299**	**299**	374	374
50% increase in lapse rates	**(1,263)**	**(1,263)**	(1,048)	(1,048)
50% decrease in lapse rates	**2,720**	**2,720**	2,328	2,328
10% increase in expense rates	**(298)**	**(298)**	(275)	(275)
10% decrease in expense rates	**289**	**289**	281	281

The effects on profit after tax and net assets shown above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established risk sharing mechanism with policyholders for participating products but do not incorporate other actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

Capital

Capital Management

(Audited)

Our approach to capital management is driven by our strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which we operate.

It is our objective to maintain a strong capital base to support the development of our business and to meet regulatory capital requirements at all times. To achieve this, our policy is to hold capital in a range of different forms and all capital raising is agreed with major subsidiaries as part of their individual and the group's capital management processes.

The policy on capital management is underpinned by a capital management framework, which enables us to manage our capital in a consistent manner. The framework defines the regulatory capital and economic capital measures as the two primary measures for the management and control of capital.

Capital measures:

- economic capital is the internally calculated capital requirement to support risks to which we are exposed and forms a core part of the internal capital adequacy assessment; and
- regulatory capital is the capital which we are required to hold in accordance with the rules established by regulators.

Our capital management process is articulated in our annual group capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between the different components of capital. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the approved annual group capital plan. In accordance with HSBC Group's Capital Management Framework, capital generated by subsidiaries in excess of planned requirements is returned to the Bank, normally by way of dividends.

The Bank is primarily the provider of equity capital to its subsidiaries and these investments are substantially funded by the Bank's own capital issuance and profit retention. As part of its capital management process, 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: share capital, retained profits, other reserves, preference shares and subordinated liabilities.

Externally imposed capital requirements
(Audited)

The Hong Kong Monetary Authority ('HKMA') supervises the group on both a consolidated and solo-consolidated basis and therefore receives information on the capital adequacy of, and sets capital requirements for, the group as a whole and on a solo-consolidated basis. Individual banking subsidiaries and branches are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. In most jurisdictions, non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

The group uses the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures and the internal ratings-based (securitisation) approach to determine credit risk for its banking book securitisation exposures. For market risk, the group uses an internal models approach to calculate its general market risk for the risk categories of interest rate exposures, foreign exchange (including gold) exposures, and equity exposures. The group also uses an internal models approach to calculate its market risk in respect of specific risk for interest rate exposures and equity exposures. The group uses the standardised (market risk) approach for calculating other market risk positions as well as trading book securitisation exposures, and the standardised (operational risk) approach to calculate its operational risk.

During the year, the individual entities within the group and the group itself complied with all of the externally imposed capital requirements of the HKMA.

Basel III
(Unaudited)

Since December 2010, the Basel Committee has developed a comprehensive set of reform measures covering additional capital and liquidity requirements, commonly referred to as 'Basel III'.

The Basel III capital rules set out the minimum common equity tier 1 (CET1) requirement of 4.5% and an additional capital conservation buffer requirement of 2.5%, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a maximum level of 2.5% effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers. In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

The provisions of the Banking (Capital) (Amendment) Rules 2012 came into effect on 1 January 2013 to implement the first phase of the Basel III capital standards in Hong Kong ('Basel III rules'). The changes in minimum capital ratio requirements are phased in from 1 January 2013 to 1 January 2019, while the capital treatment for counterparty credit risk is effective from 1 January 2013.

Leverage Ratio
(Unaudited)

Basel III introduces a simple non risk-based leverage ratio as a complementary measure to the risk-based capital requirements to limit excessive leverage on the part of banks. The leverage ratio was introduced into the Basel III framework as a non-risk-based backstop limit, to supplement risk-based capital requirements. It aims to constrain the build-up of excess leverage in the banking sector, introducing additional safeguards against model risk and measurement errors. The ratio is a volume-based measure calculated as Basel III tier 1 capital divided by total on- and off-balance sheet exposures.

Basel III provides for a transitional period for the introduction of this ratio, comprising a supervisory monitoring period that started in 2011 and a parallel run period from January 2013 to January 2017. The parallel run will be used to assess whether the proposed minimum ratio of 3% is appropriate, with a view to migrating to a Pillar 1 requirement from 1 January 2018.

Capital (continued)

Capital adequacy at 31 December 2013
(Unaudited)

The following tables show the capital ratios, risk weighted assets ('RWAs') and capital base as contained in the 'Capital Adequacy Ratio' return required to be submitted to the HKMA by The Hongkong and Shanghai Banking Corporation Limited on a consolidated basis that is specified by the HKMA under the requirements of section 3C(1) of the Banking (Capital) Rules.

The basis of consolidation for financial accounting purposes is described in Note 1 on the Financial Statements and differs from that used for regulatory purposes.

A full reconciliation between the group's accounting and regulatory balance sheets can be viewed in the Supplementary Notes on the Financial Statements 2013 (Appendices) that can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk. Subsidiaries not included in consolidation for regulatory purposes are securities and insurance companies and the capital invested by the group in these subsidiaries is deducted from regulatory capital. Entities in respect of which the basis of consolidation for financial accounting purposes differs from that used for regulatory purposes can be found in the *Supplementary Notes on the Financial Statements 2013*.

On 1 January 2013, the HKMA implemented the first phase of the Basel III capital framework in Hong Kong. The capital disclosures for December 2013 under Basel III are, therefore, not directly comparable with the disclosures for December 2012 prepared under the Basel II basis.

The Bank and its banking subsidiaries maintain regulatory reserves to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2013, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$22,563m (31 December 2012: HK$19,426m).

There are no relevant capital shortfalls in any of the group's subsidiaries at 31 December 2013 (31 December 2012: Nil) which are not included in its consolidation group for regulatory purposes.

Capital ratios
(Unaudited)

	At 31 December 2013	At 31 December 2012
	%	%
Common Equity Tier 1 (CET1) capital	**14.1**	-
Tier 1 capital	**14.1**	-
Total capital	**15.2**	-
Core capital	**-**	13.7
Capital adequacy	**-**	14.3

Risk weighted assets by risk type
(Unaudited)

	At 31 December 2013	At 31 December 2012
	HK$m	HK$m
Credit risk		
– Standardised approach	**221,923**	169,873
– IRB approach	**1,656,378**	1,284,629
– IRB (securitisation) approach	**4,250**	1,173
– Central Clearing Counterparty (CCP)	**12,999**	–
– Credit Valuation Adjustment (CVA)	**82,716**	–
Counterparty credit risk		
– Standardised approach	**5,231**	2,709
– IRB approach	**90,372**	78,700
Market risk	**134,035**	116,911
Operational risk	**274,450**	250,139
Total	**2,482,354**	1,904,134

Risk weighted assets by global business

(Unaudited)

	At 31 December 2013	At 31 December 2012
	HK$m	HK$m
Retail Banking and Wealth Management	**283,612**	278,022
Commercial Banking	**761,656**	671,001
Global Banking and Markets	**1,156,129**	849,351
Global Private Banking	**25,756**	–
Other	**255,201**	105,761
Total	**2,482,354**	1,904,134

Risk-weighted assets for credit risk increased during 2013, mainly from changes introduced by Basel III, including the risk weighting of a portion of certain exposures that were previously deducted in full from capital. Risk-weighted assets also increased from loan growth, adverse internal rating changes for both corporate and sovereign exposures and external methodology changes on sovereign exposures.

RWA Planning

(Unaudited)

Pre-tax return on RWAs is an operational metric by which the global businesses are managed on a day-to-day basis. The metric combines return on equity and regulatory capital efficiency objectives. RWA targets for each business, in accordance with the Group's strategic direction, are included as part of the Bank's Risk Appetite Statement which is approved annually by the Board.

Business performance against the targets is monitored through reporting to the Asset and Liability Management Committee of the group. The management of capital deductions is also addressed in the RWA monitoring framework through notional charges for these items, enabling a more holistic approach to performance measurement. A range of analysis is employed in the RWA monitoring framework to identify the key drivers of movements in the position, such as book size and book quality. Particular attention is paid to identifying and segmenting items within the day-to-day control of the business and those items that are driven by changes in risk models or regulatory methodology.

Capital Base

(Unaudited)

The following table sets out the composition of the group's capital base under Basel III at 31 December 2013. The position at 31 December 2013 benefits from transitional arrangements which will be phased out by 1 January 2022. The table also shows the pro-forma Basel III end point basis position once all transitional arrangements have been phased out based on the Transition Disclosures Template issued by the HKMA. A more detailed breakdown of the capital position on these bases is available in the Regulatory Disclosures section of our website www.hsbc.com.hk .

It should be noted that the pro-forma Basel III end point basis position once all transitional arrangements have been phased out takes no account of, for example, any future profits or management actions. In addition, the current regulations or their application may change before full implementation. Given this, the final impact on the group's capital ratios may differ from the pro-forma position, which is a mechanical application of the current rules to the balance sheet at 31 December 2013; it is not a projection. On this pro-forma basis, the group's CET1 ratio is 10.4%, which is above the Basel III minimum requirement, including the capital conservation buffer.

Capital (continued)

Capital adequacy at 31 December 2013

Capital base
(Unaudited)

	At 31 December 2013 HK$m	Basel III end point basis HK$m
Common Equity Tier 1 ('CET1') capital		
Shareholders' equity	**436,529**	**436,529**
Shareholders' equity per balance sheet	**480,809**	**480,809**
Revaluation reserve capitalisation issue	**(1,454)**	**(1,454)**
Unconsolidated subsidiaries	**(42,826)**	**(42,826)**
Non-controlling interests	**24,464**	**24,464**
Non-controlling interests per balance sheet	**41,415**	**41,415**
Non-controlling interests in unconsolidated subsidiaries	**(4,237)**	**(4,237)**
Portion not eligible for inclusion in CET1 capital	**(12,714)**	**(12,714)**
Regulatory deductions to CET1 capital	**(109,888)**	**(201,807)**
Valuation adjustments	**(2,473)**	**(2,473)**
Goodwill and intangible assets	**(15,943)**	**(15,943)**
Deferred tax assets net of deferred tax liabilities	**(2,350)**	**(2,350)**
Cash flow hedging reserve	**(197)**	**(197)**
Changes in own credit risk on fair valued liabilities	**(1,117)**	**(1,117)**
Defined benefit pension fund assets	**(110)**	**(110)**
Significant capital investments in unconsolidated financial sector entities	**(875)**	**(106,981)**
Property revaluation reserves[1]	**(50,073)**	**(50,073)**
Regulatory reserve	**(22,563)**	**(22,563)**
Excess AT1 deductions	**(14,187)**	**–**
Total CET1 capital	**351,105**	**259,186**
Additional Tier 1 ('AT1') capital		
Total AT1 capital before regulatory deductions	**38,866**	**2,331**
Perpetual non-cumulative preference shares	**30,651**	**–**
Non-controlling interests eligible for inclusion in AT1 capital	**8,215**	**2,331**
Regulatory deductions to AT1 capital	**(38,866)**	**–**
Significant capital investments in unconsolidated financial sector entities	**(53,053)**	**–**
Excess AT1 deductions	**14,187**	**–**
Total AT1 capital	**–**	**2,331**
Total Tier 1 capital	**351,105**	**261,517**
Tier 2 capital		
Total Tier 2 capital before regulatory deductions	**82,915**	**43,755**
Perpetual cumulative preference shares	**8,413**	**–**
Cumulative term preferences shares	**8,141**	**–**
Perpetual subordinated debt	**9,346**	**–**
Term subordinated debt	**19,463**	**6,203**
Property revaluation reserves[1]	**23,187**	**23,187**
Impairment allowances and regulatory reserve eligible for inclusion in Tier 2 capital	**13,519**	**13,519**
Non-controlling interests eligible for inclusion in Tier 2 capital	**846**	**846**
Regulatory deductions to Tier 2 capital	**(55,910)**	**(2,857)**
Significant capital investments in unconsolidated financial sector entities	**(55,910)**	**(2,857)**
Total Tier 2 capital	**27,005**	**40,898**
Total capital	**378,110**	**302,415**

1 *Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.*

A detailed breakdown of the group's CET1 capital, AT1 capital, Tier 2 capital and regulatory deductions can be viewed in the Supplementary Notes on Financial Statements 2013 (Appendices) that can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk .

Capital adequacy at 31 December 2012

Capital base
(Unaudited)

	At 31 December 2012 HK$m
Core capital:	
Share capital per balance sheet	58,969
Revaluation reserve capitalisation issue	(1,454)
Paid-up ordinary share capital	57,515
Paid-up irredeemable non-cumulative preference shares	51,570
Reserves per balance sheet	378,430
Proposed dividend	(20,000)
Unconsolidated subsidiaries	(40,088)
Cash flow hedging reserve	(210)
Regulatory reserve	(19,426)
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities	(86,111)
Unrealised gains on equities and debt securities designated at fair value	(20)
Own credit spread	(218)
Total reserves included in core capital	212,357
Non-controlling interests per balance sheet	35,679
Non-controlling interests in unconsolidated subsidiaries	(3,478)
Regulatory adjustments in non-controlling interests	(3,291)
Non-controlling interests	28,910
Goodwill, intangible assets and valuation adjustments	(21,191)
50% of unconsolidated investments	(67,692)
50% of securitisation positions and other deductions	(16)
Deductions	(88,899)
Total core capital	261,453
Supplementary capital:	
Paid-up irredeemable cumulative preference shares	16,510
Perpetual subordinated debt	9,355
Paid-up term preference shares	15,115
Term subordinated debt	16,418
Property revaluation reserves[1]	7,977
Unrealised gains on available-for-sale equities and debt securities	2,534
Unrealised gains on equities and debt securities designated at fair value	9
Regulatory reserve	2,333
Collective impairment allowance	496
Excess impairment allowances over expected losses	8,400
Supplementary capital before deductions	79,147
50% of unconsolidated investments	(67,692)
50% of securitisation positions and other deductions	(16)
Deductions	(67,708)
Total supplementary capital	11,439
Capital base	272,892

1 *Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.*

Capital (continued)

Capital instruments

(Unaudited)

The following is a summary of the group's CET1, AT1 and Tier 2 capital instruments at 31 December 2013.

	Par value	Amount recognised in regulatory capital HK$m
CET1 capital instruments		
Ordinary shares:		
34,127,482,901 issued and fully paid ordinary shares of HK$2.50 each	HK$85,319m	**83,865**
AT1 capital instruments		
Perpetual non-cumulative preference shares	US$3,953m	**30,651**
Tier 2 capital instruments		
Perpetual cumulative preference shares	US$1,085m	**8,413**
Cumulative preference shares due 2024	US$1,050m	**8,141**
Primary capital undated floating rate notes	US$1,200m	**9,346**
Subordinated loan due 2020	US$775m	**6,010**
Subordinated loan due 2021	US$450m	**3,489**
Subordinated loan due 2022	US$300m	**2,326**
Subordinated loan due 2023	US$500m	**3,877**
Floating rate subordinated notes due 2020, callable from 2015	AUD200m	**1,386**
Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017	MYR500m	**1,182**
Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022	MYR500m	**1,193**
		19,463

A description of the main features, and the full terms and conditions of the group's capital instruments can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk .

Statement of Directors' Responsibilities

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on page 76, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the financial statements.

The Directors of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') are responsible for the preparation of the Bank's Annual Report and Accounts, which contains the consolidated financial statements of the Bank and its subsidiaries (together 'the group'), in accordance with applicable law and regulations.

The Hong Kong Companies Ordinance requires the Directors to prepare for each financial year the consolidated financial statements for the group, and the balance sheet and profit or loss for the Bank.

The Directors are responsible for ensuring adequate accounting records are kept that are sufficient to show and explain the group's transactions, such that the group's financial statements give a true and fair view.

The Directors are responsible for preparing the consolidated financial statements that give a true and fair view and are in accordance with Hong Kong Financial Reporting Standards ('HKFRS') issued by the Hong Kong Institute of Certified Public Accountants. The Directors have elected to prepare the Bank's balance sheet and profit or loss on the same basis.

The Directors, the names of whom are set out in 'Report of the Directors' on page 3 of this Annual Report, confirm to the best of their knowledge that:

- the consolidated financial statements, which have been prepared in accordance with HKFRS, have been prepared in accordance with the applicable set of accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or loss of the group and the undertakings included in the consolidation taken as a whole; and
- the management report represented by the Financial Review and the Risk Report include a fair review of the development and performance of the business and the position of the group and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that the group faces.

On behalf of the Board

Stuart T Gulliver
Chairman
24 February 2014

Independent auditor's report to the shareholders of The Hongkong and Shanghai Banking Corporation Limited (incorporated in Hong Kong with limited liability)

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') set out on pages 77 to 227, which comprise the consolidated and the Bank's balance sheets as at 31 December 2013, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated and the Bank's statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information.

Directors' responsibility for the consolidated financial statements

The directors of the Bank are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. This report is made solely to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the state of the affairs of the Bank and the group as at 31 December 2013 and of the group's profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants
8th Floor, Prince's Building
10 Chater Road
Central
Hong Kong
24 February 2014

Financial Statements

Financial Statements (continued)

Consolidated income statement for the year ended 31 December 2013

	Note	**2013 HK$m**	2012 HK$m
Interest income	*4a*	**117,039**	115,511
Interest expense	*4b*	**(29,674)**	(33,092)
Net interest income		**87,365**	82,419
Fee income		**50,187**	46,221
Fee expense		**(6,341)**	(6,331)
Net fee income	*4c*	**43,846**	39,890
Net trading income	*4d*	**16,577**	19,214
Net income from financial instruments designated at fair value	*4e*	**2,475**	4,613
Gains less losses from financial investments	*4f*	**442**	2,634
Dividend income	*4g*	**1,175**	522
Net earned insurance premiums	*5b*	**53,663**	52,621
Net gain on reclassification of associates	*4h*	**8,157**	-
Gain on sale of Ping An	*4i*	**34,070**	-
Other operating income	*4j*	**11,418**	15,337
Total operating income		**259,188**	217,250
Net insurance claims incurred and movement in liabilities to policyholders	*5c*	**(56,592)**	(54,983)
Net operating income before loan impairment charges and other credit risk provisions		**202,596**	162,267
Loan impairment charges and other credit risk provisions	*4k*	**(3,532)**	(3,578)
Net operating income		**199,064**	158,689
Employee compensation and benefits	*6a*	**(36,938)**	(37,021)
General and administrative expenses	*4l*	**(26,127)**	(26,011)
Depreciation of property, plant and equipment	*26*	**(3,988)**	(4,014)
Amortisation and impairment of intangible assets	*25c*	**(1,675)**	(1,724)
Total operating expenses		**(68,728)**	(68,770)
Operating profit		**130,336**	89,919
Share of profit in associates and joint ventures		**14,420**	18,810
Profit before tax		**144,756**	108,729
Tax expense	*7*	**(15,701)**	(18,010)
Profit for the year		**129,055**	90,719
Profit attributable to shareholders		**119,009**	83,008
Profit attributable to non-controlling interests		**10,046**	7,711

Consolidated statement of comprehensive income for the year ended 31 December 2013

	2013 HK$m	2012 HK$m
Profit for the year	**129,055**	90,719
Other comprehensive income/(expense)		
Items that will subsequently be reclassified to the income statement when specific conditions are met:		
Available-for-sale investments:		
– fair value changes taken to equity	**(6,456)**	14,153
– fair value changes transferred to the income statement on disposal	**(34,643)**	(2,753)
– amounts transferred to the income statement on impairment	**–**	5
– fair value changes transferred to the income statement on hedged items	**2,179**	(287)
– income taxes	**1,097**	(768)
Cash flow hedges:		
– fair value changes taken to equity	**5,778**	3,858
– fair value changes transferred to the income statement	**(5,789)**	(3,662)
– income taxes	**(6)**	(33)
Share of changes on equity of associates and joint ventures	**(698)**	638
Exchange differences	**(5,981)**	925
Items that will not subsequently be reclassified to the income statement:		
Property revaluation:		
– fair value changes taken to equity	**5,687**	7,221
– income taxes	**(949)**	(1,161)
Remeasurement of defined benefit:		
– before income taxes	**2,281**	1,080
– income taxes	**(374)**	(198)
Other comprehensive income/(expense) for the year, net of tax	**(37,874)**	19,018
Total comprehensive income for the year, net of tax	**91,181**	109,737
Total comprehensive income for the year attributable to:		
– shareholders of the parent company	**81,689**	100,814
– non-controlling interests	**9,492**	8,923
	91,181	109,737

Financial Statements (continued)

Consolidated balance sheet at 31 December 2013

	Note	2013 HK$m	2012 HK$m
ASSETS			
Cash and short-term funds	11	**1,132,719**	1,111,199
Items in the course of collection from other banks		**16,346**	23,079
Placings with banks maturing after one month	12	**216,970**	184,711
Certificates of deposit	13	**88,207**	93,085
Hong Kong Government certificates of indebtedness	14	**195,554**	176,264
Trading assets	15	**311,400**	419,697
Financial assets designated at fair value	16	**90,146**	69,479
Derivatives	17	**388,727**	398,956
Loans and advances to customers	18	**2,669,238**	2,349,043
Financial investments	21	**765,866**	626,042
Amounts due from Group companies		**161,975**	176,004
Interests in associates and joint ventures	24	**107,852**	119,273
Goodwill and intangible assets	25	**41,882**	38,634
Property, plant and equipment	26	**101,240**	90,179
Deferred tax assets	7	**2,294**	2,629
Other assets	28	**148,939**	187,053
Total assets		**6,439,355**	6,065,327
LIABILITIES			
Hong Kong currency notes in circulation	14	**195,554**	176,264
Items in the course of transmission to other banks		**34,240**	35,525
Deposits by banks		**236,616**	244,135
Customer accounts	29	**4,254,752**	3,874,884
Trading liabilities	30	**195,032**	183,340
Financial liabilities designated at fair value	31	**41,715**	44,270
Derivatives	17	**365,052**	397,151
Debt securities in issue	32	**52,334**	74,647
Retirement benefit liabilities	6	**4,856**	6,725
Amounts due to Group companies		**91,797**	97,618
Other liabilities and provisions	33	**88,809**	94,791
Liabilities under insurance contracts issued	34	**276,180**	244,921
Current tax liabilities	7	**3,722**	3,842
Deferred tax liabilities	7	**16,051**	16,923
Subordinated liabilities	36	**13,107**	13,867
Preference shares	37	**47,314**	83,346
Total liabilities		**5,917,131**	5,592,249
EQUITY			
Share capital	38	**85,319**	58,969
Other reserves		**89,564**	133,790
Retained profits		**290,926**	224,640
Proposed fourth interim dividend	9	**15,000**	20,000
Total shareholders' equity		**480,809**	437,399
Non-controlling interests		**41,415**	35,679
Total equity		**522,224**	473,078
Total equity and liabilities		**6,439,355**	6,065,327

Directors
Stuart T Gulliver
Rose W M Lee
Peter T S Wong

Secretary
Paul A Stafford

Consolidated statement of changes in equity for the year ended 31 December 2013

	2013									
			Other reserves							
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	58,969	244,640	43,451	40,580	210	15,193	34,356	437,399	35,679	473,078
Profit for the year	–	119,009	–	–	–	–	–	119,009	10,046	129,055
Other comprehensive income (net of tax)	–	1,451	4,272	(37,293)	(13)	(5,574)	(163)	(37,320)	(554)	(37,874)
Available-for-sale investments	–	–	–	(36,744)	–	–	–	(36,744)	(1,079)	(37,823)
Cash flow hedges	–	–	–	–	(13)	–	–	(13)	(4)	(17)
Property revaluation	–	(202)	4,272	–	–	–	–	4,070	668	4,738
Actuarial gains on defined benefit plans	–	1,661	–	–	–	–	–	1,661	246	1,907
Share of other comprehensive income of associates and joint ventures	–	(9)	–	(526)	–	–	(163)	(698)	–	(698)
Exchange differences	–	1	–	(23)	–	(5,574)	–	(5,596)	(385)	(5,981)
Total comprehensive income for the year	–	120,460	4,272	(37,293)	(13)	(5,574)	(163)	81,689	9,492	91,181
Shares issued	26,350	–	–	–	–	–	–	26,350	–	26,350
Dividends paid	–	(47,000)	–	–	–	–	–	(47,000)	(3,836)	(50,836)
Movement in respect of share-based payment arrangements	–	(355)	–	–	–	–	240	(115)	11	(104)
Other movements[6]	–	7	–	(7)	–	–	(17,514)	(17,514)	69	(17,445)
Transfers[7]	–	(11,826)	(1,387)	–	–	–	13,213	–	–	–
At 31 December	85,319	305,926	46,336	3,280	197	9,619	30,132	480,809	41,415	522,224

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2013 *(continued)*

	2012									
			Other reserves							
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	30,190	198,416	38,939	29,786	51	14,265	29,177	340,824	30,519	371,343
Profit for the year	–	83,008	–	–	–	–	–	83,008	7,711	90,719
Other comprehensive income (net of tax)	–	519	5,522	10,788	159	928	(110)	17,806	1,212	19,018
Available-for-sale investments	–	–	–	10,040	–	–	–	10,040	310	10,350
Cash flow hedges	–	–	–	–	159	–	–	159	4	163
Property revaluation	–	(168)	5,522	–	–	–	–	5,354	706	6,060
Actuarial losses on defined benefit plans	–	689	–	–	–	–	–	689	193	882
Share of other comprehensive income of associates and joint ventures	–	(1)	–	749	–	–	(110)	638	–	638
Exchange differences	–	(1)	–	(1)	–	928	–	926	(1)	925
Total comprehensive income for the year	–	83,527	5,522	10,788	159	928	(110)	100,814	8,923	109,737
Shares issued	28,779	–	–	–	–	–	–	28,779	–	28,779
Dividends paid	–	(32,500)	–	–	–	–	–	(32,500)	(3,766)	(36,266)
Movement in respect of share-based payment arrangements	–	(246)	–	–	–	–	(277)	(523)	14	(509)
Other movements	–	(3)	–	8	–	–	–	5	(11)	(6)
Transfers [7]	–	(4,554)	(1,010)	(2)	–	–	5,566	–	–	–
At 31 December	58,969	244,640	43,451	40,580	210	15,193	34,356	437,399	35,679	473,078

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

2 *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.*

3 *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.*

4 *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.*

5 *The other reserves mainly comprise the share-based payment reserve account, purchase premium arising from transfer of business within the HSBC Group 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.*

6 *In November 2013 we acquired the Hong Kong and Singapore branches of HSBC Private Bank (Suisse) SA. The purchase premium paid in excess of the net assets acquired was charged to reserves within the line item 'Other movements'.*

7 *The movement from Retained profits to Other reserves includes the relevant transfers in associates according to local regulatory requirements.*

Consolidated statement of cash flows for the year ended 31 December 2013

	Note	2013 HK$m	2012 HK$m
Operating activities			
Cash generated from/(used in) operations	*41*	**158,886**	(20,651)
Interest received on financial investments		**13,222**	14,349
Dividends received on financial investments		**1,087**	464
Dividends received from associates		**4,468**	2,297
Taxation paid		**(16,182)**	(17,423)
Net cash inflow/(outflow) from operating activities		**161,481**	(20,964)
Investing activities			
Purchase of financial investments		**(350,187)**	(262,280)
Proceeds from sale or redemption of financial investments		**267,382**	350,945
Purchase of property, plant and equipment		**(8,419)**	(1,990)
Proceeds from sale of property, plant and equipment and assets held for sale		**1,003**	35
Purchase of other intangible assets		**(1,502)**	(1,303)
Net cash inflow in respect of the sale of subsidiaries		**–**	1,416
Net cash outflow in respect of the purchase of interests in business portfolios	*42*	**(1,792)**	–
Net cash outflow in respect of the purchase of interests in associates and joint ventures		**–**	(13,521)
Net cash outflow from the sale of interests in business portfolios		**(2,670)**	(12,242)
Proceeds from the sale of interests in associates		**2,840**	3,970
Net cash (outflow)/inflow from investing activities		**(93,345)**	65,030
Net cash inflow before financing		**68,136**	44,066
Financing			
Issue of ordinary share capital		**26,350**	28,779
Issue of preference shares		**–**	29
Redemption of preference shares		**(36,042)**	(13,566)
Repayment of subordinated liabilities		**(338)**	(2,326)
Issue of subordinated liabilities		**–**	2,328
Ordinary dividends paid	*9*	**(47,000)**	(32,500)
Dividends paid to non-controlling interests		**(3,836)**	(3,766)
Interest paid on preference shares		**(2,294)**	(2,301)
Interest paid on subordinated liabilities		**(829)**	(884)
Net cash outflow from financing		**(63,989)**	(24,207)
Increase in cash and cash equivalents	*42*	**4,147**	19,859

Financial Statements (continued)

Bank balance sheet at 31 December 2013

	Note	2013 HK$m	2012 HK$m
ASSETS			
Cash and short-term funds	11	**763,529**	761,187
Items in the course of collection from other banks		**10,922**	17,355
Placings with banks maturing after one month	12	**92,945**	80,200
Certificates of deposit	13	**10,012**	20,150
Hong Kong Government certificates of indebtedness	14	**195,554**	176,264
Trading assets	15	**235,599**	284,573
Financial assets designated at fair value	16	**1,561**	1,432
Derivatives	17	**377,183**	391,839
Loans and advances to customers	18	**1,503,251**	1,282,720
Financial investments	21	**322,860**	260,317
Amounts due from Group companies		**366,889**	321,600
Investments in subsidiaries	23	**63,272**	58,819
Interests in associates and joint ventures	24	**40,410**	40,919
Goodwill and intangible assets	25	**4,530**	4,765
Property, plant and equipment	26	**80,144**	53,852
Deferred tax assets	7	**999**	1,333
Other assets	28	**98,400**	143,480
Total assets		**4,168,060**	3,900,805
LIABILITIES			
Hong Kong currency notes in circulation	14	**195,554**	176,264
Items in the course of transmission to other banks		**24,774**	25,766
Deposits by banks		**197,283**	204,520
Customer accounts	29	**2,724,015**	2,417,400
Trading liabilities	30	**82,623**	82,146
Financial liabilities designated at fair value	31	**4,759**	7,731
Derivatives	17	**354,695**	392,084
Debt securities in issue	32	**30,062**	40,406
Retirement benefit liabilities	6	**2,689**	3,710
Amounts due to Group companies		**156,144**	149,237
Other liabilities and provisions	33	**51,265**	58,887
Current tax liabilities	7	**2,029**	2,348
Deferred tax liabilities	7	**6,503**	6,194
Subordinated liabilities	36	**9,346**	9,355
Preference shares	37	**47,205**	83,195
Total liabilities		**3,888,946**	3,659,243
EQUITY			
Share capital	38	**85,319**	58,969
Other reserves		**10,337**	62,219
Retained profits		**168,458**	100,374
Proposed fourth interim dividend	9	**15,000**	20,000
Total equity		**279,114**	241,562
Total equity and liabilities		**4,168,060**	3,900,805

Directors
Stuart T Gulliver
Rose W M Lee
Peter T S Wong

Secretary
Paul A Stafford

Bank statement of changes in equity for the year ended 31 December 2013

	2013							
			Other reserves					
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total equity HK$m
At 1 January	58,969	120,374	26,876	36,118	220	(2,784)	1,789	241,562
Profit for the year	–	108,678	–	–	–	–	–	108,678
Other comprehensive income (net of tax)	–	972	2,061	(31,542)	(32)	(4,343)	–	(32,884)
Available-for-sale investments	–	–	–	(31,520)	–	–	–	(31,520)
Cash flow hedges	–	–	–	–	(32)	–	–	(32)
Property revaluation	–	(116)	2,061	–	–	–	–	1,945
Actuarial gains on defined benefit plans	–	1,088	–	–	–	–	–	1,088
Exchange differences	–	–	–	(22)	–	(4,343)	–	(4,365)
Total comprehensive income	–	109,650	2,061	(31,542)	(32)	(4,343)	–	75,794
Shares issued	26,350	–	–	–	–	–	–	26,350
Dividends paid	–	(47,000)	–	–	–	–	–	(47,000)
Movement in respect of share-based payment arrangements	–	(267)	–	–	–	–	183	(84)
Other movements[6]	–	20	–	(14)	–	–	(17,514)	(17,508)
Transfers	–	681	(681)	–	–	–	–	–
At 31 December	85,319	183,458	28,256	4,562	188	(7,127)	(15,542)	279,114

Financial Statements (continued)

Bank statement of changes in equity for the year ended 31 December 2013 *(continued)*

	2012							
			Other reserves					
	Share Capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total equity HK$m
At 1 January	30,190	103,932	24,296	26,013	63	(3,152)	2,058	183,400
Profit for the year	–	48,377	–	–	–	–	–	48,377
Other comprehensive income (net of tax)	–	224	3,142	10,105	157	368	–	13,996
Available-for-sale investments	–	–	–	10,106	–	–	–	10,106
Cash flow hedges	–	–	–	–	157	–	–	157
Property revaluation	–	(97)	3,142	–	–	–	–	3,045
Actuarial losses on defined benefit plans	–	321	–	–	–	–	–	321
Exchange differences	–	–	–	(1)	–	368	–	367
Total comprehensive income	–	48,601	3,142	10,105	157	368	–	62,373
Shares issued	28,779	–	–	–	–	–	–	28,779
Dividends paid	–	(32,500)	–	–	–	–	–	(32,500)
Movement in respect of share-based payment arrangements	–	(221)	–	–	–	–	(269)	(490)
Other movements	–	–	–	–	–	–	–	–
Transfers	–	562	(562)	–	–	–	–	–
At 31 December	58,969	120,374	26,876	36,118	220	(2,784)	1,789	241,562

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

2 *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.*

3 *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.*

4 *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.*

5 *The other reserves mainly comprise the share-based payment reserve account, purchase premium arising from transfer of business within the HSBC Group 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.*

6 *In November 2013 we acquired the Hong Kong and Singapore branches of HSBC Private Bank (Suisse) SA. The purchase premium paid in excess of the net assets acquired was charged to reserves within the line item 'Other movements'.*

Notes on the Financial Statements

1 Basis of preparation

a Compliance with Hong Kong Financial Reporting Standards

The consolidated financial statements have been prepared in accordance with Hong Kong Financial Reporting Standards ('HKFRS'), the provisions of the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong. HKFRS is a collective term which includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ('HKAS') 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, premises, and certain assets and liabilities related to insurance contracts.

Standards adopted during the year ended 31 December 2013

On 1 January 2013, the group adopted the following significant new standards and amendments to standards. The financial effect of these new standards and amendments is insignificant to these consolidated financial statements:

- HKFRS 10 'Consolidated Financial Statements', HKFRS 11 'Joint Arrangements', HKFRS 12 'Disclosure of Interests in Other Entities' and amendments to HKFRS 10, HKFRS 11 and HKFRS 12 'Transition Guidance' are required to be applied retrospectively.
- Under HKFRS 10, there is one approach for determining consolidation for all entities, based on the concepts of power, variability of returns and their linkage. This replaces the approach which applied to previous financial statements which emphasised legal control or exposure to risks and rewards, depending on the nature of the entity. The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns by exercising its power over the entity. In accordance with the transitional provisions of HKFRS 10, we reviewed the population of investments in entities as at 1 January 2013 to determine whether entities previously consolidated or unconsolidated in accordance with HKAS 27 'Consolidated and Separate Financial Statements' and SIC 12 'Consolidation – Special Purpose Entities' changed their consolidation status as a result of applying HKFRS 10. The result of this review was that the effect of applying the requirements of HKFRS 10 did not have a material effect on these consolidated financial statements. Therefore no restatements are necessary on application of HKFRS 10. HKFRS 11 places more focus on the investors' rights and obligations than on the structure of the arrangement when determining the type of joint arrangement with which the group is involved, unlike the previous approach, and introduces the concept of a joint operation. The application of HKFRS 11 'Joint Arrangements' did not have a material effect on these consolidated financial statements.
- HKFRS 12 is a comprehensive standard on disclosure requirements for all forms of interests in other entities, including unconsolidated structured entities. The disclosure requirements of HKFRS 12 do not require comparative information to be provided for periods prior to initial application. New disclosures are provided in note 53.
- HKFRS 13 'Fair Value Measurement' establishes a single framework for measuring fair value and introduces new requirements for disclosure of fair value measurements. HKFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of HKFRS 13 do not require comparative information to be provided for periods prior to initial application. Disclosures are provided in note 51.
- Amendments to HKFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' requires disclosure of the effect or potential effects of netting arrangements on an entity's financial position. The amendment requires disclosure of recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement. The amendments have been applied retrospectively. Disclosures are provided in note 47.

Notes on the Financial Statements (continued)

1 Basis of preparation *(continued)*

The amendments to HKAS 19 'Employee Benefits' ('HKAS 19 revised') are required to be applied retrospectively. The main effect of HKAS 19 revised for the group is that it replaces the interest cost on the plan liability and expected return on plan assets with a finance cost comprising the net interest on the net defined benefit liability or asset. This finance cost is determined by applying to the net defined benefit liability or asset the same discount rate used to measure the defined benefit obligation. The difference between the actual return on plan assets and the return included in the finance cost component reflected in the income statement is presented in other comprehensive income. The effect of this change is to increase or decrease the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

During 2013, the group adopted a number of interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of the Bank.

b Presentation of information

Disclosures under HKFRS 4 'Insurance Contracts' and HKFRS 7 'Financial Instruments: Disclosures' concerning the nature and extent of risks relating to insurance contracts and financial instruments have been included in the audited sections of the 'Risk Report' on pages 26 to 67.

Capital disclosures under HKAS 1 'Presentation of Financial Statements' have been included in the audited sections of 'Capital' on pages 68 to 74.

In accordance with the group's policy to provide disclosures that help stakeholders understand the group's performance, financial position and changes thereto, the information provided in the notes on the Financial Statements the Risk Report and the Capital section goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements. In particular, the group provides additional disclosures having regard to the recommendation of the Enhanced Disclosure Task Force ('EDTF') report 'Enhancing the Risk Disclosures of Banks' in 2013. The report aims to help financial institutions identify areas in which users had requested additional information about banks' risks, and how these risks relate to performance measurement and reporting. The recommendations for disclosure improvement focused on the principal risks faced by the banking industry, and included disclosures about risk governance, capital adequacy, liquidity, funding, credit risk, market risk and other risks.

c Consolidation

The consolidated financial statements comprise the financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') made up to 31 December 2013. The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The group is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities of the entity. For the group to have power over an entity, it must have the practical ability to exercise those rights. In situations where potential voting rights exist, these are taken into account if the group has the practical ability to exercise those rights.

Where voting rights are not relevant in deciding whether the group has power over an entity, the assessment of control is based on all facts and circumstances. The group may have power over an entity even though it holds less than a majority of the voting rights, if it holds additional rights arising through other contractual arrangements or substantive potential voting rights which give it power.

When assessing whether to consolidate investment funds, the group reviews all facts and circumstances to determine whether the group, as fund manager, is acting as agent or principal. The group may be deemed to be a principal, and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or a guarantee, and is able to influence the returns of the funds by exercising its power.

1 Basis of preparation *(continued)*

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are treated as transactions between equity holders and are reported in equity.

Entities that are controlled by the group are consolidated from the date the group gains control and ceases to be consolidated from the date the group loses control of the entities.

The group performs a re-assessment of consolidation whenever there is a change in the facts and circumstances relevant to determining the control of entities.

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements also include the attributable share of the results and reserves of associates and joint ventures based on accounts prepared at dates not earlier than three months prior to 31 December 2013.

d Future accounting developments

At 31 December 2013, a number of standards and interpretations, and amendments thereto, had been issued by the HKICPA, which are not effective for the group's consolidated financial statements as at 31 December 2013. In addition to the projects to complete financial instrument accounting, discussed below, the HKICPA is continuing to monitor projects on insurance and lease accounting which could involve significant changes to accounting requirements in the future.

During 2012 and 2013, the HKICPA issued various amendments to HKFRS that are effective from 1 January 2014 and which are expected to have an insignificant effect on the consolidated financial statements of the group.

In December 2011, the HKICPA issued amendments to HKAS 32 'Offsetting Financial Assets and Financial Liabilities' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32 'Financial Instruments: Presentation'. The amendments are effective for annual periods beginning on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively.

We do not expect the amendments to HKAS 32 to have a material effect on the group's financial statements.

In November 2009, the HKICPA issued HKFRS 9 'Financial Instruments' which introduced new requirements for the classification and measurement of financial assets. In November 2010, the HKICPA issued an amendment to HKFRS 9 incorporating requirements for financial liabilities. Together, these changes represent the first phase in the HKICPA's planned replacement of HKAS 39 'Financial Instruments: Recognition and Measurement' HKFRS 9 classification and measurement requirements are to be applied retrospectively but prior periods need not be restated.

Since the final requirements for classification and measurement are uncertain, it remains impracticable to quantify the effect of HKFRS 9 as at the date of the publication of these financial statements.

The second phase in the HKICPA's project to replace HKAS 39 will address the impairment of financial assets. It is proposed to replace the 'incurred loss' approach to the impairment of financial assets carried at amortised cost in HKAS 39 with an expected credit loss approach, and require that the expected credit loss approach be applied to other categories of financial instrument, including loan commitments and financial guarantees. The final requirements for impairment of financial assets are expected to be published in 2014.

The third phase of the project addresses general hedge accounting. Macro hedging is not included in the HKFRS 9 project and will be considered separately. In December 2013, the HKICPA issued amendments to HKFRS 9 in respect of the general hedge accounting requirements, transition and effective date. As a result of these amendments, it is confirmed that all phases of HKFRS 9 (except for changes to the presentation of gains and losses for certain liabilities measured at fair value) must be applied from the same effective date. This effective date has not yet been set by the HKICPA but is not expected to be earlier than 1 January 2017. The revised hedge accounting requirements are applied prospectively and the group is currently assessing the impact they may have on the financial statements.

2 Critical accounting estimates and judgements in applying accounting policies

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements. The significant accounting policies are described in note 3 on the financial statements.

The accounting policies that are deemed critical to our results and financial position, in terms of the materiality of the items to which the policies are applied and the high degree of judgement involved, including the use of assumptions and estimation, are discussed below.

Loan impairment

Application of the group's methodology for assessing loan impairment, as set out in note 3(e), involves considerable judgement and estimation.

For individually significant loans, judgement is required in determining whether there are indications that an impairment loss may already have 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.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is included in note 3(i) and is discussed further in note 51 'Fair value of financial instruments carried at fair value'.

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

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt;
- an appropriate discount rate for the instrument. Management uses all relevant market information in determining the appropriate spread over the risk-free/benchmark rate used by market participants for the particular instrument; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivatives.

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

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

When unobservable market data have a significant impact on the valuation of derivatives, the entire initial difference in fair value from the transaction price as 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 comprises financial instruments held for trading, derivatives and financial instruments designated at fair value. Changes in their fair value directly impact the group’s income statement in the period in which they occur.

A change in the fair value of a financial asset which is classified as ‘available-for-sale’ is recorded directly in equity and other comprehensive income 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 other comprehensive income 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.

Interests in associates

Determining whether an investment in another entity should be classified as an investment in an associate requires judgement. Management considers all aspects of the relationship between the investor and the investee in order to determine whether the group has significant influence over the investee. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies. Where significant influence exists, an investment is classified as an associate and is accounted for using the equity method, while an investment in an entity which is not an associate, joint venture, or subsidiary is accounted for either at fair value through profit and loss, or as an available for sale investment.

Under the equity accounting method, investments in associates are initially stated at cost, and are adjusted thereafter for the post-acquisition change in the group's share of the net assets of the associate. An investment in an associate is tested for impairment when there is an indication that the investment may be impaired. At 31 December 2013, the fair value of the group's investment in Bank of Communications Co., Ltd. ('BoCom') had been below the carrying amount for approximately 20 months, apart from a short period in 2013. The conclusion of the impairment test, based on the assessment of the value in use, was that the investment is not impaired. The measurement of value in use involves significant judgements in estimating the present values of cash flows expected to arise from continuing to hold the investment. Note 24 on the Financial Statements includes detailed information on the group's investment in BoCom. It provides a description of the key assumptions used in estimating value in use, the sensitivity of the value in use calculation to different assumptions and a sensitivity analysis that shows the changes in key assumptions that would reduce the excess of value in use over the carrying amount (‘headroom’) to nil.

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 equities, as well as behavioural and other future events, have a significant impact on the amount recognised as a liability.

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

Insurance contracts

Classification

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

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

The value of PVIF, which is recorded as an intangible asset, depends upon assumptions regarding future events. These are described in more detail in note 25(b). The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

Insurance liabilities

The estimation of insurance liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts.

3 Summary of significant accounting policies

a *Interest income and expense*

Interest income and expense for all financial instruments, except those classified as held for trading or designated at fair value (except for debt securities issued by the group and derivatives managed in conjunction with those debt securities) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest rate method. The effective interest rate method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

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

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

b *Non interest income*

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

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

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with the related interest income, expense and dividends.

3 Summary of significant accounting policies *(continued)*

Net income/ (expense) from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss, including liabilities under investment contracts;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value through profit or loss; and
- interest income, interest expense and dividend income in respect of:
  - financial assets and financial liabilities designated at fair value through profit or loss; and
  - derivatives managed in conjunction with the above,

  except for interest arising from debt securities issued by the group and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense' (note 3(a)).

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

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c *Operating segments*

The group has a matrix management structure. The group's chief operating decision-maker regularly reviews operating activity on a number of bases, including by geographical region and by global business. The group considers that geographical operating segments represent the most appropriate information for the users of the financial statements to best evaluate the nature and financial effects of the business activities in which the group engages, and the economic environments in which it operates. This reflects the importance of geographic factors on business strategy and performance, the allocation of capital resources, and the role of geographical regional management in executing strategy. As a result, the group's operating segments are considered to be geographical regions.

Measurement of segmental assets, liabilities, income and expenses is in accordance with the group's accounting policies. Segmental income and expenses include transfers between segments and these transfers are conducted on arm's length terms and conditions. Shared costs are included in segments on the basis of the actual recharges made.

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d *Loans and advances to customers and placings with banks*

Loans and advances to customers and placings with banks 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 a borrower. They are derecognised when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest rate method, less any reduction from impairment or uncollectibility. Where exposures 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 relating only to the hedged risk.

Loans and advances are reclassified to 'Assets held for sale' when their carrying amounts are to be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable (note 3(ad)); however, such loans and advances continue to be measured in accordance with the policy described above.

3 Summary of significant accounting policies *(continued)*

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 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 but to hold 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 loan to be held is recorded at its fair value and subsequently measured at amortised cost using the effective interest rate method. For certain transactions, such as leveraged finance and syndicated lending activities, the cash advanced is not necessarily the best evidence of the fair value of the loan. For these loans, 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 rate method, unless the loan becomes impaired. The write-down is recorded as a reduction to other operating income.

Financial assets which have been reclassified into the loans and receivables category are initially recorded at the fair value at the date of reclassification and are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

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e *Impairment of loans and advances*

Losses for impaired loans are promptly recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of impairment allowance accounts. Losses which may arise from future events are not recognised.

Individually assessed loans and advances

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include:

- the size of the loan;
- the number of loans in the portfolio; and
- the importance of the individual loan relationship, and how this is managed.

Such loans will be individually assessed for impairment, except for when volumes of defaults and losses are sufficient to justify treatment under a collective assessment methodology.

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual relationship basis. Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogeneous loans.

3 Summary of significant accounting policies *(continued)*

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

- known cash flow difficulties experienced by the borrower;
- contractual payments of either principal or interest being past due for more than 90 days;
- the probability that the borrower will enter bankruptcy or other financial realisation;
- a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in the forgiveness or postponement of principal, interest or fees, where the concession is not insignificant; and
- there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful.

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

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or pari passu with, the group and the likelihood of other creditors continuing to support the 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 currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

The realisable value of security is determined based on the current market value when the impairment assessment is performed. The value is not adjusted for expected future changes in market prices; however, adjustments are made to reflect local conditions, such as forced sale discounts.

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

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

3 Summary of significant accounting policies *(continued)*

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective impairment. The credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. This reflects impairment losses that the group has incurred as a result of events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed on an individual basis for impairment.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. As it is assessed empirically on a periodic basis the estimated period between a loss occurring and its identification may vary over time as these factors change.

Homogeneous groups of loans and advances

Statistical methods are used to determine impairment losses on a collective basis for homogeneous groups of loans that are not considered individually significant, because individual loan assessment is impracticable.

Losses in these groups of loans are recorded on an individual basis when individual loans are written off, at which point they are removed from the group. Two alternative methods are used to calculate allowances on a collective basis:

- When appropriate empirical information is available, the group uses a roll rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency, and ultimately prove irrecoverable. In addition to the delinquency groupings, loans are segmented according to their credit characteristics as described below. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience. The period between a loss occurring and its identification is explicitly estimated by local management, and is typically between six and twelve months.

The inherent loss within each portfolio is assessed on the basis of statistical models using historical data observations, which are updated periodically to reflect recent portfolio and economic trends. When the most recent trends in portfolio risk factors arising from changes in economic, regulatory or behavioural conditions are not fully reflected in the statistical models, they are taken into account by adjusting the impairment allowances derived solely from historical loss experience to reflect these changes as at the balance sheet date.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

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

Write-off of loans and advances

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

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 excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

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’ if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and their sale is highly probable. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance amounts) at the date of exchange. No depreciation is charged 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, together with any realised gains or losses on disposal. Debt securities or equities acquired in debt-to-debt/equity swaps are included in ‘Financial investments’ and are classified as available-for-sale.

Renegotiated loans

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument.

f *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, placings with and by 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. Financial assets and financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell the financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, the fair values are remeasured and gains and losses from changes therein are recognised in the income statement within 'Net trading income'.

g *Financial instruments designated at fair value*

Financial instruments, other than those held for trading, are classified in this category if they meet the criteria set out below and are so designated by management on initial recognition. The group may designate financial instruments at fair value when the designation:

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

  Long-term debt issues. The interest payable on certain fixed-rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement;

  Financial assets and financial liabilities under unit-linked insurance and unit-linked investment contracts. Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded in other comprehensive income. These financial instruments are managed on a fair value basis and management information is also prepared on this basis. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line;

· 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 reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under non-linked insurance contracts are the main class of financial instrument so designated. The group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations; and

· relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issuances and debt securities held.

This fair value designation, once made, is irrevocable. Financial assets and financial liabilities are recognised when the group enters the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, the fair values are remeasured and gains and losses from changes therein are recognised in the income statement within 'Net income from financial instruments designated at fair value'.

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h *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 other comprehensive income in the 'Available-for-sale investment reserve' until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income 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 method, 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. 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 other comprehensive income 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. The impairment methodologies for available-for-sale financial assets are set out in more detail below.

Available-for-sale debt securities

When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer.

These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

3 Summary of significant accounting policies *(continued)*

In addition, when assessing available-for-sale asset-backed securities ('ABS's) for objective evidence of impairment, the group considers the performance of underlying collateral and the extent and depth of market price declines. Changes in credit ratings are considered but a downgrade of a security's credit rating is not, of itself, evidence of impairment. The primary indicators of potential impairment are considered to be adverse fair value movements and the disappearance of an active market for a security.

Available-for-sale equity securities

Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if, there is objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised directly in other comprehensive income. 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. If there is no longer objective evidence that the debt security is impaired, the impairment loss is also reversed through the income statement;
- 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 other comprehensive income. 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, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost, less cumulative impairment to date, of the equity security.

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.

3 Summary of significant accounting policies *(continued)*

i *Valuation of financial instruments*

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

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the group's valuation methodologies, which are described in note 51.

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

When 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 'Loans and advances to customers' or 'Placings with banks' as appropriate. The difference between the sale and repurchase price is treated as interest income and recognised over the life of the agreement for loans and advances to customers and placings with banks, and as net trading income for trading assets.

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'.

k *Derivative financial instruments and hedge accounting*

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

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

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

The method of recognising fair value gains and losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When 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 hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of a net investment in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

3 Summary of significant accounting policies *(continued)*

Hedge accounting

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

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are 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 the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

The accumulated gains and losses recognised in other comprehensive income 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 recognised in other comprehensive income are removed from equity and included in the initial measurement of the cost of the asset or liability.

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

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

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

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted by an entity to assess hedge effectiveness will depend on the risk management strategy.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in 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 must offset each other in the range of 80% to 125%.

Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.

3 Summary of significant accounting policies *(continued)*

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in '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'.

Derivatives that do not qualify for hedge accounting include non-qualifying hedges entered into as part of documented interest rate management strategies for which hedge accounting was not, or could not, be applied. The size and direction of changes in fair value of non-qualifying hedges can be volatile from year to year, but do not alter the cash flows expected as part of the documented management strategies for both the non-qualifying hedge instruments and the assets and liabilities to which the documented interest rate strategies relate. Non-qualifying hedges therefore operate as economic hedges of the related assets and liabilities.

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l *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, cancelled or expires.

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m *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.

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n *Subsidiaries, associates and joint ventures*

The group classifies investments in entities which it controls as subsidiaries. Investments in which the group, together with one or more parties, has joint control of an arrangement set up to undertake an economic activity are classified as joint ventures. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates.

Investments in associates and interests in joint ventures are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the group's share of net assets less any impairment losses.

Profits on transactions between the group and its associates and joint ventures are eliminated to the extent of the group's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of the group's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

The Bank's investments in subsidiaries, associates and joint ventures are stated at cost less any impairment losses. An impairment loss recognised in prior periods shall be reversed through the income statement if, and only if, there has been a change in the estimates used to determine the recoverable amount of the investment since the last impairment loss was recognised.

In order to determine whether an impairment test under HKAS 36 'Impairment of Assets' is required in respect of an interest in an associate or a joint venture, it is necessary to consider the indicators in HKAS 39 'Financial Instruments: Recognition and Measurement'. Where the review of the indicators suggests that the interest in an associate or joint venture may be impaired, the impairment testing requirements of HKAS 36 are applied.

3 Summary of significant accounting policies *(continued)*

The group's policy for impairment testing of goodwill arising on acquisition of subsidiaries is included under note 3(o). In the case of an interest in an associate or joint venture, the entire carrying amount in the consolidated balance sheet is compared to its recoverable amount. If the recoverable amount is less than its carrying amount, an impairment loss is recognised in the group's consolidated financial statements.

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, for example when any voting rights relate to administrative tasks only, and key activities are directed by contractual agreement. Structured entities often have restricted activities and a narrow and well-defined objective. Examples of structured entities include investment funds, securitisation vehicles and asset backed financings. Involvement with consolidated and unconsolidated structured entities is disclosed in note 53.

The group would be considered to sponsor another entity if it had a key role in establishing that entity or in bringing together the relevant counterparties so that the transaction, which is the purpose of the entity, could occur in addition to on-going involvement with the entity. This would generally include situations where the group initially sets up an entity for a structured transaction. The group would not be considered a sponsor once its initial involvement in setting up the structured entity had ceased if the group were subsequently involved with the entity only to the extent of providing arm's length services, for example through the provision of senior lending in the ordinary course of business.

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o *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.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units ('CGU') 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 of 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 of 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.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures' and is not tested separately for impairment.

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.

Goodwill is included in a disposal group if the disposal group is a CGU to which goodwill has been allocated or it is an operation within such a CGU. The amount of goodwill included in a disposal group is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained.

(ii) Intangible assets include the present value of in-force long-term insurance business, operating rights, computer software and, when acquired in a business combination, 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 present value of in-force long-term insurance 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 present value of in-force long-term insurance business is set out in note 3(x).

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p *Property, plant and equipment*

(i) Land and buildings

Land and buildings held for own use are carried at their revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses.

Revaluations are performed 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 land and buildings, 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 land and buildings, and are thereafter recognised in the income statement.

Buildings held for own use which are situated on leasehold land where it is possible reliably to 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 land and buildings is calculated to write off the assets over their estimated useful lives as follows:

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

(ii) 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 based on the highest and best use of the property, primarily using the 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 properties on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 3(q)).

3 Summary of significant accounting policies *(continued)*

(iii) Leasehold land and land use rights

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

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

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

(iv) 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.

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.

q *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 ‘Loans and 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) Leasehold land is included under ‘Other assets’ in the balance sheet if such land is considered to be held under operating leases 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.

r *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. The group provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

3 Summary of significant accounting policies *(continued)*

(iii) Deferred tax is recognised on temporary differences between the carrying amount of assets and liabilities in the balance sheet 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 used.

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 offset 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 share-based payment transactions is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense.

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 fair value gain or loss is recognised in the income statement.

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s *Pension and other post-employment benefits*

The group operates a number of pension and post-employment 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. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit liability and is presented in operating expenses. Service cost comprises current service cost, past service cost, and gain or loss on settlement.

The past service cost which is charged immediately to the income statement is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or curtailment (a significant reduction by the entity in the number of employees covered by a plan). A settlement is a transaction that eliminates all further legal and constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Remeasurements of the net defined benefit liability, which comprise actuarial gains and losses, return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income.

Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions.

The defined benefit liability recognised on the balance sheet represents the present value of defined benefit obligations reduced by the fair value of plan assets. Any net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

t *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 is recognised as an expense on a straight-line basis over the vesting period. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

HSBC Holdings is the grantor of its equity instruments for all share awards and share options across the group. The credit to 'Other reserves' over the vesting period on expensing an award represents the effective capital contribution from HSBC Holdings. To the extent the group will be, or has been, required to fund a share-based payment arrangement, this capital contribution is reduced and the fair value of shares expected to be released to employees is recorded within 'Other liabilities'.

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

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

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

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

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u *Foreign currencies*

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 currency.

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.

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's 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 previously recognised in reserves are recognised in the income statement.

3 Summary of significant accounting policies *(continued)*

v *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.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the group; or are present obligations that have arisen from past events but are not recognised because it is not probable that settlement will require the outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

w *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.

x *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

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

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contracts based on the proportion of risks borne during the accounting period. The unearned premium (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.

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

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long-term investment contracts with discretionary participating features ('DPF') and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders' interest in the profits expected to emerge from those contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long-term investment contracts with DPF, referred to as 'PVIF', is determined by discounting the equity holders' interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in 'Other operating income' on a gross of tax basis.

3 Summary of significant accounting policies *(continued)*

Claims and reinsurance recoveries

Gross insurance claims for life insurance contracts 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. Claims arising during the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

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

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Some insurance contracts may contain discretionary participation features whereby the policyholder is entitled to additional payments whose amount and/or timing is at the discretion of the issuer. The discretionary element of these contracts is included in 'Liabilities under insurance contracts issued'.

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred 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. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

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y *Investment contracts*

Customer liabilities under linked and certain non-linked investment contracts without discretionary participation features and the corresponding financial assets are designated at fair value. Movements in fair value are recognised in 'Net income from financial instruments designated at fair value'. Deposits receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in 'Net fee income'.

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z *Dividends*

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

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aa *Debt securities in issue and subordinated liabilities*

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the consideration received, net of directly attributable transaction costs incurred. 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'.

3 Summary of significant accounting policies *(continued)*

ab *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.

ac *Share capital*

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

ad *Assets held for sale*

Non-current assets held for sale and disposal groups (including both assets and liabilities of the disposal groups) are classified as held for sale when their carrying amounts will be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable. Non-current assets held for sale and disposal groups are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets, financial assets, investment properties, insurance contracts and assets arising from employee benefits, which are measured in accordance with the accounting policies described above.

Immediately before the initial classification as held for sale, the carrying amounts of the asset (or assets and liabilities in the disposal group) are measured in accordance with applicable HKFRS. On subsequent re-measurement of a disposal group, the carrying amounts of the assets and liabilities that are not within the scope of the measurement requirements of HKFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' are measured in accordance with applicable HKFRS before the fair value less costs to sell of the disposal group is determined.

Income earned and expenses incurred on assets and liabilities of disposal groups held for sale continue to be recognised in the appropriate line items in the income statement until the transaction is complete.

Notes on the Financial Statements (continued)

4 Operating profit

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

a *Interest income*

	2013 HK$m	2012 HK$m
Interest income on listed securities	**6,539**	7,708
Interest income on unlisted securities	**19,946**	19,458
Other interest income	**98,969**	97,465
	125,454	124,631
Less: interest income classified as 'Net trading income' (note 4(d))	**(8,352)**	(9,064)
Less: interest income classified as 'Net income from financial instruments designated at fair value'(note 4(e))	**(63)**	(56)
	117,039	115,511

Included in the above is interest income accrued on impaired financial assets of HK$200m (2012: HK$174m), including the unwinding of discounts on loan impairment losses of HK$128m (2012: HK$152m).

b *Interest expense*

	2013 HK$m	2012 HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**525**	726
Interest expense on preference shares	**1,591**	2,386
Other interest expense	**32,068**	34,547
	34,184	37,659
Less: interest expense classified as 'Net trading income' (note 4(d))	**(4,493)**	(4,544)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**(17)**	(23)
	29,674	33,092

c *Net fee income*

	2013 HK$m	2012 HK$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	**15,596**	15,315
– fee expense	**(1,833)**	(1,542)
	13,763	13,773
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**8,607**	8,287
– fee expense	**(981)**	(1,069)
	7,626	7,218

4 Operating profit *(continued)*

d *Net trading income*

	2013 HK$m	2012 HK$m
Dealing profits	**15,104**	16,633
– Foreign exchange	**15,317**	14,002
– Interest rate derivatives	**217**	2,145
– Debt securities	**(1,462)**	2,322
– Equities and other trading	**1,032**	(1,836)
Loss from hedging activities	**(37)**	(31)
Fair value hedges		
– Net gain/ (loss) on hedged items attributable to the hedged risk	**(1,977)**	345
– Net gain/ (loss) on hedging instruments	**1,938**	(376)
– Other	**–**	–
Cash flow hedges		
– Net hedging gain	**2**	–
Interest on trading assets and liabilities	**3,859**	4,520
– Interest income (note 4(a))	**8,352**	9,064
– Interest expense (note 4(b))	**(4,493)**	(4,544)
Dividend income from trading securities	**974**	786
– Listed investments	**815**	653
– Unlisted investments	**159**	133
Ping An contingent forward sale contract (note 28)	**(3,323)**	(2,694)
	16,577	19,214

e *Net income from financial instruments designated at fair value*

	2013 HK$m	2012 HK$m
Income on assets designated at fair value which back insurance and investment contracts	**3,589**	6,670
Increase in fair value of liabilities to customers under investment contracts	**(1,050)**	(2,209)
	2,539	4,461
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**(110)**	119
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	**63**	56
– Interest expense (note 4(b))	**(17)**	(23)
	2,475	4,613

1 *Gains and losses from changes in the fair value of the group's issued debt securities include those arising from changes in the group's own credit risk. In 2013 the group recognised a HK$18m loss on changes in the fair value of these instruments arising from changes in own credit risk (2012:HK$22m loss).*

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

f *Gains less losses from financial investments*

	2013 HK$m	2012 HK$m
Gains on disposal of available-for-sale securities	**470**	2,809
Impairment of available-for-sale equity investments	**(28)**	(175)
	442	2,634

There were no gains or losses on the disposal of held-to-maturity investments in the year (2012: nil).

g *Dividend income*

	2013 HK$m	2012 HK$m
Listed investments	**1,008**	325
Unlisted investments	**167**	197
	1,175	522

h *Net gain on reclassification of associates*

	2013 HK$m	2012 HK$m
Gain on reclassification of Industrial Bank	**8,454**	–
Loss on reclassification of Yantai Bank	**(297)**	–
	8,157	–

i *Gain on sale of Ping An*

	2013 HK$m	2012 HK$m
Gain on sale of Ping An	**34,070**	–

j *Other operating income*

	2013 HK$m	2012 HK$m
Rental income from investment properties	**312**	216
Movement in present value of in-force insurance business	**4,735**	4,432
Gains on investment properties	**1,389**	834
Gain on disposal of property, plant and equipment and assets held for sale	**299**	30
Gain on disposal of subsidiaries, associates and business portfolios	**758**	5,246
Surplus arising on property revaluation	**–**	2
Other	**3,925**	4,577
	11,418	15,337

Other includes recoveries against initial fair value on acquired loan portfolios of HK$388m (2012: HK$650m). There were no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2012: nil).

4 Operating profit *(continued)*

k *Loan impairment charges and other credit risk provisions*

	2013 HK$m	2012 HK$m
Individually assessed impairment charges:		
– New allowances	**2,433**	2,201
– Releases	**(1,426)**	(1,230)
– Recoveries	**(198)**	(237)
	809	734
Collectively assessed impairment charges	**2,602**	2,596
Other credit risk provisions	**121**	248
Loan impairment charges and other credit risk provisions	**3,532**	3,578

There were no impairment release against available-for-sale debt securities included in other credit risk provisions (2012: HK$82m). There were no impairment losses or provisions relating to held-to-maturity investments (2012: nil).

l *General and administrative expenses*

	2013 HK$m	2012 HK$m
Premises and equipment		
– Rental expenses	**3,428**	3,292
– Amortisation of prepaid operating lease payments	**18**	18
– Other premises and equipment expenses	**3,953**	3,941
	7,399	7,251
Marketing and advertising expenses	**3,565**	3,578
Other administrative expenses	**15,163**	15,182
	26,127	26,011

Included in operating expenses were direct operating expenses of HK$25m (2012: HK$23m) 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$1m (2012: HK$1m).

Included in operating expenses are minimum lease payments under operating leases of HK$3,404m (2012: HK$3,361m).

m *Auditors' remuneration*

Auditors' remuneration amounted to HK$74m (2012: HK$77m), of which HK$29m (2012: HK$29m) related to the Bank.

Notes on the Financial Statements (continued)

5 Insurance income

Included in the consolidated income statement are the following revenues earned by the insurance business:

a *Insurance income*

	2013 HK$m	2012 HK$m
Net interest income	8,702	7,864
Net fee income	1,864	1,216
Net trading (loss)/ income	(349)	56
Net income from financial instruments designated at fair value	2,426	4,538
Net earned insurance premiums (note 5(b))	53,663	52,621
Movement in present value of in-force business	4,735	4,432
Other operating income	1,052	1,308
	72,093	72,035
Net insurance claims incurred and movement in liabilities to policyholders (note 5(c))	(56,592)	(54,983)
Net operating income	15,501	17,052

b *Net earned insurance premiums*

	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
2013					
Gross written premiums	184	43,193	12,088	–	55,465
Movement in unearned premiums	(1)	–	–	–	(1)
Gross earned premiums	183	43,193	12,088	–	55,464
Gross written premiums ceded to reinsurers	(25)	(1,758)	(18)	–	(1,801)
Reinsurers' share of movement in unearned premiums	–	–	–	–	–
Reinsurers' share of gross earned premiums	(25)	(1,758)	(18)	–	(1,801)
Net earned premiums	158	41,435	12,070	–	53,663
2012					
Gross written premiums	2,935	41,405	10,605	–	54,945
Movement in unearned premiums	(385)	–	–	–	(385)
Gross earned premiums	2,550	41,405	10,605	–	54,560
Gross written premiums ceded to reinsurers	(365)	(1,587)	(11)	–	(1,963)
Reinsurers' share of movement in unearned premiums	24	–	–	–	24
Reinsurers' share of gross earned premiums	(341)	(1,587)	(11)	–	(1,939)
Net earned premiums	2,209	39,818	10,594	–	52,621

5 Insurance income *(continued)*

c *Net insurance claims incurred and movement in liabilities to policyholders*

	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
2013					
Claims, benefits and surrenders paid	**33**	**20,309**	**4,898**	**28**	**25,268**
Movement in provision	**70**	**26,319**	**5,632**	**(28)**	**31,993**
Gross claims incurred and movement in liabilities to policyholders	**103**	**46,628**	**10,530**	**–**	**57,261**
Reinsurers' share of claims, benefits and surrenders paid	**–**	**(201)**	**(3,267)**	**–**	**(3,468)**
Reinsurers' share of movement in provision	**(53)**	**(1,429)**	**4,281**	**–**	**2,799**
Reinsurers' share of claims incurred and movement in liabilities to policyholders	**(53)**	**(1,630)**	**1,014**	**–**	**(669)**
Net insurance claims incurred and movement in liabilities to policyholders	**50**	**44,998**	**11,544**	**–**	**56,592**
2012					
Claims, benefits and surrenders paid	1,135	6,931	7,286	62	15,414
Movement in provision	71	35,445	3,686	(61)	39,141
Gross claims incurred and movement in liabilities to policyholders	1,206	42,376	10,972	1	54,555
Reinsurers' share of claims, benefits and surrenders paid	(98)	(143)	(5,233)	–	(5,474)
Reinsurers' share of movement in provision	(1)	(1,172)	7,075	–	5,902
Reinsurers' share of claims incurred and movement in liabilities to policyholders	(99)	(1,315)	1,842	–	428
Net insurance claims incurred and movement in liabilities to policyholders	1,107	41,061	12,814	1	54,983

Notes on the Financial Statements (continued)

6 Employee compensation and benefits

a *Employee compensation and benefits*

	2013 HK$m	2012 HK$m
Wages and salaries	**33,761**	34,233
Social security costs	**970**	935
Retirement benefit costs		
– Defined contribution plans	**1,115**	1,063
– Defined benefit plans (note 6(c)(i))	**1,092**	790
	36,938	37,021

b *Directors' emoluments*

The aggregate emoluments of the Directors of the Bank, calculated in accordance with section 161 of the Hong Kong Companies Ordinance, were HK$71m (2012: HK$74m). This comprises fees of HK$9m (2012: HK$8m) and other emoluments of HK$62m (2012: HK$66m) which includes pension benefits of HK$1m (2012: HK$1m).

c *Retirement benefit pension plans*

(i) Total defined benefit expense recognised in the income statement

Included within 'Employee compensation and benefits' are components of the expense related to the group's defined benefit pension plans, as follows:

	2013 HK$m	2012 HK$m
Defined benefit pension plan		
Current service cost	**1,023**	1,126
Net interest cost/(income) on the net defined benefit liability/asset	**74**	(276)
Past service cost and gains on settlements	**(10)**	(65)
Administrative costs and taxes paid by plan	**5**	5
Total expense	**1,092**	790

(ii) Cumulative actuarial gains/(losses) recognised in other comprehensive income in respect of defined benefit plans

	The group		The Bank	
	2013 HK$m	2012 HK$m	2013 HK$m	2012 HK$m
At 1 January	**(9,218)**	(10,298)	**(5,573)**	(5,988)
Actuarial gains recognised in other comprehensive income	**2,281**	1,080	**1,297**	415
At 31 December	**(6,937)**	(9,218)	**(4,276)**	(5,573)

The group operates 86 (2012: 85) retirement benefit plans, with a total cost of HK$2,207m (2012: HK$1,853m), of which HK$605m (2012: HK$658m) relates to overseas plans and HK$14m (2012: HK$19m) to a plan sponsored by HSBC Asia Holdings BV.

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

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme ('the Principal Plan') covers employees of the Bank and certain other local employees of HSBC Group. The Principal Plan comprises a funded defined benefit scheme (which provides a lump sum on retirement but is now closed to new members) and a defined contribution scheme. The latter was established on 1 January 1999 for new employees. Since the defined benefit section of the Principal Plan is a final salary lump sum scheme, its exposure to longevity risk and interest rate risk is limited.

6 Employee compensation and benefits *(continued)*

The trustee assumes the overall responsibility for the Principal Plan but a management committee and a number of sub-committees have also been established. These committees have been established to broaden the governance and manage the concomitant issues. The finance and investment sub-committee manages the various issues in relation to both assets and liabilities of the Principal Plan.

The Principal Plan is predominantly a funded plan with assets which are held either under insurance policies or in trust funds separate from the group. The Principal Plan is reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the defined benefit obligations of the Principal Plan vary according to the economic conditions.

The Principal Plan mainly invests in bonds with a smaller portion in equities and each investment manager has been assigned an investment mandate with the targeted asset allocation. The ranges of target asset allocations for the portfolio are as follows: Bonds and cash (55 – 100%), Equity (0 – 25%) and Alternative Investments (0 – 20 %). Alternative investments refer to high-return and high-risk alternatives, including but not limited to private equity funds, hedge funds, energy, gold, agriculture, commodities and distressed assets.

Defined benefit pension plans

(iii)Net asset/(liability) under defined benefit pension plans

The group

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability				
At 1 January 2013	14,576	(21,239)	(1)	(6,664)
Current service cost	–	(1,023)	–	(1,023)
Past service cost and gains from settlements[1]	–	12	–	12
Service cost	–	(1,011)	–	(1,011)
Net interest income/(cost) on the net defined benefit liability	135	(209)	–	(74)
Remeasurement effects recognised in other comprehensive income	276	2,005	–	2,281
– Return on plan assets (excluding interest income)	276	–	–	276
– Actuarial gains from changes in demographic assumptions	–	30	–	30
– Actuarial gains from changes in financial assumptions	–	2,092	–	2,092
– Actuarial losses from experience	–	(117)	–	(117)
Exchange differences and other movements	32	36	–	68
Contributions by the group	598	–	–	598
Contributions by employees	2	(2)	–	–
Benefits paid	(1,114)	1,213	–	99
At 31 December 2013	14,505	(19,207)	(1)	(4,703)
Retirement benefit liabilities recognised on the balance sheet				(4,856)
Retirement benefit assets recognised on the balance sheet (within ‘Other assets’)				153
Present value of defined benefit obligation relating to:				
– Actives		(18,954)		
– Deferreds		(5)		
– Pensioners		(248)		

1 *Gains from settlements arise as the difference between assets distributed and liabilities extinguished on settlements.*

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The group

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability At 1 January 2012	14,113	(22,101)	(1)	(7,989)
Current service cost	–	(1,126)	–	(1,126)
Past service cost and gains from settlements[1]	(113)	183	–	70
Service cost	(113)	(943)	–	(1,056)
Net interest income/(cost) on the net defined benefit liability	674	(398)	–	276
Remeasurement effects recognised in other comprehensive income	694	386	–	1,080
– Return on plan assets (excluding interest income)	694	–	–	694
– Actuarial gains from changes in financial assumptions	–	386	–	386
Exchange differences and other movements	(129)	125	–	(4)
Contributions by the group	876	–	–	876
Contributions by employees	2	(2)	–	–
Benefits paid	(1,541)	1,694	–	153
At 31 December 2012	14,576	(21,239)	(1)	(6,664)
Retirement benefit liabilities recognised on the balance sheet				(6,725)
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				61
Present value of defined benefit obligation relating to:				
– Actives		(20,962)		
– Deferreds		(5)		
– Pensioners		(272)		

1 *(Losses)/gains from settlements arise as the difference between assets distributed and liabilities extinguished on settlements.*

6 Employee compensation and benefits *(continued)*

The Bank

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability				
At 1 January 2013	**9,329**	**(13,015)**	**(1)**	**(3,687)**
Current service cost	**–**	**(647)**	**–**	**(647)**
Past service cost and gains from settlements[1]	**–**	**10**	**–**	**10**
Service cost	**–**	**(637)**	**–**	**(637)**
Net interest income/(cost) on the net defined benefit liability	**100**	**(149)**	**–**	**(49)**
Remeasurement effects recognised in other comprehensive income	**86**	**1,211**	**–**	**1,297**
– Return on plan assets (excluding interest income)	**86**	**–**	**–**	**86**
– Actuarial gains from changes in demographic assumptions	**–**	**(1)**	**–**	**(1)**
– Actuarial gains from changes in financial assumptions	**–**	**1,410**	**–**	**1,410**
– Actuarial losses from experience	**–**	**(198)**	**–**	**(198)**
Exchange differences and other movements	**40**	**(6)**	**–**	**34**
Contributions by the group	**353**	**–**	**–**	**353**
Benefits paid	**(698)**	**768**	**–**	**70**
At 31 December 2013	**9,210**	**(11,828)**	**(1)**	**(2,619)**
Retirement benefit liabilities recognised on the balance sheet				**(2,689)**
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				**70**
Present value of defined benefit obligation relating to:				
– Actives		**(11,762)**		
– Deferreds		**(5)**		
– Pensioners		**(61)**		
Net defined benefit liability				
At 1 January 2012	9,352	(13,433)	(1)	(4,082)
Current service cost	–	(706)	–	(706)
Net interest income/(cost) on the net defined benefit liability	460	(265)	–	195
Remeasurement effects recognised in other comprehensive income	323	92	–	415
– Return on plan assets (excluding interest income)	323	–	–	323
– Actuarial gains from changes in financial assumptions	–	92	–	92
Exchange differences and other movements	(135)	130	–	(5)
Contributions by the group	394	–	–	394
Benefits paid	(1,065)	1,167	–	102
At 31 December 2012	9,329	(13,015)	(1)	(3,687)
Retirement benefit liabilities recognised on the balance sheet				(3,710)
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				23
Present value of defined benefit obligation relating to:				
– Actives		(12,961)		
– Deferreds		(5)		
– Pensioners		(49)		

1 *Gains from settlements arise as the difference between assets distributed and liabilities extinguished on settlements.*

6 Employee compensation and benefits *(continued)*

The group expects to make HK$706m of contributions to defined benefit pension plans during 2014. Contributions to be made by the Bank are expected to be HK$392m.

(iv) Benefits expected to be paid from the Principal Plan

Benefits expected to be paid from the Principal Plan to retirees over each of the next five years, and in aggregate for the five years thereafter, are as follows:

	2014 HK$m	2015 HK$m	2016 HK$m	2017 HK$m	2018 HK$m	2019-2023 HK$m
HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	**775**	**889**	**989**	**1,191**	**1,355**	**8,759**

(v) Fair value of plan assets by asset classes

The group

	As at December 2013			As at December 2012		
	Value HK$m	**Quoted market price in active market HK$m**	**Thereof HSBC HK$m**	Value HK$m	Quoted market price in active market HK$m	Thereof HSBC HK$m
Fair value of plan assets	**14,505**	**14,505**	**156**	14,576	14,576	220
– Equities	**4,750**	**4,750**	**109**	3,977	3,977	155
– Bonds	**8,573**	**8,573**	**–**	9,051	9,051	4
– Derivatives	**(1)**	**(1)**	**–**	–	–	–
– Other[1]	**1,183**	**1,183**	**47**	1,548	1,548	61

The Bank

	As at December 2013			As at December 2012		
	Value HK$m	**Quoted market price in active market HK$m**	**Thereof HSBC HK$m**	Value HK$m	Quoted market price in active market HK$m	Thereof HSBC HK$m
Fair value of plan assets	**9,210**	**9,210**	**62**	9,329	9,329	94
– Equities	**2,369**	**2,369**	**54**	2,176	2,176	80
– Bonds	**6,279**	**6,279**	**–**	6,107	6,107	–
– Other[1]	**562**	**562**	**8**	1,046	1,046	14

1 *Other mainly consists of cash and deposits.*

6 Employee compensation and benefits *(continued)*

(vi) The Principal Plan's principal actuarial financial assumptions

The latest actuarial valuation of the Principal Plan was made on 31 December 2012 and was performed by Wing Lui, Fellow of the Society of Actuaries of the United States of America, of Towers Watson Hong Kong Limited, an external consultant. At that valuation date, the market value of the defined benefit scheme's assets was HK$8,428m. On an on-going basis, the value of the Principal Plan's assets represented 99.9% of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries. On a wind-up basis, the Principal Plan's assets represents 107% of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$527m. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 5% per annum and long-term salary increases of 4% per annum. The recommended employer contribution rate as a percentage of scheme salaries is 15% in 2013, and 16.1% (local staff category) and 20% (senior staff category) in 2014 and 2015. No additional special contributions have been recommended.

The determinations for actuarial funding valuation purposes are based on different methods and assumptions from those used for financial reporting purposes, and as a result should neither be compared nor related to other determinations included in these financial statements.

The present value of the Principal Plan's obligation was a final lump sum salary of HK$10,284m (2012: HK$11,438m). The principal actuarial assumptions used to calculate the group's obligations for the Principal Plan for each year, and used as the basis for measuring the expenses in relation to the Principal Plan, were as follows:

Principal actuarial assumptions for the Principal Plan

	2013	2012
	% p.a.	% p.a.
Discount rate	**2.15%**	0.60
Rate of pay increase	**4.0**	4.0
Mortality table	**HKLT2011**[1]	HKLT2011[1]

1 *HKLT2011- Hong Kong Life Tables 2011.*

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The group determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. In countries where there is not a deep market in corporate bonds, government bond yields have been used, and this is the case for the Principal Plan in Hong Kong. The yield curve has been extrapolated where the term of the liabilities is longer than the duration of available bonds and the discount rate used then takes into account the term of the liabilities and the shape of the yield curve.

(vii) Actuarial assumption sensitivities

The discount rate and rate of pay increase are sensitive to changes in market conditions arising during the reporting period. The following table shows the effect of changes in these on the Principal Plan:

The effect of changes in key assumptions on the Principal Plan

	HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	
	2013	2012
	HK$m	HK$m
Discount rate		
– Change in pension obligation at year end from a 25bps increase	**(195)**	(243)
– Change in pension obligation at year end from a 25bps decrease	**201**	251
– Change in 2014/2013 pension cost from a 25bps increase	**(8)**	(2)
– Change in 2014/2013 pension cost from a 25bps decrease	**8**	8
Rate of pay increase		
– Change in pension obligation at year end from a 25bps increase	**207**	249
– Change in pension obligation at year end from a 25bps decrease	**(202)**	(243)
– Change in 2014/2013 pension cost from a 25bps increase	**14**	14
– Change in 2014/2013 pension cost from a 25bps decrease	**(14)**	(12)

7 Tax expense

a The Bank and its subsidiaries in Hong Kong have provided for Hong Kong profits tax at the rate of 16.5% (2012: 16.5%) on the profits for the year assessable in Hong Kong. Overseas branches and subsidiaries have similarly provided for tax in the countries in which they operate at the appropriate rates of tax ruling in 2013. Deferred taxation is provided for in accordance with the group's accounting policy in note 3(r).

The charge for taxation in the income statement comprises:

	2013	2012
	HK$m	HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**8,643**	7,810
– Hong Kong profits tax – adjustments in respect of prior years	**(164)**	(20)
– Overseas taxation – on current year profit	**8,964**	10,631
– Overseas taxation – adjustments in respect of prior years	**(806)**	(203)
	16,637	18,218
Deferred tax		
– Origination and reversal of temporary differences	**(1,385)**	35
– Effect of changes in tax rates	**(1)**	65
– Adjustments in respect of prior years	**450**	(308)
	(936)	(208)
	15,701	18,010

7 Tax expense *(continued)*

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

(i) Deferred tax assets

The group

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2013							
At 1 January	**109**	**–**	**1,093**	**894**	**(800)**	**1,333**	**2,629**
Exchange and other adjustments	**35**	**–**	**(324)**	**(284)**	**142**	**(50)**	**(481)**
Credit/(charge) to income statement	**10**	**–**	**83**	**59**	**3**	**(298)**	**(143)**
(Charge)/credit to reserves	**–**	**–**	**–**	**–**	**(88)**	**377**	**289**
At 31 December	**154**	**–**	**852**	**669**	**(743)**	**1,362**	**2,294**
2012							
At 1 January	105	–	952	782	(740)	1,226	2,325
Exchange and other adjustments	(13)	–	(2)	(404)	(65)	205	(279)
Credit to income statement	17	–	143	516	4	135	815
Credit/(charge) to reserves	–	–	–	–	1	(233)	(232)
At 31 December	109	–	1,093	894	(800)	1,333	2,629

The Bank

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2013							
At 1 January	**5**	**–**	**380**	**586**	**(730)**	**1,092**	**1,333**
Exchange and other adjustments	**24**	**–**	**(18)**	**(180)**	**91**	**(106)**	**(189)**
Credit/(charge) to income statement	**7**	**–**	**(5)**	**81**	**2**	**(401)**	**(316)**
(Charge)/credit to reserves	**–**	**–**	**–**	**–**	**(49)**	**220**	**171**
At 31 December	**36**	**–**	**357**	**487**	**(686)**	**805**	**999**
2012							
At 1 January	(16)	–	335	544	(723)	958	1,098
Exchange and other adjustments	7	–	(9)	(83)	(21)	27	(79)
Credit to income statement	14	–	54	125	2	277	472
Credit/(charge) to reserves	–	–	–	–	12	(170)	(158)
At 31 December	5	–	380	586	(730)	1,092	1,333

Notes on the Financial Statements (continued)

7 Tax expense *(continued)*

(ii) Deferred tax liabilities

The group

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2013							
At 1 January	**402**	**4,041**	**(16)**	**(262)**	**9,804**	**2,954**	**16,923**
Exchange and other adjustments	**47**	**(11)**	**(290)**	**(188)**	**65**	**14**	**(363)**
Charge/(credit) to income statement	**119**	**766**	**(8)**	**407**	**(181)**	**(2,182)**	**(1,079)**
Charge/(credit) to reserves	**–**	**–**	**–**	**–**	**861**	**(291)**	**570**
At 31 December	**568**	**4,796**	**(314)**	**(43)**	**10,549**	**495**	**16,051**
2012							
At 1 January	997	3,299	(35)	5	9,608	838	14,712
Exchange and other adjustments	(541)	18	–	(293)	(99)	666	(249)
(Credit)/charge to income statement	(54)	724	19	26	(867)	759	607
Charge to reserves	–	–	–	–	1,162	691	1,853
At 31 December	402	4,041	(16)	(262)	9,804	2,954	16,923

The Bank

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2013							
At 1 January	**323**	**–**	**(8)**	**(230)**	**5,805**	**304**	**6,194**
Exchange and other adjustments	**23**	**–**	**1**	**(139)**	**16**	**(52)**	**(151)**
Charge/(credit) to income statement	**115**	**–**	**6**	**161**	**(114)**	**(198)**	**(30)**
Charge to reserves	**–**	**–**	**–**	**–**	**377**	**113**	**490**
At 31 December	**461**	**–**	**(1)**	**(208)**	**6,084**	**167**	**6,503**
2012							
At 1 January	838	–	–	(236)	5,359	(77)	5,884
Exchange and other adjustments	(479)	–	–	(12)	(57)	485	(63)
(Credit)/charge to income statement	(36)	–	(8)	18	(98)	(345)	(469)
Charge to reserves	–	–	–	–	601	241	842
At 31 December	323	–	(8)	(230)	5,805	304	6,194

7 Tax expense *(continued)*

(iii) Net deferred tax liabilities

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Deferred tax liabilities recognised on the balance sheet	**16,051**	16,923	**6,503**	6,194
Deferred tax assets recognised on the balance sheet	**(2,294)**	(2,629)	**(999)**	(1,333)
	13,757	14,294	**5,504**	4,861

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK$2,951m (2012: HK$3,891m). Of this amount, HK$1,955m (2012: HK$2,041m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK$156m (2012: HK$2,084m) has been provided in respect of distributable reserves or post-acquisition reserves of associates that, on distribution or sale, would attract withholding tax.

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance or other realisation is not probable, and for those associates and interests in joint ventures where it has been determined that no additional tax will arise.

c *Provisions for taxation*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Current tax liabilities	**3,722**	3,842	**2,029**	2,348
Deferred tax liabilities	**16,051**	16,923	**6,503**	6,194
	19,773	20,765	**8,532**	8,542

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

	2013	2012
	HK$m	HK$m
Profit before tax	**144,756**	108,729
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**26,788**	21,376
Adjustments in respect of prior years	**(520)**	(531)
Deferred tax temporary differences previously not recognised	**(19)**	(17)
Effects of profits in associates and joint ventures	**(2,380)**	(3,104)
Non taxable income and gains	**(9,068)**	(2,381)
Permanent disallowables	**1,757**	1,609
Change in tax rates	**(1)**	65
Local taxes and overseas withholding taxes	**1,248**	970
Others	**(2,104)**	23
	15,701	18,010

Notes on the Financial Statements (continued)

8 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$108,678m (2012: HK$48,377m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2013		2012	
	HK$ per share	**HK$m**	HK$ per share	HK$m
Ordinary dividends paid				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	**0.85**	**20,000**	0.83	10,000
– first interim dividend paid	**0.38**	**9,000**	0.58	7,500
– second interim dividend paid	**0.38**	**9,000**	0.41	7,500
– third interim dividend paid	**0.38**	**9,000**	0.40	7,500
	1.99	**47,000**	2.22	32,500

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2013 of HK$15,000m (HK$0.44 per ordinary share).

10 Analysis of financial assets and liabilities by measurement basis

The group

	At 31 December 2013								
	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	–	–	–	448,142	525,698	158,879	–	–	1,132,719
Items in the course of collection from other banks	–	–	–	–	–	16,346	–	–	16,346
Placings with banks maturing after one month	–	–	–	216,970	–	–	–	–	216,970
Certificates of deposit	–	–	12,223	–	75,984	–	–	–	88,207
Hong Kong Government certificates of indebtedness	–	–	–	–	–	195,554	–	–	195,554
Trading assets	311,400	–	–	–	–	–	–	–	311,400
Financial assets designated at fair value	–	90,146	–	–	–	–	–	–	90,146
Derivatives	378,603	–	–	–	–	–	964	9,160	388,727
Loans and advances to customers	–	–	–	2,669,238	–	–	–	–	2,669,238
Financial investments	–	–	167,242	–	598,624	–	–	–	765,866
Amounts due from Group companies	4,644	–	–	–	–	157,331	–	–	161,975
Other assets	–	–	–	–	4,295	77,895	–	–	82,190
Total financial assets	694,647	90,146	179,465	3,334,350	1,204,601	606,005	964	9,160	6,119,338
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	195,554	–	–	195,554
Items in the course of transmission to other banks	–	–	–	–	–	34,240	–	–	34,240
Deposits by banks	–	–	–	–	–	236,616	–	–	236,616
Customer accounts	–	–	–	–	–	4,254,752	–	–	4,254,752
Trading liabilities	195,032	–	–	–	–	–	–	–	195,032
Financial liabilities designated at fair value	–	41,715	–	–	–	–	–	–	41,715
Derivatives	362,963	–	–	–	–	–	1,924	165	365,052
Debt securities in issue	–	–	–	–	–	52,334	–	–	52,334
Amounts due to Group companies	10,804	1	–	–	–	80,992	–	–	91,797
Other liabilities	–	–	–	–	–	79,540	–	–	79,540
Subordinated liabilities	–	–	–	–	–	13,107	–	–	13,107
Preference shares	–	–	–	–	–	47,314	–	–	47,314
Total financial liabilities	568,799	41,716	–	–	–	4,994,449	1,924	165	5,607,053

Notes on the Financial Statements (continued)

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The group

At 31 December 2012	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	–	–	–	362,197	534,898	214,104	–	–	1,111,199
Items in the course of collection from other banks	–	–	–	–	–	23,079	–	–	23,079
Placings with banks maturing after one month	–	–	–	184,711	–	–	–	–	184,711
Certificates of deposit	–	–	8,426	–	84,659	–	–	–	93,085
Hong Kong Government certificates of indebtedness	–	–	–	–	–	176,264	–	–	176,264
Trading assets	419,697	–	–	–	–	–	–	–	419,697
Financial assets designated at fair value	–	69,479	–	–	–	–	–	–	69,479
Derivatives	394,787	–	–	–	–	–	359	3,810	398,956
Loans and advances to customers	–	–	–	2,349,043	–	–	–	–	2,349,043
Financial investments	–	–	155,393	–	470,649	–	–	–	626,042
Amounts due from Group companies	6,710	4,966	–	–	–	164,328	–	–	176,004
Other assets	–	200	–	–	45,918	79,432	–	–	125,550
Total financial assets	821,194	74,645	163,819	2,895,951	1,136,124	657,207	359	3,810	5,753,109
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	176,264	–	–	176,264
Items in the course of transmission to other banks	–	–	–	–	–	35,525	–	–	35,525
Deposits by banks	–	–	–	–	–	244,135	–	–	244,135
Customer accounts	–	–	–	–	–	3,874,884	–	–	3,874,884
Trading liabilities	183,340	–	–	–	–	–	–	–	183,340
Financial liabilities designated at fair value	–	44,270	–	–	–	–	–	–	44,270
Derivatives	393,264	–	–	–	–	–	3,626	261	397,151
Debt securities in issue	–	–	–	–	–	74,647	–	–	74,647
Amounts due to Group companies	27,112	2	–	–	–	70,504	–	–	97,618
Other liabilities	–	175	–	–	–	84,549	–	–	84,724
Subordinated liabilities	–	–	–	–	–	13,867	–	–	13,867
Preference shares	–	–	–	–	–	83,346	–	–	83,346
Total financial liabilities	603,716	44,447	–	–	–	4,657,721	3,626	261	5,309,771

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The Bank

	At 31 December 2013								
	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	–	–	–	225,233	425,711	112,585	–	–	763,529
Items in the course of collection from other banks	–	–	–	–	–	10,922	–	–	10,922
Placings with banks maturing after one month	–	–	–	92,945	–	–	–	–	92,945
Certificates of deposit	–	–	–	–	10,012	–	–	–	10,012
Hong Kong Government certificates of indebtedness	–	–	–	–	–	195,554	–	–	195,554
Trading assets	235,599	–	–	–	–	–	–	–	235,599
Financial assets designated at fair value	–	1,561	–	–	–	–	–	–	1,561
Derivatives	368,372	–	–	–	–	–	336	8,475	377,183
Loans and advances to customers	–	–	–	1,503,251	–	–	–	–	1,503,251
Financial investments	–	–	–	–	322,860	–	–	–	322,860
Amounts due from Group companies	11,420	–	–	–	–	355,469	–	–	366,889
Other assets	–	–	–	–	4,295	37,255	–	–	41,550
Total financial assets	615,391	1,561	–	1,821,429	762,878	711,785	336	8,475	3,921,855
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	195,554	–	–	195,554
Items in the course of transmission to other banks	–	–	–	–	–	24,774	–	–	24,774
Deposits by banks	–	–	–	–	–	197,283	–	–	197,283
Customer accounts	–	–	–	–	–	2,724,015	–	–	2,724,015
Trading liabilities	82,623	–	–	–	–	–	–	–	82,623
Financial liabilities designated at fair value	–	4,759	–	–	–	–	–	–	4,759
Derivatives	353,712	–	–	–	–	–	867	116	354,695
Debt securities in issue	–	–	–	–	–	30,062	–	–	30,062
Amounts due to Group companies	19,977	–	–	–	–	136,167	–	–	156,144
Other liabilities	–	–	–	–	–	44,918	–	–	44,918
Subordinated liabilities	–	–	–	–	–	9,346	–	–	9,346
Preference shares	–	–	–	–	–	47,205	–	–	47,205
Total financial liabilities	456,312	4,759	–	–	–	3,409,324	867	116	3,871,378

Notes on the Financial Statements (continued)

10 Analysis of financial assets and liabilities by measurement basis *(continued)*

The Bank

	At 31 December 2012								
	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	–	–	–	165,904	419,345	175,938	–	–	761,187
Items in the course of collection from other banks	–	–	–	–	–	17,355	–	–	17,355
Placings with banks maturing after one month	–	–	–	80,200	–	–	–	–	80,200
Certificates of deposit	–	–	–	–	20,150	–	–	–	20,150
Hong Kong Government certificates of indebtedness	–	–	–	–	–	176,264	–	–	176,264
Trading assets	284,573	–	–	–	–	–	–	–	284,573
Financial assets designated at fair value	–	1,432	–	–	–	–	–	–	1,432
Derivatives	388,298	–	–	–	–	–	65	3,476	391,839
Loans and advances to customers	–	–	–	1,282,720	–	–	–	–	1,282,720
Financial investments	–	–	–	–	260,317	–	–	–	260,317
Amounts due from Group companies	13,126	–	–	–	–	308,474	–	–	321,600
Other assets	–	–	–	–	43,691	45,232	–	–	88,923
Total financial assets	685,997	1,432	–	1,528,824	743,503	723,263	65	3,476	3,686,560
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	176,264	–	–	176,264
Items in the course of transmission to other banks	–	–	–	–	–	25,766	–	–	25,766
Deposits by banks	–	–	–	–	–	204,520	–	–	204,520
Customer accounts	–	–	–	–	–	2,417,400	–	–	2,417,400
Trading liabilities	82,146	–	–	–	–	–	–	–	82,146
Financial liabilities designated at fair value	–	7,731	–	–	–	–	–	–	7,731
Derivatives	390,282	–	–	–	–	–	1,632	170	392,084
Debt securities in issue	–	–	–	–	–	40,406	–	–	40,406
Amounts due to Group companies	18,969	–	–	–	–	130,268	–	–	149,237
Other liabilities	–	–	–	–	–	53,011	–	–	53,011
Subordinated liabilities	–	–	–	–	–	9,355	–	–	9,355
Preference shares	–	–	–	–	–	83,195	–	–	83,195
Total financial liabilities	491,397	7,731	–	–	–	3,140,185	1,632	170	3,641,115

11 Cash and short-term funds

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Cash in hand	**17,982**	17,925	**9,625**	11,139
Sight balances with central banks	**140,897**	196,179	**102,960**	164,799
Placings with banks with remaining maturity of one month or less	**448,142**	362,197	**225,233**	165,904
Treasury bills and other eligible bills	**525,698**	534,898	**425,711**	419,345
	1,132,719	1,111,199	**763,529**	761,187

As at 31 December 2013, included within notes 11 and 12, the total amount placed with central banks by the group, including sight balances, amounted to HK$321,433m (2012: HK$356,880m). Placings with central banks made by the Bank amounted to HK$169,767m (2012: HK$230,427m).

Treasury bills and other eligible bills are analysed as follows:

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Treasury bills and other eligible bills – available-for-sale				
– subject to repledge or resale by counterparties	**–**	512	**–**	512
– not subject to repledge or resale by counterparties	**525,698**	534,386	**425,711**	418,833
	525,698	534,898	**425,711**	419,345

Treasury bills and other eligible bills held for trading are included under 'Trading assets' (note 15). Treasury bills and other eligible bills are largely unlisted.

12 Placings with banks maturing after one month

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Gross placings with banks maturing after one month but not more than one year	**185,410**	150,504	**76,363**	58,846
Gross placings with banks maturing after one year	**31,560**	34,207	**16,582**	21,354
Total placings with banks	**216,970**	184,711	**92,945**	80,200

There were no rescheduled placings included in the above table. Details of overdue placings are included in the Risk Report.

13 Certificates of deposit

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Held-to-maturity	**12,223**	8,426	**–**	–
Available-for-sale	**75,984**	84,659	**10,012**	20,150
	88,207	93,085	**10,012**	20,150

Certificates of deposit held are largely unlisted. There were no disposals of held-to-maturity certificates of deposit during the year (2012: nil).

14 Hong Kong currency notes in circulation

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

Notes on the Financial Statements (continued)

15 Trading assets

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**150,145**	176,757	**111,588**	125,372
Equity shares	**31,640**	30,401	**31,530**	30,250
Treasury bills and other eligible bills	**109,174**	155,464	**82,003**	116,214
Other	**20,441**	57,075	**10,478**	12,737
	311,400	419,697	**235,599**	284,573
Trading assets				
– which may be repledged or resold by counterparties	**2,421**	651	**2,421**	651
– not subject to repledge or resale by counterparties	**308,979**	419,046	**233,178**	283,922
	311,400	419,697	**235,599**	284,573

The amount of listed treasury bills and other eligible bills amounted to HK$1,296m at both group and Bank level as at 31 December 2013 (2012: HK$2,838m).

'Other' trading assets primarily includes settlement accounts with banks and customers.

a *Debt securities*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**16,908**	11,377	**13,125**	8,330
– listed outside Hong Kong	**31,681**	62,102	**31,512**	61,791
	48,589	73,479	**44,637**	70,121
Unlisted	**101,556**	103,278	**66,951**	55,251
	150,145	176,757	**111,588**	125,372
Issued by public bodies				
– central governments and central banks	**111,721**	128,866	**81,818**	89,724
– other public sector entities	**4,620**	7,160	**4,294**	6,760
	116,341	136,026	**86,112**	96,484
Issued by				
– banks	**15,343**	16,870	**11,239**	12,922
– corporate entities	**18,461**	23,861	**14,237**	15,966
	150,145	176,757	**111,588**	125,372

b *Equity shares*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**13,149**	10,543	**13,120**	10,513
– listed outside Hong Kong	**14,686**	13,884	**14,686**	13,884
	27,835	24,427	**27,806**	24,397
Unlisted	**3,805**	5,974	**3,724**	5,853
	31,640	30,401	**31,530**	30,250
Issued by				
– banks	**3,945**	2,986	**3,945**	2,986
– corporate entities	**27,695**	27,415	**27,585**	27,264
	31,640	30,401	**31,530**	30,250

16 Financial assets designated at fair value

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**19,871**	17,001	**1,561**	1,432
Equity shares	**70,246**	52,058	**–**	–
Other	**29**	420	**–**	–
	90,146	69,479	**1,561**	1,432

a *Debt securities*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**1,707**	1,884	**555**	576
– listed outside Hong Kong	**4,855**	4,365	**1,006**	856
	6,562	6,249	**1,561**	1,432
Unlisted	**13,309**	10,752	**–**	–
	19,871	17,001	**1,561**	1,432
Issued by public bodies				
– central governments and central banks	**2,160**	2,135	**555**	576
– other public sector entities	**1,243**	1,586	**–**	–
	3,403	3,721	**555**	576
Issued by other bodies				
– banks	**7,846**	5,330	**–**	–
– corporate entities	**8,622**	7,950	**1,006**	856
	19,871	17,001	**1,561**	1,432

b *Equity shares*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**7,723**	5,790	**–**	–
– listed outside Hong Kong	**31,106**	19,682	**–**	–
	38,829	25,472	**–**	–
Unlisted	**31,417**	26,586	**–**	–
	70,246	52,058	**–**	–
Issued by				
– banks	**3,815**	2,365	**–**	–
– corporate entities	**66,431**	49,693	**–**	–
	70,246	52,058	**–**	–

17 Derivatives

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange rates, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposures to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposures to credit and market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. A description of how the fair value of derivatives is derived is set out in note 51.

Derivative assets and liabilities on different transactions are only offset if the transactions are with the same counterparty, a legal right of offset 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 3(k).

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio risk arising from client business, 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 used 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.

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 include market-making and risk management. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume. Risk management activity is undertaken to manage the risk arising from client transactions, with the principal purpose of retaining client margin.

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.

17 Derivatives *(continued)*

Contract amounts and fair values of assets and liabilities by class of derivatives

The notional contract amounts of derivatives held indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

The group

	2013			2012		
	Contract amounts HK$m	**Assets HK$m**	**Liabilities HK$m**	Contract amounts HK$m	Assets HK$m	Liabilities HK$m
Trading derivatives						
Exchange rate contracts	**11,953,908**	**196,420**	**183,644**	12,166,808	182,941	185,274
– spot, forward and future	**7,847,361**	**99,121**	**96,534**	8,122,717	81,196	75,780
– swaps	**3,303,017**	**93,128**	**83,819**	3,219,733	98,168	106,514
– options purchased	**398,079**	**3,185**	**261**	394,957	3,205	119
– options written	**405,451**	**986**	**3,030**	429,401	372	2,861
Interest rate contracts	**18,258,980**	**162,048**	**158,252**	18,115,892	200,790	193,208
– forward and future	**383,180**	**59**	**40**	639,265	311	92
– swaps	**17,669,570**	**159,024**	**155,739**	16,919,103	195,781	189,097
– options purchased	**66,425**	**1,354**	**12**	222,359	2,468	28
– options written	**87,884**	**80**	**1,583**	282,512	3	2,988
– other	**51,921**	**1,531**	**878**	52,653	2,227	1,003
Equity derivatives	**1,227,483**	**50,308**	**51,597**	818,543	29,824	33,607
Credit derivatives	**232,812**	**1,904**	**1,906**	335,214	2,631	2,655
Commodity and other	**140,496**	**2,511**	**2,131**	114,226	1,173	1,175
Total held for trading	**31,813,679**	**413,191**	**397,530**	31,550,683	417,359	415,919
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**546**	**4**	**–**	546	5	–
Interest rate contracts	**5,061**	**18**	**41**	6,573	123	45
	5,607	**22**	**41**	7,119	128	45
Cash flow hedging derivatives						
Exchange rate contracts	**48,904**	**9,115**	**97**	40,044	3,740	151
Interest rate contracts	**19,402**	**45**	**68**	40,216	70	110
	68,306	**9,160**	**165**	80,260	3,810	261
Fair value hedging derivatives						
Interest rate contracts	**140,952**	**963**	**1,925**	114,887	359	3,626
Gross total derivatives	**32,028,544**	**423,336**	**399,661**	31,752,949	421,656	419,851
Netting	**–**	**(34,609)**	**(34,609)**	–	(22,700)	(22,700)
Total	**32,028,544**	**388,727**	**365,052**	31,752,949	398,956	397,151

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

The Bank

	2013			2012		
	Contract amounts HK$m	**Assets HK$m**	**Liabilities HK$m**	Contract amounts HK$m	Assets HK$m	Liabilities HK$m
Trading derivatives						
Exchange rate contracts	**10,677,757**	**188,003**	**177,012**	10,989,189	177,543	182,472
– spot, forward and future	**6,789,558**	**92,340**	**90,711**	7,226,499	77,226	73,693
– swaps	**3,342,242**	**91,965**	**83,444**	3,190,866	97,084	106,156
– options purchased	**269,883**	**2,784**	**262**	270,035	2,926	119
– options written	**276,074**	**914**	**2,595**	301,789	307	2,504
Interest rate contracts	**17,857,951**	**159,413**	**155,688**	17,697,104	199,813	192,287
– forward and future	**387,455**	**59**	**38**	635,628	311	90
– swaps	**17,267,281**	**156,386**	**153,203**	16,488,092	194,643	188,302
– options purchased	**65,139**	**1,359**	**102**	221,674	2,426	15
– options written	**85,565**	**80**	**1,515**	280,675	–	2,874
– other	**52,511**	**1,529**	**830**	71,035	2,433	1,006
Equity derivatives	**1,251,970**	**51,010**	**51,673**	827,109	29,844	33,752
Credit derivatives	**232,812**	**1,904**	**1,906**	339,873	2,675	2,655
Commodity and other	**131,786**	**2,629**	**2,011**	82,557	999	1,771
Total held for trading	**30,152,276**	**402,959**	**388,290**	29,935,832	410,874	412,937
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**546**	**4**	**–**	546	5	–
Interest rate contracts	**5,061**	**18**	**30**	6,573	119	45
	5,607	**22**	**30**	7,119	124	45
Cash flow hedging derivatives						
Exchange rate contracts	**45,441**	**8,448**	**92**	35,781	3,461	148
Interest rate contracts	**8,930**	**26**	**24**	19,587	15	22
	54,371	**8,474**	**116**	55,368	3,476	170
Fair value hedging derivatives						
Interest rate contracts	**75,280**	**337**	**868**	51,689	65	1,632
Gross total derivatives	**30,287,534**	**411,792**	**389,304**	30,050,008	414,539	414,784
Netting	**–**	**(34,609)**	**(34,609)**	–	(22,700)	(22,700)
Total	**30,287,534**	**377,183**	**354,695**	30,050,008	391,839	392,084

b *Hedging derivatives*

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

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

The cash flows of the above hedging derivatives are expected to affect the income statement in 2014 and beyond.

17 Derivatives *(continued)*

Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

Gains or losses arising from fair value hedges

	2013 HK$m	2012 HK$m
Gains/(losses):		
On hedging instruments	**1,938**	(376)
On the hedged items attributable to hedged risk	**(1,977)**	345
	(39)	(31)

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and currency swaps that are used to protect against exposures to variability in future interest and principal 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 2013, the amount transferred to the income statement was HK$239m (2012: HK$352m) included in net interest income. The group does not have any qualifying cash flow hedges that involve non-financial assets or non-financial liabilities (2012: none).

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2013, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2012: insignificant amount).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2013 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 2013			
Cash inflows from assets	**21,698**	**38,271**	**18,252**
Cash outflows from liabilities	**(5,813)**	**(14,957)**	**(14,680)**
Net cash inflows	**15,885**	**23,314**	**3,572**
At 31 December 2012			
Cash inflows from assets	43,626	50,643	37,167
Cash outflows from liabilities	(3,661)	(2,896)	(2,640)
Net cash inflows	39,965	47,747	34,527

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

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 unobservable inception profit yet to be recognised in the income statement at the beginning and end of the year with a reconciliation of the changes during the year.

The group

	2013	2012
	HK$m	HK$m
Balance at 1 January	**124**	137
Deferrals on new transactions	**211**	169
Reduction due to amortisation	**(109)**	(96)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(142)**	(89)
Exchange differences and others	**(10)**	3
Balance at 31 December	**74**	124

The Bank

	2013	2012
	HK$m	HK$m
Balance at 1 January	**110**	124
Deferrals on new transactions	**180**	117
Reduction due to amortisation	**(84)**	(75)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(133)**	(58)
Exchange differences and others	**(4)**	2
Balance at 31 December	**69**	110

18 Loans and advances to customers

a *Loans and advances to customers*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Gross loans and advances to customers	**2,678,739**	2,358,814	**1,508,457**	1,288,269
Impairment allowances (note 19(a))	**(9,501)**	(9,771)	**(5,206)**	(5,549)
	2,669,238	2,349,043	**1,503,251**	1,282,720

18 Loans and advances to customers *(continued)*

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

The following analysis of loans and advances to customers is based on the categories used by the HSBC Group, including the group, to manage associated risks.

The group

2013	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
Residential mortgages[1]	416,857	296,860	713,717
Credit card advances	49,843	29,824	79,667
Other personal	103,593	68,558	172,151
Total personal	570,293	395,242	965,535
Commercial, industrial and international trade	423,536	432,984	856,520
Commercial real estate	196,621	71,348	267,969
Other property-related lending	151,554	58,937	210,491
Government	5,728	2,190	7,918
Other commercial	112,939	131,812	244,751
Total corporate and commercial	890,378	697,271	1,587,649
Non-bank financial institutions	57,012	65,995	123,007
Settlement accounts	1,989	559	2,548
Total financial	59,001	66,554	125,555
Gross loans and advances to customers	1,519,672	1,159,067	2,678,739
Individually assessed impairment allowances	(1,349)	(3,658)	(5,007)
Collectively assessed impairment allowances	(2,131)	(2,363)	(4,494)
Net loans and advances to customers	1,516,192	1,153,046	2,669,238
2012			
Residential mortgages[1]	401,855	284,317	686,172
Credit card advances	45,961	33,489	79,450
Other personal	51,721	42,337	94,058
Total personal	499,537	360,143	859,680
Commercial, industrial and international trade	342,463	402,735	745,198
Commercial real estate	177,339	71,925	249,264
Other property-related lending	127,099	51,448	178,547
Government	21,995	8,804	30,799
Other commercial	96,055	133,921	229,976
Total corporate and commercial	764,951	668,833	1,433,784
Non-bank financial institutions	31,545	30,263	61,808
Settlement accounts	3,031	511	3,542
Total financial	34,576	30,774	65,350
Gross loans and advances to customers	1,299,064	1,059,750	2,358,814
Individually assessed impairment allowances	(1,418)	(3,827)	(5,245)
Collectively assessed impairment allowances	(2,167)	(2,359)	(4,526)
Net loans and advances to customers	1,295,479	1,053,564	2,349,043

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$25,040m (2012: HK$24,426m).*

Notes on the Financial Statements (continued)

18 Loans and advances to customers *(continued)*

The Bank

2013	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
Residential mortgages[1]	**254,465**	**113,548**	**368,013**
Credit card advances	**28,343**	**11,446**	**39,789**
Other personal	**82,949**	**48,393**	**131,342**
Total personal	**365,757**	**173,387**	**539,144**
Commercial, industrial and international trade	**298,895**	**195,114**	**494,009**
Commercial real estate	**130,123**	**29,710**	**159,833**
Other property-related lending	**64,171**	**23,652**	**87,823**
Government	**5,462**	**1,460**	**6,922**
Other commercial	**81,482**	**68,767**	**150,249**
Total corporate and commercial	**580,133**	**318,703**	**898,836**
Non-bank financial institutions	**51,164**	**19,064**	**70,228**
Settlement accounts	**-**	**249**	**249**
Total financial	**51,164**	**19,313**	**70,477**
Gross loans and advances to customers	**997,054**	**511,403**	**1,508,457**
Individually assessed impairment allowances	**(808)**	**(1,774)**	**(2,582)**
Collectively assessed impairment allowances	**(1,521)**	**(1,103)**	**(2,624)**
Net loans and advances to customers	**994,725**	**508,526**	**1,503,251**
2012			
Residential mortgages[1]	244,780	111,721	356,501
Credit card advances	25,557	12,198	37,755
Other personal	32,314	21,468	53,782
Total personal	302,651	145,387	448,038
Commercial, industrial and international trade	235,972	171,735	407,707
Commercial real estate	113,958	33,314	147,272
Other property-related lending	45,402	21,682	67,084
Government	21,814	2,786	24,600
Other commercial	66,809	81,040	147,849
Total corporate and commercial	483,955	310,557	794,512
Non-bank financial institutions	28,771	16,814	45,585
Settlement accounts	–	134	134
Total financial	28,771	16,948	45,719
Gross loans and advances to customers	815,377	472,892	1,288,269
Individually assessed impairment allowances	(903)	(1,994)	(2,897)
Collectively assessed impairment allowances	(1,579)	(1,073)	(2,652)
Net loans and advances to customers	812,895	469,825	1,282,720

The geographical information shown above has been 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 advancing the funds.

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$10,588m (2012: HK$10,540m).*

18 Loans and advances to customers *(continued)*

c *Loans and advances to customers include equipment leased to customers under finance leases and hire purchase contracts having the characteristics of finance leases*

The group

	2013			2012		
	Present value of the minimum lease payments HK$m	**Unearned future finance income HK$m**	**Total minimum lease payments HK$m**	Present value of the minimum lease payments HK$m	Unearned future finance income HK$m	Total minimum lease payments HK$m
Amounts receivable						
– Within one year	**2,982**	**697**	**3,679**	2,965	684	3,649
– After one year but within five years	**9,184**	**2,107**	**11,291**	7,667	2,005	9,672
– After five years	**14,893**	**2,236**	**17,129**	14,506	2,042	16,548
	27,059	**5,040**	**32,099**	25,138	4,731	29,869
Impairment allowances number	**(39)**			(47)		
Net investment in finance leases and hire purchase contracts	**27,020**			25,091		

The Bank

	2013			2012		
	Present value of the minimum lease payments HK$m	**Unearned future finance income HK$m**	**Total minimum lease payments HK$m**	Present value of the minimum lease payments HK$m	Unearned future finance income HK$m	Total minimum lease payments HK$m
Amounts receivable						
– Within one year	**1,643**	**344**	**1,987**	1,590	321	1,911
– After one year but within five years	**4,218**	**1,042**	**5,260**	4,058	924	4,982
– After five years	**11,700**	**1,878**	**13,578**	10,217	1,586	11,803
	17,561	**3,264**	**20,825**	15,865	2,831	18,696
Impairment allowances number	**(6)**			(9)		
Net investment in finance leases and hire purchase contracts	**17,555**			15,856		

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers

a *Impairment allowances against loans and advances to customers*

The group

2013	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**5,245**	**4,526**	**9,771**
Amounts written off	**(856)**	**(3,495)**	**(4,351)**
Recoveries of loans and advances written off in previous years	**198**	**1,089**	**1,287**
Net charge to income statement (note 4(k))	**809**	**2,602**	**3,411**
Unwinding of discount of loan impairment	**(51)**	**(77)**	**(128)**
Exchange and other adjustments	**(338)**	**(151)**	**(489)**
At 31 December (note 18(a))	**5,007**	**4,494**	**9,501**
2012			
At 1 January	6,894	4,407	11,301
Amounts written off	(2,730)	(3,597)	(6,327)
Recoveries of loans and advances written off in previous years	237	1,166	1,403
Net charge to income statement (note 4(k))	734	2,596	3,330
Unwinding of discount of loan impairment	(57)	(94)	(151)
Exchange and other adjustments	167	48	215
At 31 December (note 18(a))	5,245	4,526	9,771

The Bank

2013	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**2,897**	**2,652**	**5,549**
Amounts written off	**(454)**	**(1,664)**	**(2,118)**
Recoveries of loans and advances written off in previous years	**67**	**479**	**546**
Net charge to income statement	**357**	**1,225**	**1,582**
Unwinding of discount of loan impairment	**(37)**	**(35)**	**(72)**
Exchange and other adjustments	**(248)**	**(33)**	**(281)**
At 31 December (note 18(a))	**2,582**	**2,624**	**5,206**
2012			
At 1 January	4,985	2,729	7,714
Amounts written off	(2,236)	(1,833)	(4,069)
Recoveries of loans and advances written off in previous years	71	542	613
Net charge to income statement	162	1,223	1,385
Unwinding of discount of loan impairment	(42)	(41)	(83)
Exchange and other adjustments	(43)	32	(11)
At 31 December (note 18(a))	2,897	2,652	5,549

19 Impairment allowances against loans and advances to customers *(continued)*

b *Impairment allowances on loans and advances to customers*

Impaired loans and advances to customers are those loans and advances where objective evidence exists that full repayment of principal or interest is considered unlikely. Individually assessed allowances are made after taking into account the value of collateral in respect of such loans and advances.

The geographical information shown below has been 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 advancing the funds.

The group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2013			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**2,928**	**8,867**	**11,795**
Collectively assessed	**1,516,744**	**1,150,200**	**2,666,944**
– Impaired loans and advances	**524**	**816**	**1,340**
– Non-impaired loans and advances	**1,516,220**	**1,149,384**	**2,665,604**
Total gross loans and advances to customers	**1,519,672**	**1,159,067**	**2,678,739**
Impairment allowances	**(3,480)**	**(6,021)**	**(9,501)**
– Individually assessed	**(1,349)**	**(3,658)**	**(5,007)**
– Collectively assessed	**(2,131)**	**(2,363)**	**(4,494)**
Net loans and advances	**1,516,192**	**1,153,046**	**2,669,238**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**1,433**	**3,619**	**5,052**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.2%**	**0.8%**	**0.4%**
Total allowances as a percentage of total gross loans and advances	**0.2%**	**0.5%**	**0.4%**
At 31 December 2012			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	2,927	8,467	11,394
Collectively assessed	1,296,137	1,051,283	2,347,420
– Impaired loans and advances	621	999	1,620
– Non-impaired loans and advances	1,295,516	1,050,284	2,345,800
Total gross loans and advances to customers	1,299,064	1,059,750	2,358,814
Impairment allowances	(3,585)	(6,186)	(9,771)
– Individually assessed	(1,418)	(3,827)	(5,245)
– Collectively assessed	(2,167)	(2,359)	(4,526)
Net loans and advances	1,295,479	1,053,564	2,349,043
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,264	3,790	5,054
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.2%	0.8%	0.5%
Total allowances as a percentage of total gross loans and advances	0.3%	0.6%	0.4%

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers *(continued)*

The Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2013			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**1,965**	**4,468**	**6,433**
Collectively assessed	**995,089**	**506,935**	**1,502,024**
– Impaired loans and advances	**370**	**315**	**685**
– Non-impaired loans and advances	**994,719**	**506,620**	**1,501,339**
Total gross loans and advances to customers	**997,054**	**511,403**	**1,508,457**
Impairment allowances	**(2,329)**	**(2,877)**	**(5,206)**
– Individually assessed	**(808)**	**(1,774)**	**(2,582)**
– Collectively assessed	**(1,521)**	**(1,103)**	**(2,624)**
Net loans and advances	**994,725**	**508,526**	**1,503,251**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**1,058**	**1,093**	**2,151**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.2%**	**0.9%**	**0.4%**
Total allowances as a percentage of total gross loans and advances	**0.2%**	**0.6%**	**0.3%**
At 31 December 2012			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	1,963	3,754	5,717
Collectively assessed	813,414	469,138	1,282,552
– Impaired loans and advances	471	360	831
– Non-impaired loans and advances	812,943	468,778	1,281,721
Total gross loans and advances to customers	815,377	472,892	1,288,269
Impairment allowances	(2,482)	(3,067)	(5,549)
– Individually assessed	(903)	(1,994)	(2,897)
– Collectively assessed	(1,579)	(1,073)	(2,652)
Net loans and advances	812,895	469,825	1,282,720
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	925	1,032	1,957
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.2%	0.8%	0.4%
Total allowances as a percentage of total gross loans and advances	0.3%	0.6%	0.4%

19 Impairment allowances against loans and advances to customers *(continued)*

For individually assessed customer loans and advances where the industry sector comprises not less than 10% of the group's total gross loans and advances to customers, the analysis of gross impaired loans and advances and allowances by major industry sectors based on categories and definitions used by the HSBC Group is as follows:

The group

	Total gross loans and advances HK$m	Gross impaired advances HK$m	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Net new impairment allowances HK$m	Advances written-off in year HK$m
At 31 December 2013						
Residential mortgages	**713,717**	**2,121**	**(363)**	**(77)**	**(12)**	**58**
Commercial, industrial and international trade	**856,520**	**6,264**	**(3,194)**	**(2,050)**	**1,061**	**567**
Commercial real estate	**267,969**	**189**	**(82)**	**(89)**	**(14)**	**54**
At 31 December 2012						
Residential mortgages	686,172	2,485	(428)	(122)	67	59
Commercial, industrial and international trade	745,198	5,117	(2,897)	(2,060)	140	2,410
Commercial real estate	249,264	533	(413)	(107)	226	59

The Bank

	Total gross loans and advances HK$m	Gross impaired advances HK$m	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Net new impairment allowances HK$m	Advances written-off in year HK$m
At 31 December 2013						
Residential mortgages	**368,013**	**607**	**(98)**	**(22)**	**6**	**10**
Commercial, industrial and international trade	**494,009**	**3,757**	**(1,814)**	**(1,267)**	**622**	**327**
Commercial real estate	**159,833**	**85**	**(16)**	**(67)**	**(3)**	**–**
At 31 December 2012						
Residential mortgages	356,501	620	(101)	(38)	(1)	23
Commercial, industrial and international trade	407,707	2,932	(1,694)	(1,292)	(91)	2,063
Commercial real estate	147,272	335	(281)	(68)	223	1

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

19 Impairment allowances against loans and advances to customers *(continued)*

c *Overdue and rescheduled loans and advances to customers*

The group

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
At 31 December 2013						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	**402**	**0.0**	**1,836**	**0.2**	**2,238**	**0.1**
– more than six months but less than one year	**223**	**0.0**	**1,300**	**0.1**	**1,523**	**0.1**
– more than one year	**1,956**	**0.1**	**2,449**	**0.2**	**4,405**	**0.2**
	2,581	**0.1**	**5,585**	**0.5**	**8,166**	**0.4**
Individually assessed impairment allowances made in respect of amounts overdue	**(1,132)**		**(2,698)**		**(3,830)**	
Fair value of collateral held in respect of amounts overdue	**914**		**2,429**		**3,343**	
Rescheduled loans and advances to customers	**464**	**0.0**	**1,928**	**0.2**	**2,392**	**0.1**
At 31 December 2012						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	288	0.0	1,733	0.2	2,021	0.1
– more than six months but less than one year	166	0.0	1,283	0.1	1,449	0.1
– more than one year	1,856	0.1	2,828	0.3	4,684	0.2
	2,310	0.1	5,844	0.6	8,154	0.4
Individually assessed impairment allowances made in respect of amounts overdue	(895)		(3,008)		(3,903)	
Fair value of collateral held in respect of amounts overdue	769		2,285		3,054	
Rescheduled loans and advances to customers	565	0.0	2,781	0.3	3,346	0.1

19 Impairment allowances against loans and advances to customers *(continued)*

The Bank

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
At 31 December 2013						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	**297**	**0.0**	**602**	**0.1**	**899**	**0.1**
– more than six months but less than one year	**176**	**0.0**	**430**	**0.1**	**606**	**0.0**
– more than one year	**1,433**	**0.1**	**968**	**0.2**	**2,401**	**0.2**
	1,906	**0.1**	**2,000**	**0.4**	**3,906**	**0.3**
Individually assessed impairment allowances made in respect of amounts overdue	**(671)**		**(966)**		**(1,637)**	
Fair value of collateral held in respect of amounts overdue	**742**		**512**		**1,254**	
Rescheduled loans and advances to customers	**340**	**0.0**	**647**	**0.1**	**987**	**0.1**
At 31 December 2012						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	189	0.0	427	0.1	616	0.1
– more than six months but less than one year	109	0.0	303	0.1	412	0.0
– more than one year	1,272	0.2	1,489	0.3	2,761	0.2
	1,570	0.2	2,219	0.5	3,789	0.3
Individually assessed impairment allowances made in respect of amounts overdue	(551)		(1,357)		(1,908)	
Fair value of collateral held in respect of amounts overdue	681		501		1,182	
Rescheduled loans and advances to customers	427	0.1	1,234	0.3	1,661	0.1

Rescheduled loans and advances to customers are those loans and advances which have been restructured or renegotiated because of deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule. Rescheduled loans and advances to customers are stated net of any loans and advances which have subsequently become overdue for more than three months and which are included in the overdue amounts shown above.

20 Impairment and rescheduled amounts relating to loans and advances to banks and other assets

There are no significant impaired or rescheduled loans and advances to banks or overdue or rescheduled other assets as at 31 December 2013 and 31 December 2012. Information relating to overdue balances can be found in Risk Report.

Notes on the Financial Statements (continued)

21 Financial investments

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– held-to-maturity	**167,242**	155,393	**–**	–
– available-for-sale	**563,828**	463,278	**319,849**	257,804
Equity shares				
– available-for-sale	**34,796**	7,371	**3,011**	2,513
	765,866	626,042	**322,860**	260,317
Financial investments				
– which may be repledged or resold by counterparties	**1,641**	985	**1,545**	897
– not subject to repledge or resale by counterparties	**764,225**	625,057	**321,315**	259,420
	765,866	626,042	**322,860**	260,317

a *Held-to-maturity debt securities*

The group

	Book value		Fair value	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**4,715**	4,174	**4,850**	4,644
– listed outside Hong Kong	**43,172**	39,217	**43,848**	42,814
	47,887	43,391	**48,698**	47,458
Unlisted	**119,355**	112,002	**119,297**	119,873
	167,242	155,393	**167,995**	167,331
Issued by public bodies				
– central governments and central banks	**4,653**	3,538	**4,753**	4,189
– other public sector entities	**21,917**	20,660	**22,714**	22,646
	26,570	24,198	**27,467**	26,835
Issued by				
– banks	**59,547**	75,744	**60,707**	80,819
– corporate entities	**81,125**	55,451	**79,821**	59,677
	167,242	155,393	**167,995**	167,331

21 Financial Investments *(continued)*

b *Available-for-sale debt securities*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**16,099**	21,587	**4,791**	5,235
– listed outside Hong Kong	**215,434**	166,320	**171,915**	126,066
	231,533	187,907	**176,706**	131,301
Unlisted	**332,295**	275,371	**143,143**	126,503
	563,828	463,278	**319,849**	257,804
Issued by public bodies				
– central governments and central banks	**364,831**	263,466	**214,354**	158,035
– other public sector entities	**71,762**	70,715	**47,721**	41,214
	436,593	334,181	**262,075**	199,249
Issued by				
– banks	**92,618**	94,758	**48,720**	46,467
– corporate entities	**34,617**	34,339	**9,054**	12,088
	563,828	463,278	**319,849**	257,804

c *Available-for-sale equity shares*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**446**	663	**–**	–
– listed outside Hong Kong	**26,959**	26	**59**	15
	27,405	689	**59**	15
Unlisted	**7,391**	6,682	**2,952**	2,498
	34,796	7,371	**3,011**	2,513
Issued by				
– banks	**27,528**	42	**17**	31
– corporate entities	**7,268**	7,329	**2,994**	2,482
	34,796	7,371	**3,011**	2,513

Notes on the Financial Statements (continued)

22 Transfers of financial assets not qualifying for derecognition

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

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

The majority of transferred financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) securities lent under securities lending agreements.

As the substance of these transactions is secured borrowings the asset collateral continues to be recognised in full and the related liability reflecting the group's obligation to repurchase the transferred assets for a fixed price at a future date is recognised in deposits by banks or customer accounts as appropriate. As a result of these transactions, the group is unable to use, sell or pledge the transferred assets for the duration of the transaction. The group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

The following table analyses the carrying amount of financial assets that did not qualify for derecognition and their associated liabilities.

Financial assets and associated financial liabilities not qualifying for full derecognition

The group

	2013		2012	
	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	**10,287**	**11,146**	15,223	15,202
Securities lending agreements	**3,431**	**2,088**	2,090	2,085
	13,718	**13,234**	17,313	17,287

The Bank

	2013		2012	
	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	**10,986**	**11,786**	26,415	26,451
Securities lending agreements	**3,335**	**2,088**	2,002	2,085
	14,321	**13,874**	28,417	28,536

23 Investments in subsidiaries

	The Bank	
	2013	2012
	HK$m	HK$m
Investments in subsidiaries:		
Unlisted investments	**62,407**	57,954
Listed investment	**865**	865
	63,272	58,819

The principal subsidiaries of the Bank are:

	Place of incorporation	**Principal activity**	**Nominal value of issued share capital / registered capital**	**Class of share / registered capital**	**The group's interest in issued share capital / registered capital**
Hang Seng Bank Limited	Hong Kong	Banking	HK$9,559m	Ordinary	62.14%
HSBC Bank (China) Company Limited	PRC[1]	Banking	RMB15,400m	Ordinary	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	MYR115m	Ordinary	100%
HSBC Bank Australia Limited[2]	Australia	Banking	AUD811m	Ordinary	100%
HSBC Bank (Taiwan) Limited[2]	Taiwan	Banking	TWD30,000m	Ordinary	100%
HSBC Insurance (Asia) Limited[2]	Hong Kong	Insurance	HK$2,798m	Ordinary	100%
HSBC Life (International) Limited[2]	Bermuda	Retirement benefits and life insurance	HK$4,178m	Ordinary	100%
HSBC Bank (Vietnam) Limited	Vietnam	Banking	VND3,000,000m	Ordinary	100%

1 *People's Republic of China*

2 *Held indirectly*

All the above subsidiaries are included in the group's consolidated financial statements. All these subsidiaries make their financial statements up to 31 December.

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

The proportion of voting rights held is the same as the proportion of ownership interest held.

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 shareholder loans or cash dividends.

Subsidiary with material non-controlling interest

	2013	2012
Hang Seng Bank Limited		
Ownership interest and voting rights held by non-controlling interests	**37.86%**	37.86%
	HK$m	HK$m
Profit attributable to non-controlling interests	**10,100**	7,685
Accumulated non-controlling interests of the subsidiary	**40,807**	34,955
Dividends paid to non-controlling interests	**3,836**	3,764
Summarised financial information (before intra-group eliminations):		
– Assets	**1,143,730**	1,077,096
– Liabilities	**1,035,952**	984,773
– Net operating income before loan impairment	**37,589**	25,497
– Profit for the year	**26,678**	20,297
– Other comprehensive income	**(1,120)**	3,158
– Total comprehensive income	**25,558**	23,455

Notes on the Financial Statements (continued)

23 Investment in subsidiaries *(continued)*

Acquisition

On 1 November 2013, the assets, liabilities and operations of both the Hong Kong and Singapore branches of HSBC Private Bank (Suisse) SA, a fellow subsidiary of HSBC Holdings plc, were transferred to the Bank for a cash consideration of US$2.5bn. The total assets acquired and total liabilities assumed were HK$247.2bn and HK$245.5bn respectively. The purchase premium paid in excess of the net assets acquired was charged to 'Other reserves'. The transferred businesses contributed HK$164m to the net profit of the group during 2013. No goodwill was recognised as a result of this transaction.

24 Interests in associates and joint ventures

	The group	
	2013	2012
	HK$m	HK$m
Share of net assets	**103,435**	113,415
Goodwill	**4,720**	5,191
Intangible assets	**688**	1,409
Deferred tax on intangible assets	**(172)**	(347)
Impairment	**(819)**	(395)
	107,852	119,273

At 31 December 2013, the group's interests in associates amounted to HK$107,384m (2012: HK$117,946m).

	The Bank	
	2013	2012
	HK$m	HK$m
Listed investments	**39,824**	39,824
Unlisted investments	**586**	1,095
	40,410	40,919

24 Interests in associates and joint ventures *(continued)*

Associates

(i) Principal associates

The principal associates of the group are:

	At 31 December 2013		At 31 December 2012	
	Carrying value HK$m	**Fair value[1] HK$m**	Carrying value HK$m	Fair value[1] HK$m
Listed				
Bank of Communications Co., Ltd.	**104,636**	**77,181**	91,840	82,411
Industrial Bank Co., Ltd.[2]	**–**	**–**	22,099	28,409
	104,636	**77,181**	113,939	110,820

1 *Principal associates are listed on recognised stock exchanges. The fair value represents valuation based on quoted market price of the shares held (Level 1 in the fair value hierarchy).*
2 *Following its issue of additional share capital in January 2013, Industrial Bank was reclassified as a financial investment.*

	Place of incorporation	**Principal activity**	**Nominal value of issued share capital / registered capital**	**Class of share / registered capital**	**The group's interest in issued share capital / registered capital**
Listed					
Bank of Communications Co., Ltd.	PRC[1]	Banking	RMB74,263m	Ordinary	19.03%
Unlisted					
Barrowgate Limited[3]	Hong Kong	Property investment	–[2]	Ordinary	24.64%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND8,878bn	Ordinary	19.41%

1 *People's Republic of China*
2 *Nominal value of issued share capital is less than HK$1m*
3 *Held indirectly*

The principal place of business is the same as the place of incorporation. The proportion of voting rights held is the same as the proportion of ownership interest held.

24 Interests in associates and joint ventures *(continued)*

Bank of Communications Co., Limited ('BoCom')

The group's investment in BoCom was equity accounted with effect from August 2004. The group's significant influence in BoCom was established as a result of representation on the Board of Directors and, in accordance with the Technical Cooperation and Exchange Programme, the group is assisting in the maintenance of financial and operating policies and a number of staff have been seconded to assist in this process.

Impairment testing

As at 31 December 2013, the fair value of the group's investment in BoCom had been below the carrying amount for approximately 20 months, apart from a short period in 2013. As a result, the group performed an impairment test on the carrying amount of the investment in BoCom. The test confirmed that there was no impairment as at 31 December 2013.

Basis of recoverable amount

The impairment test was performed by comparing the recoverable amount of BoCom, determined by a value-in-use ('VIU') calculation, with its carrying amount. The VIU calculation used discounted cash flow projections based on management's estimates. Cash flows beyond the short to medium-term were then extrapolated in perpetuity using a long-term growth rate. Management judgement is required in estimating the future cash flows of BoCom. The projected values are particularly sensitive to the following key assumptions.

Key assumptions in VIU calculation

Long-term growth rate: the growth rate is 5% for periods after 2018 and does not exceed forecast GDP growth in China.

Discount rate: the discount rate of 13% is derived from a range of values obtained by applying a Capital Asset Pricing Model ('CAPM') calculation for BoCom, using market data. Management supplements this by comparing the rates derived from the CAPM with discount rates available from external sources, and the group's discount rate for evaluating investments in mainland China. The discount rate used is within the range of 10.5% to 15% indicated by the CAPM and external sources.

Loan impairment charge as a percentage of customer advances: the ratio used increases from 0.64% to 1% in the short to medium term. The long-term ratio is assumed to revert to a historical rate of 0.64%. The rates are within the medium-term range forecasts of 0.55% and 1.20% disclosed by external analysts.

Management's judgement in estimating the VIU

In 2013, the impairment testing model for BoCom was changed to reflect the expected regulatory impact on cash flow projections. The changes reduced the projected available cash flows by including a regulatory cap on the loan-to-deposit ratio and by retaining a proportion of cash flows to maintain capital ratio requirements above the expected regulatory minima. If these changes had been made as at 31 December 2012, the VIU would still have been above the carrying amount as at that date.

VIU was HK$108.9bn, or HK$4.3bn ('headroom') in excess of the carrying amount of the investment in BoCom of HK$104.6bn as at 31 December 2013. The carrying amount increased by HK$12.8bn during 2013.

Sensitivity analyses were performed on each key assumption to ascertain the impact of reasonably possible changes in assumptions. The following changes to the key assumptions used in the VIU calculation would be necessary to reduce headroom to nil:

Key assumption	Changes to key assumption to reduce headroom to nil
· Discount rate	· Increase by 20 basis points
· Long-term growth rate	· Decrease by 23 basis points
· Loan impairment charge as a percentage of customer advances	· Increase by 0.12% in each of the years from 2013 to 2018 respectively

24 Interests in associates and joint ventures *(continued)*

The following table further illustrates the impact on VIU of variances in key assumptions:

HK$bn **Carrying value: 104.6**	**Favourable change**		**Current model**	**Unfavourable change**	
Long-term growth rate	+50bp	+100bp	5.00%	-50bp	-100bp
VIU	119.3	131.3	108.9	99.7	91.5
Increase/(decrease) in VIU	10.4	22.4		(9.2)	(17.4)
Discount rate	-50bp	-110bp	13.00%	+50bp	+100bp
VIU	120.7	134.4	108.9	98.7	89.8
Increase/(decrease) in VIU	11.8	25.5		(10.2)	(19.1)
Loan impairment charge as a percentage of customer advances	0.64% throughout		2013 – 2018: 0.64% to 1.00% 2019+: 0.64%	1.00% from 2014 to 2018	
VIU	114.5		108.9	103.9	
Increase/(decrease) in VIU	5.6			(5.0)	

Selected financial information of BoCom

The statutory accounting reference date of BoCom is 31 December. For the year ended 31 December 2013, the group included the associate's results on the basis of financial statements made up for the 12 months to 30 September 2013, but taking into account the financial effect of significant transactions or events in the subsequent period from 1 October 2013 to 31 December 2013.

	At 30 September 2013 HK$m	At 30 September 2012 HK$m
Selected balance sheet information of BoCom		
Cash and balances at central banks	**1,102,661**	1,015,654
Loans and advances to banks and other financial institutions	**682,714**	635,860
Loans and advances to customers	**4,002,207**	3,456,376
Other financial assets	**1,283,423**	1,071,755
Other assets	**270,034**	204,752
Total assets	**7,341,039**	6,384,397
Deposits by banks and other financial institutions	**1,325,248**	1,171,459
Customer accounts	**5,176,342**	4,488,739
Other financial liabilities	**159,446**	125,201
Other liabilities	**152,405**	140,242
Total liabilities	**6,813,441**	5,925,641
Total equity	**527,598**	458,756
Total equity attributable to:		
– shareholders	**525,195**	456,919
– non-controlling interests	**2,403**	1,837
Reconciliation of BoCom's net assets to carrying amount in the group's consolidated financial statements		
The group's share of net assets	**99,969**	86,972
Add: Goodwill	**4,191**	4,064
Add: Intangible assets	**476**	804
Carrying amount	**104,636**	91,840

Notes on the Financial Statements (continued)

24 Interests in associates and joint ventures *(continued)*

	For the 12 months ended 30 September	
	2013	2012
	HK$m	HK$m
Selected income statement information of BoCom		
Net interest income	**161,092**	142,764
Net fee and commission income	**31,101**	24,188
Loan impairment charges	**(21,807)**	(16,704)
Depreciation and amortisation	**(6,277)**	(5,344)
Tax expense	**(21,895)**	(20,306)
Profit for the year	**78,541**	69,921
Other comprehensive (loss)/ income	**(2,909)**	1,937
Total comprehensive income	**75,632**	71,858
Dividends received from BoCom	**4,264**	1,457

(ii) Other principal associates

The group's investment in Industrial Bank Co., Limited ('Industrial Bank') was equity accounted with effect from May 2004. The group's significant influence was established as a result of representation on the Board of Directors. In January 2013, Industrial Bank completed a private placement of additional share capital to a number of third parties, thereby diluting the group's equity holding from 12.8% to 10.9%. As a result of this and other factors, the group considers that it is no longer in a position to exercise significant influence over Industrial Bank and ceased to account for the investment as an associate from that date, giving rise to an accounting gain of HK$8.5bn. Thereafter, the holding is recognised as an available-for-sale financial investment.

The group acquired 15% of Vietnam Technological & Commercial Joint Stock Bank ('TechCom Bank') in October 2007. This investment was equity accounted from that date due to the group's representation on the Board of Directors and involvement in the Technical Support and Assistance Agreement. In December 2007, as a result of a rights issue in which the group did not participate, the group's equity interest was diluted to 14.44%. In September 2008, the group increased its equity interest to 20%. The group's equity interest has been subsequently diluted to below 20% due to the issue of shares by the associate to its own employees. The investment in TechCom Bank was tested for impairment as at 31 December 2013, and an impairment loss of HK$819m was recognised.

The group's investment in Yantai Bank was equity accounted with effect from January 2009, reflecting the group's significant influence over this associate. On 13 December 2013, Yantai Bank approved an increase in its registered share capital to enable a private placement of additional share capital to a third party, leading to the group's equity holding being diluted from 20% to 15.09%. As a result of this and other factors, the group considers that it is no longer in a position to exercise significant influence over Yantai Bank and ceased to account for its investment as an associate from that date. Thereafter, the holding in Yantai Bank is classified as an available-for-sale financial investment. The loss arising from this reclassification was HK$297m.

Summarised aggregate financial information in respect of associates not individually material

	2013	2012
	HK$m	HK$m
Carrying value	**2,748**	26,105
The group's share of:		
– Assets	**13,524**	491,019
– Liabilities	**11,229**	465,883
– Profit or loss from continuing operations	**659**	5,915
– Other comprehensive income	**9**	444
– Total comprehensive income	**668**	6,359
Other expense related to investment in an associate:		
– Impairment of an associate	**819**	–

At 31 December 2013, the group's share of associates' contingent liabilities incurred relating to the group's interest in associates was HK$361,129m (2012: HK$357,664m).

25 Goodwill and intangible assets

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

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**6,362**	7,237	**1,181**	1,180
Present value of in-force long-term insurance business	**28,916**	24,425	**–**	–
Other intangible assets	**6,604**	6,972	**3,349**	3,585
	41,882	38,634	**4,530**	4,765

a *Goodwill*

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Cost at 1 January	**7,237**	7,629	**1,180**	1,177
Disposals	**–**	(67)	**–**	(2)
Exchange and other movements	**(875)**	(325)	**1**	5
Net book value at 31 December	**6,362**	7,237	**1,181**	1,180

Segmental analysis of goodwill

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Retail Banking and Wealth Management	**–**	–	**–**	–
Hong Kong – Commercial Banking	**24**	24	**24**	24
Hong Kong – Global Banking and Markets	**750**	750	**498**	498
Hong Kong – Private Banking	**82**	–	**82**	–
Rest of Asia-Pacific – Retail Banking and Wealth Management	**1,180**	1,192	**80**	80
Rest of Asia-Pacific – Commercial Banking	**3,408**	4,184	**–**	–
Rest of Asia-Pacific – Global Banking and Markets	**918**	1,087	**497**	578
Rest of Asia-Pacific – Private Banking	**–**	–	**–**	–
Total goodwill in the CGUs listed	**6,362**	7,237	**1,181**	1,180

25 Goodwill and intangible assets *(continued)*

During 2013 there was no impairment of goodwill (2012: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2013 based on a value in use calculation, with the carrying amount of the CGUs. 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 for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of 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 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.

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 in 2013 were in the range of 9% to 11% (2012: 11%) across different CGUs. The nominal long-term growth rates used in the impairment test in 2013 for Hong Kong and Rest of Asia-Pacific were 3.7% and 4.9% respectively (2012: 4.7% and 5.0%).

b *The present value of in-force long-term insurance 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 operation:

	2013	2012
Risk free rate	**2.31%**	0.60%
Risk discount rate	**7.41%**	7.46%
Expenses inflation	**3.00%**	3.00%

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

	The group	
	2013	2012
	HK$m	HK$m
At 1 January	**24,425**	20,232
Value of new business written during the year	**5,075**	5,559
Movements arising from in-force business:		
– expected return	**(1,358)**	(1,077)
– experience variances	**(33)**	162
– changes in operating assumptions	**1,499**	(153)
Investment return variances	**(75)**	(94)
Changes in investment assumptions	**(387)**	133
Other adjustments	**14**	(98)
Changes in PVIF	**4,735**	4,432
Exchange differences and other	**(244)**	(239)
At 31 December	**28,916**	24,425

25 Goodwill and intangible assets *(continued)*

c *Other intangible assets*

The group

	2013			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other[1] HK$m**	**Total HK$m**
Cost				
At 1 January	**11,521**	**1,842**	**2,367**	**15,730**
Additions	**1,502**	**–**	**–**	**1,502**
Disposals/amounts written-off	**(295)**	**–**	**(13)**	**(308)**
Exchange and other movements	**(83)**	**(236)**	**(66)**	**(385)**
At 31 December	**12,645**	**1,606**	**2,288**	**16,539**
Accumulated amortisation and impairment				
At 1 January	**7,653**	**1,039**	**66**	**8,758**
Amortisation charge for the year	**1,440**	**128**	**15**	**1,583**
Impairment	**71**	**–**	**21**	**92**
Disposals/amounts written-off	**(287)**	**–**	**(14)**	**(301)**
Exchange and other movements	**(59)**	**(134)**	**(4)**	**(197)**
At 31 December	**8,818**	**1,033**	**84**	**9,935**
Net book value at 31 December	**3,827**	**573**	**2,204**	**6,604**

	2012			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost				
At 1 January	9,776	1,889	2,253	13,918
Additions	1,303	–	–	1,303
Disposals/amounts written-off	(208)	(30)	–	(238)
Exchange and other movements	650	(17)	114	747
At 31 December	11,521	1,842	2,367	15,730
Accumulated amortisation and impairment				
At 1 January	5,991	915	34	6,940
Amortisation charge for the year	1,398	164	16	1,578
Impairment	130	–	16	146
Disposals/amounts written-off	(193)	(31)	–	(224)
Exchange and other movements	327	(9)	–	318
At 31 December	7,653	1,039	66	8,758
Net book value at 31 December	3,868	803	2,301	6,972

1. *'Other' includes operating licenses 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.*

Notes on the Financial Statements (continued)

25 Goodwill and intangible assets *(continued)*

The Bank

	2013			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other HK$m**	**Total HK$m**
Cost				
At 1 January	**9,049**	**1,286**	**78**	**10,413**
Additions	**1,140**	**–**	**–**	**1,140**
Disposals/amounts written-off	**(173)**	**–**	**–**	**(173)**
Exchange and other movements	**4**	**(141)**	**1**	**(136)**
At 31 December	**10,020**	**1,145**	**79**	**11,244**
Accumulated amortisation and impairment				
At 1 January	**6,079**	**719**	**30**	**6,828**
Amortisation charge for the year	**1,169**	**99**	**8**	**1,276**
Impairment	**32**	**–**	**6**	**38**
Disposals/amounts written-off	**(172)**	**–**	**–**	**(172)**
Exchange and other movements	**5**	**(81)**	**1**	**(75)**
At 31 December	**7,113**	**737**	**45**	**7,895**
Net book value at 31 December	**2,907**	**408**	**34**	**3,349**

	2012			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other HK$m	Total HK$m
Cost				
At 1 January	7,715	1,264	44	9,023
Additions	908	–	–	908
Disposals/amounts written-off	(170)	–	–	(170)
Exchange and other movements	596	22	34	652
At 31 December	9,049	1,286	78	10,413
Accumulated amortisation and impairment				
At 1 January	4,760	604	5	5,369
Amortisation charge for the year	1,111	105	24	1,240
Impairment	75	–	–	75
Disposals/amounts written-off	(169)	–	–	(169)
Exchange and other movements	302	10	1	313
At 31 December	6,079	719	30	6,828
Net book value at 31 December	2,970	567	48	3,585

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 10 years
Other (excluding operating licenses)	from 3 years to 10 years

25 Goodwill and intangible assets *(continued)*

An impairment test was carried out in respect of the operating licenses in Taiwan as at 1 July 2013. 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, with the carrying amounts of the CGUs. 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.

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 used during 2013 was 9% to 11% (2012: 13%) across different CGUs. The long-term growth rate used during 2013 was 3% (2012: 3%).

26 Property, plant and equipment

a *Property, plant and equipment*

	The group			The Bank		
	Land and buildings HK$m	**Investment properties HK$m**	**Equipment HK$m**	**Land and buildings HK$m**	**Investment properties HK$m**	**Equipment HK$m**
Cost or valuation						
At 1 January 2013	**80,104**	**5,282**	**22,228**	**50,895**	**197**	**13,872**
Exchange and other adjustments	**(188)**	**–**	**(402)**	**(156)**	**–**	**(202)**
Additions	**1,743**	**4,868**	**1,808**	**25,060**	**251**	**1,300**
Disposals	**(11)**	**–**	**(975)**	**–**	**–**	**(530)**
Elimination of accumulated depreciation on revalued land and buildings	**(2,048)**	**–**	**–**	**(1,238)**	**–**	**–**
Surplus on revaluation	**5,687**	**1,389**	**–**	**2,370**	**25**	**–**
Reclassifications	**19**	**(147)**	**27**	**14**	**–**	**25**
At 31 December 2013	**85,306**	**11,392**	**22,686**	**76,945**	**473**	**14,465**
Accumulated depreciation						
At 1 January 2013	**60**	**–**	**17,375**	**57**	**–**	**11,055**
Exchange and other adjustments	**(4)**	**–**	**(303)**	**(4)**	**–**	**(156)**
Charge for the year	**2,084**	**–**	**1,904**	**1,349**	**–**	**1,174**
Disposals	**–**	**–**	**(944)**	**–**	**–**	**(519)**
Elimination of accumulated depreciation on revalued land and buildings	**(2,048)**	**–**	**–**	**(1,238)**	**–**	**–**
Reclassifications	**(1)**	**–**	**21**	**–**	**–**	**21**
At 31 December 2013	**91**	**–**	**18,053**	**164**	**–**	**11,575**
Net book value at 31 December 2013	**85,215**	**11,392**	**4,633**	**76,781**	**473**	**2,890**
Total at 31 December 2013			**101,240**			**80,144**

During the year, the Bank acquired certain properties from a wholly-owned subsidiary at fair value for HK$23,606m.

Notes on the Financial Statements (continued)

26 Property, plant and equipment *(continued)*

	The group			The Bank		
	Land and buildings HK$m	Investment properties HK$m	Equipment HK$m	Land and buildings HK$m	Investment properties HK$m	Equipment HK$m
Cost or valuation						
At 1 January 2012	75,090	4,616	21,922	48,318	147	13,862
Exchange and other adjustments	(159)	–	62	(177)	–	(2)
Additions	240	–	1,750	234	–	1,033
Disposals	(2)	–	(824)	(1)	–	(393)
Elimination of accumulated depreciation on revalued land and buildings	(1,857)	–	–	(1,106)	–	–
Surplus on revaluation	7,223	834	–	3,636	50	–
Reclassifications	(431)	(168)	(682)	(9)	–	(628)
At 31 December 2012	80,104	5,282	22,228	50,895	197	13,872
Accumulated depreciation						
At 1 January 2012	21	–	16,313	–	–	10,451
Exchange and other adjustments	1	–	52	1	–	(1)
Charge for the year	1,897	–	2,117	1,162	–	1,299
Disposals	–	–	(772)	–	–	(366)
Elimination of accumulated depreciation on revalued land and buildings	(1,857)	–	–	(1,106)	–	–
Reclassifications	(2)	–	(335)	–	–	(328)
At 31 December 2012	60	–	17,375	57	–	11,055
Net book value at 31 December 2012	80,044	5,282	4,853	50,838	197	2,817
Total at 31 December 2012			90,179			53,852

b *The carrying amount of land and buildings, had they been stated at cost less accumulated depreciation, would have been as follows:*

	The group		The Bank	
	2013 HK$m	2012 HK$m	**2013 HK$m**	2012 HK$m
Cost less accumulated depreciation	**19,998**	18,847	**38,477**	14,031

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

	The group		The Bank	
	2013 HK$m	2012 HK$m	**2013 HK$m**	2012 HK$m
Land and buildings carried at valuation	**85,296**	80,094	**76,945**	50,895
Other land and buildings stated at cost	**10**	10	**–**	–
Land and buildings before deduction of accumulated depreciation	**85,306**	80,104	**76,945**	50,895

26 Property, plant and equipment *(continued)*

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

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**36,988**	35,604	**33,028**	30,216
Medium-term leaseholds				
(between ten and fifty years)	**48,407**	38,716	**35,265**	11,985
Short leaseholds (less than ten years)	**63**	76	**63**	76
	85,458	74,396	**68,356**	42,277
Outside Hong Kong:				
Freehold	**4,522**	4,562	**3,451**	3,537
Long leaseholds (over fifty years)	**158**	174	**129**	126
Medium-term leaseholds				
(between ten and fifty years)	**6,444**	6,157	**5,293**	5,058
Short leaseholds (less than ten years)	**25**	37	**25**	37
	11,149	10,930	**8,898**	8,758
	96,607	85,326	**77,254**	51,035
Analysed as follows:				
Land and buildings	**85,215**	80,044	**76,781**	50,838
Investment properties	**11,392**	5,282	**473**	197
	96,607	85,326	**77,254**	51,035

The group's land and buildings and investment properties were revalued at 27 November 2013 and updated for any material changes at 31 December 2013. The basis of valuation for land and buildings and investment properties was open market value, depreciated replacement cost or surrender value as noted in note 3(p). The resultant values would mainly be categorised as Level 3 in the fair value hierarchy. 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 'Land and buildings' includes HK$11,731m (2012: HK$10,108m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$7,076m (2012: HK$8,057m). Amounts of HK$4,073m (2012: HK$5,327m) and HK$1,389m (2012: HK$836m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$4,073m (2012: HK$5,327m) is stated after deduction of non-controlling interests of HK$796m (2012: HK$841m) and deferred tax of HK$818m (2012: HK$1,053m). The amount credited to the income statement represents the surplus of HK$1,389m (2012: HK$834m) on revaluation of investment properties.

Land and buildings and investment properties in Hong Kong, Macau and mainland China, representing 95% by value of the group's properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited who has 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 eleven countries, which represent 5% by value of the group's properties, were valued by different independent professionally qualified valuers.

26 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$312m (2012: HK$216m) was recognised as rental income in the income statement in respect of operating leases.

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

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**303**	181	**20**	18
After one but within five years	**190**	98	**7**	8
Over five years	**1**	–	**–**	–
	494	279	**27**	26

27 Leasehold land and land use rights

The net book value of the group's interests in leasehold land and land use rights that have been accounted for as operating leases is analysed as follows:

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Medium-term leaseholds (between ten and fifty years)	**295**	313	**73**	75

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 28).

28 Other assets

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Current taxation recoverable	**2,034**	1,029	**1,723**	823
Assets held for sale	**4,476**	48,280	**4,330**	44,669
Prepayments and accrued income	**3,578**	3,823	**1,721**	1,926
Accrued interest receivable	**15,898**	14,992	**5,794**	5,806
Acceptances and endorsements	**34,239**	31,965	**19,845**	21,191
Other	**88,714**	86,964	**64,987**	69,065
	148,939	187,053	**98,400**	143,480

Assets held for sale comprise assets acquired by repossession of collateral for realisation, own properties held for sale, certain investments and assets of businesses to be sold, including the following:

At 31 December 2012, the fair value of our investment in Ping An was HK$39,813m, included in 'Assets held for sale'. The sale of this investment was completed on 6 February 2013. The gain from this transaction was HK$28,053m, being the proceeds of HK$36,222m based on the agreed sale price of HK$59 per share, less the original cost of HK$8,112m and expenses of HK$57m. The income statement impact of this transaction was a loss of HK$2,694m in 2012 and a net gain in 2013 of HK$30,747m.

On 10 December 2013 we entered into an agreement to sell our entire 8% shareholding in Bank of Shanghai to Banco Santander, S.A. The transaction is subject to regulatory approvals and is expected to complete in the first half of 2014.

29 Customer accounts

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**862,138**	831,256	**526,698**	509,183
Savings accounts	**2,246,618**	2,063,565	**1,571,836**	1,433,809
Other deposit accounts	**1,145,996**	980,063	**625,481**	474,408
	4,254,752	3,874,884	**2,724,015**	2,417,400

30 Trading liabilities

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**4,261**	3,470	**198**	796
Other debt securities in issue	**18,104**	15,479	**16,922**	15,159
Short positions in securities	**53,889**	48,116	**29,228**	26,519
Deposits by banks	**6,558**	7,982	**4,918**	7,430
Customer accounts	**112,220**	108,293	**31,357**	32,242
	195,032	183,340	**82,623**	82,146

31 Financial liabilities designated at fair value

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**222**	271	**222**	271
Customer accounts	**–**	1,366	**–**	1,366
Debt securities in issue	**4,807**	6,414	**4,537**	6,094
Liabilities to customers under investment contracts	**36,686**	36,219	**–**	–
	41,715	44,270	**4,759**	7,731

At 31 December 2013, the carrying amount of financial liabilities designated at fair value was HK$12m higher than the contractual amount at maturity (2012: the carrying amount was HK$81m higher than the contractual amount). At 31 December 2013, the accumulated loss in fair value attributable to changes in credit risk was HK$29m (2012: HK$13m).

32 Debt securities in issue

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**16,319**	29,066	**11,782**	9,243
Other debt securities	**36,015**	45,581	**18,280**	31,163
	52,334	74,647	**30,062**	40,406

Notes on the Financial Statements (continued)

33 Other liabilities and provisions

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**26,021**	24,705	**15,144**	15,013
Liabilities of business held for sale	**–**	4,811	**–**	3,451
Provisions for liabilities and charges (note 35)	**1,723**	2,144	**1,260**	1,266
Acceptances and endorsements	**34,239**	31,965	**19,845**	21,191
Share based payment liability to HSBC	**2,303**	2,560	**1,900**	2,068
Other liabilities	**24,523**	28,606	**13,116**	15,898
	88,809	94,791	**51,265**	58,887

34 Liabilities under insurance contracts issued

	Gross	**Reinsurance**	**Net**
	HK$m	**HK$m**	**HK$m**
2013			
Life insurance liabilities to policyholders			
Life (non-linked)	**236,783**	**(2,836)**	**233,947**
Life (linked)	**39,269**	**(1,695)**	**37,574**
Investment contracts with discretionary participation features	–	–	–
	276,052	**(4,531)**	**271,521**
Non-life insurance liabilities			
Unearned premiums	**35**	–	**35**
Notified claims	**25**	–	**25**
Claims incurred but not reported	**25**	–	**25**
Other	**43**	–	**43**
	128	–	**128**
Total liabilities under insurance contracts	**276,180**	**(4,531)**	**271,649**
2012			
Life insurance liabilities to policyholders			
Life (non-linked)	210,825	(1,389)	209,436
Life (linked)	33,948	(3,103)	30,845
Investment contracts with discretionary participation features	28	–	28
	244,801	(4,492)	240,309
Non-life insurance liabilities			
Unearned premiums	39	–	39
Notified claims	12	–	12
Claims incurred but not reported	26	–	26
Other	43	–	43
	120	–	120
Total liabilities under insurance contracts	244,921	(4,492)	240,429

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

34 Liabilities under insurance contracts issued *(continued)*

a *Movement of liabilities under insurance contracts*

(i) Non-life insurance

	Gross HK$m	Reinsurance HK$m	Net HK$m
2013			
Unearned premiums			
At 1 January	**39**	**–**	**39**
Gross written premiums	**184**	**(25)**	**159**
Gross earned premiums	**(183)**	**25**	**(158)**
Business disposals	–	–	–
Foreign exchange and other movements	**(5)**	–	**(5)**
At 31 December	**35**	**–**	**35**
Notified and incurred but not reported claims			
At 1 January	**38**	–	**38**
– Notified claims	**12**	–	**12**
– Claims incurred but not reported	**26**	–	**26**
Claims paid in current year	**(33)**	–	**(33)**
Claims incurred	**103**	**(53)**	**50**
Business disposals	–	–	–
Foreign exchange and other movements	**(56)**	**53**	**(3)**
At 31 December			
– Notified claims	**25**	–	**25**
– Claims incurred but not reported	**25**	–	**25**
Total at 31 December	**50**	–	**50**
2012			
Unearned premiums			
At 1 January	1,674	(157)	1,517
Gross written premiums	2,935	(365)	2,570
Gross earned premiums	(2,550)	341	(2,209)
Business disposals	(2,037)	181	(1,856)
Foreign exchange and other movements	17	–	17
At 31 December	39	–	39
Notified and incurred but not reported claims			
At 1 January	1,240	(238)	1,002
– Notified claims	984	(203)	781
– Claims incurred but not reported	256	(35)	221
Claims paid in current year	(1,135)	98	(1,037)
Claims incurred	1,206	(99)	1,107
Business disposals	(1,341)	246	(1,095)
Foreign exchange and other movements	68	(7)	61
At 31 December			
– Notified claims	12	–	12
– Claims incurred but not reported	26	–	26
Total at 31 December	38	–	38

Notes on the Financial Statements (continued)

34 Liabilities under insurance contracts issued *(continued)*

(ii) Life insurance liabilities to policyholders

	Gross HK$m	Reinsurance HK$m	Net HK$m
2013			
Life (non-linked)			
At 1 January	**210,825**	**(1,389)**	**209,436**
Benefits paid	**(20,309)**	**201**	**(20,108)**
Increase in liabilities to policyholders	**46,628**	**(1,630)**	**44,998**
Foreign exchange and other movements	**(361)**	**(18)**	**(379)**
At 31 December	**236,783**	**(2,836)**	**233,947**
Life (linked)			
At 1 January	**33,948**	**(3,103)**	**30,845**
Benefits paid	**(4,898)**	**3,267**	**(1,631)**
Increase in liabilities to policyholders	**10,530**	**1,014**	**11,544**
Foreign exchange and other movements	**(311)**	**(2,873)**	**(3,184)**
At 31 December	**39,269**	**(1,695)**	**37,574**
Investment contracts with discretionary participation features			
At 1 January	**28**	–	**28**
Benefits paid	**(28)**	–	**(28)**
Increase in liabilities to policyholders	–	–	–
Foreign exchange and other movements	**–**	–	**–**
At 31 December	**–**	–	**–**
Total liabilities to policyholders	**276,052**	**(4,531)**	**271,521**
2012			
Life (non-linked)			
At 1 January	176,238	(228)	176,010
Benefits paid	(6,931)	143	(6,788)
Increase in liabilities to policyholders	42,376	(1,315)	41,061
Foreign exchange and other movements	(858)	11	(847)
At 31 December	210,825	(1,389)	209,436
Life (linked)			
At 1 January	30,055	(6,666)	23,389
Benefits paid	(7,286)	5,233	(2,053)
Increase in liabilities to policyholders	10,972	1,842	12,814
Foreign exchange and other movements	207	(3,512)	(3,305)
At 31 December	33,948	(3,103)	30,845
Investment contracts with discretionary participation features			
At 1 January	86	–	86
Benefits paid	(62)	–	(62)
Increase in liabilities to policyholders	1	–	1
Foreign exchange and other movements	3	–	3
At 31 December	28	–	28
Total liabilities to policyholders	244,801	(4,492)	240,309

35 Provisions for liabilities and charges

Provisions for liabilities and charges

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**2,144**	1,686	**1,266**	1,184
Additional provisions/increase in provisions	**909**	1,835	**465**	1,053
Provisions used	**(325)**	(1,362)	**(269)**	(970)
Amounts reversed	**(720)**	(225)	**(322)**	(135)
Exchange and other movements	**(285)**	210	**120**	134
At 31 December	**1,723**	2,144	**1,260**	1,266

Of which: provisions for restructuring costs

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**287**	476	**256**	439
Additional provisions/increase in provisions	**133**	619	**52**	483
Provisions used	**(165)**	(683)	**(136)**	(556)
Amounts reversed	**(1)**	(92)	**(1)**	(78)
Exchange and other movements	**(29)**	(33)	**(26)**	(32)
At 31 December	**225**	287	**145**	256

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 Bank and the group for the development and expansion of its business.

		2013	2012
		HK$m	HK$m
The Bank			
US$1,200m	Undated floating rate primary capital notes	**9,346**	9,355
		9,346	9,355
The group			
AUD42m	Floating rate subordinated notes due 2018, callable from 2013[1]	–	338
AUD200m	Floating rate subordinated notes due 2020, callable from 2015	**1,386**	1,608
MYR500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[2]	**1,182**	1,267
MYR500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[3]	**1,193**	1,299
		13,107	13,867

1 *The AUD42m callable subordinated floating rate notes due 2018 were redeemed in March 2013.*

2 *The interest rate on the MYR500m 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.*

3 *The interest rate on the MYR500m 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.*

37 Preference shares

Authorised

At both 31 December 2013 and 31 December 2012, the authorised preference share capital of the Bank was US$13,450.5m comprising 3,750.5m cumulative redeemable preference shares of US$1 each, 7,500m non-cumulative irredeemable preference shares of US$1 each and 2,200m cumulative irredeemable preference shares of US$1 each.

At a group level, there was an additional INR870m (2012: INR1,320m) of authorised preference share capital comprising 8.7m compulsorily convertible preference shares of INR100 each in the share capital of a subsidiary.

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Issued and fully paid				
Redeemable preference shares	**8,141**	11,243	**8,141**	11,243
Irredeemable preference shares	**39,173**	68,231	**39,064**	68,080
Share premium	**-**	3,872	**-**	3,872
	47,314	83,346	**47,205**	83,195

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. 500,000 cumulative redeemable preference shares were redeemed on 19 December 2013 at the issue price of US$1,000 per share.

400m cumulative redeemable preference 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. 400m cumulative redeemable preference shares were early redeemed on 19 December 2013 at the issue price of US$1 per share before reaching their optional redemption date.

1,050m cumulative redeemable preference 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 2013 was 1,050m (2012: 1,450.5m). No cumulative redeemable preference shares were issued during the year (2012: nil).

The non-cumulative irredeemable preference shares were issued at nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, 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 cancellation, subject to the Bank having sufficient distributable profits. A total of 2,700m non-cumulative irredeemable preference shares at par value of US$1 each was cancelled on 28 March, 26 April and 21 June 2013. The number of issued non-cumulative irredeemable preference shares at 31 December 2013 was 3,953m (2012: 6,653m). No non-cumulative irredeemable preference shares were issued during the year (2012: nil).

37 Preference shares *(continued)*

The cumulative irredeemable preference shares were issued at nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, 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 cancellation, subject to the Bank having sufficient distributable profits. 1,045m cumulative irredeemable preference shares at nominal value of US$1 each were cancelled on 20 March 2013. The number of issued cumulative irredeemable preference shares at 31 December 2013 was 1,085m (2012: 2,130m). No cumulative irredeemable preference shares were issued during the year (2012: nil). The holders of the preference shares are entitled to one vote per share at shareholder meetings of the Bank.

8.7m compulsorily convertible preference shares ('CCPS') were issued by HSBC InvestDirect Securities (India) Limited ('HSBC InvestDirect') in 2009 at a nominal value of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after one year from the date of allotment of the CCPS by written notice. The conversion shall be made at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion. The CCPS shall carry a fixed dividend of 0.001% of the face value per annum. After ten years following the allotment of the CCPS all outstanding CCPS shall be converted at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion.

HSBC InvestDirect converted 2m CCPS into 5,882,352 equity shares of INR 10 each at a premium of INR 24 per share amounting to INR 200m during 2013 (2.5m CCPS into 3,906,250 equity shares of INR10 each at a premium of INR64 per share amounting to INR250m during 2012).

38 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2013 was HK$100,000m (2012: HK$80,000m) divided into 40,000m (2012: 32,000m) ordinary shares of HK$2.50 each. The authorised ordinary share capital was increased on 31 October 2013 by the creation of HK$20,000m divided into 8,000m new ordinary shares of HK$2.50 each. 10,540m new ordinary shares were issued during 2013 (2012: 11,511,335,607).

Issued and fully paid

	The group and the Bank	
	2013	2012
	HK$m	HK$m
Ordinary share capital	**85,319**	58,969

	The group and the Bank	
	2013	**2013**
Ordinary shares of HK$2.50 each	**Number**	**HK$m**
At 1 January	**23,587,482,901**	**58,969**
Issued during the year	**10,540,000,000**	**26,350**
At 31 December	**34,127,482,901**	**85,319**

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 shareholder meetings of the Bank.

Notes on the Financial Statements (continued)

39 Maturity analysis of assets and liabilities

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

The group

2013	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	318,274	432,101	217,209	165,135	–	–	–	–	–	1,132,719
Items in the course of collection from other banks	–	16,346	–	–	–	–	–	–	–	16,346
Placings with banks maturing after one month	–	–	154,637	30,773	21,958	9,602	–	–	–	216,970
Certificates of deposit	–	7,380	22,981	45,723	8,028	4,078	17	–	–	88,207
Hong Kong Government certificates of indebtedness	195,554	–	–	–	–	–	–	–	–	195,554
Trading assets	–	–	–	–	–	–	–	311,400	–	311,400
Financial assets designated at fair value	–	203	632	3,792	10,500	4,773	70,246	–	–	90,146
Debt securities	–	203	632	3,763	10,500	4,773	–	–	–	19,871
Equity shares	–	–	–	–	–	–	70,246	–	–	70,246
Other	–	–	–	29	–	–	–	–	–	29
Derivatives	–	–	–	–	–	–	–	378,603	10,124	388,727
Loans and advances to customers	142,080	366,872	314,298	484,556	714,044	656,889	(9,501)	–	–	2,669,238
Financial investments	–	27,863	60,870	201,238	306,136	134,104	35,655	–	–	765,866
Debt securities held to maturity	–	1,497	5,976	14,600	56,487	88,682	–	–	–	167,242
Debt securities available for sale	–	26,366	54,894	186,638	249,649	45,422	859	–	–	563,828
Equity shares available for sale	–	–	–	–	–	–	34,796	–	–	34,796
Amounts due from Group companies	60,639	69,830	21,833	1,757	1,558	1,714	–	4,644	–	161,975
Interests in associates and joint ventures	–	–	–	–	–	–	107,852	–	–	107,852
Goodwill and intangible assets	–	–	–	–	–	–	41,882	–	–	41,882
Property, plant and equipment	–	–	–	–	–	–	101,240	–	–	101,240
Deferred tax assets	–	–	–	–	–	–	2,294	–	–	2,294
Other assets	8,428	24,763	25,563	20,223	5,539	4,070	60,353	–	–	148,939
Total assets	724,975	945,358	818,023	953,197	1,067,763	815,230	410,038	694,647	10,124	6,439,355

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

The group

	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
2013										
Liabilities										
Hong Kong currency notes in circulation	195,554	–	–	–	–	–	–	–	–	195,554
Items in the course of transmission to other banks	–	34,240	–	–	–	–	–	–	–	34,240
Deposits by banks	140,201	85,782	1,850	3,992	4,563	228	–	–	–	236,616
Customer accounts	3,166,759	575,626	268,174	208,687	35,411	95	–	–	–	4,254,752
Trading liabilities	–	–	–	–	–	–	–	195,032	–	195,032
Financial liabilities designated at fair value	164	–	–	–	4,752	269	36,530	–	–	41,715
Derivatives	–	–	–	–	–	–	–	362,963	2,089	365,052
Debt securities in issue	–	4,829	6,922	6,373	29,383	4,827	–	–	–	52,334
Retirement benefit liabilities	–	–	–	–	–	–	4,856	–	–	4,856
Amounts due to Group companies	51,477	10,256	2,014	1,346	9	15,891	–	10,804	–	91,797
Other liabilities and provisions	4,897	28,792	27,367	16,750	3,104	363	7,536	–	–	88,809
Liabilities under insurance contracts issued	1,310	–	–	–	–	–	274,870	–	–	276,180
Current tax liabilities	204	366	385	2,767	–	–	–	–	–	3,722
Deferred tax liabilities	–	–	–	–	–	–	16,051	–	–	16,051
Subordinated liabilities	–	–	–	–	2,568	1,193	9,346	–	–	13,107
Preference shares	–	–	–	–	–	8,141	39,173	–	–	47,314
Total liabilities	3,560,566	739,891	306,712	239,915	79,790	31,007	388,362	568,799	2,089	5,917,131

Notes on the Financial Statements (continued)

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

The Bank

2013	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	240,171	210,138	169,908	143,312	–	–	–	–	–	763,529
Items in the course of collection from other banks	–	10,922	–	–	–	–	–	–	–	10,922
Placings with banks maturing after one month	–	–	59,119	17,244	15,416	1,166	–	–	–	92,945
Certificates of deposit	–	3,279	5,299	1,434	–	–	–	–	–	10,012
Hong Kong Government certificates of indebtedness	195,554	–	–	–	–	–	–	–	–	195,554
Trading assets	–	–	–	–	–	–	–	235,599	–	235,599
Financial assets designated at fair value	–	–	–	555	1,006	–	–	–	–	1,561
Debt securities	–	–	–	555	1,006	–	–	–	–	1,561
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–	368,372	8,811	377,183
Loans and advances to customers	98,235	211,910	156,222	272,342	421,195	348,553	(5,206)	–	–	1,503,251
Financial investments	–	7,880	18,840	119,013	155,119	18,605	3,403	–	–	322,860
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available for sale	–	7,880	18,840	119,013	155,119	18,605	392	–	–	319,849
Equity shares available for sale	–	–	–	–	–	–	3,011	–	–	3,011
Amounts due from Group companies	65,294	166,578	47,962	34,448	19,925	21,262	–	11,420	–	366,889
Investments in subsidiaries	–	–	–	–	–	–	63,272	–	–	63,272
Interests in associates and joint ventures	–	–	–	–	–	–	40,410	–	–	40,410
Goodwill and intangible assets	–	–	–	–	–	–	4,530	–	–	4,530
Property, plant and equipment	–	–	–	–	–	–	80,144	–	–	80,144
Deferred tax assets	–	–	–	–	–	–	999	–	–	999
Other assets	1,514	11,716	16,541	11,454	1,783	394	54,998	–	–	98,400
Total assets	600,768	622,423	473,891	599,802	614,444	389,980	242,550	615,391	8,811	4,168,060

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

The Bank

	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
2013										
Liabilities										
Hong Kong currency notes in circulation	195,554	–	–	–	–	–	–	–	–	195,554
Items in the course of transmission to other banks	–	24,774	–	–	–	–	–	–	–	24,774
Deposits by banks	112,683	75,667	1,800	3,894	3,011	228	–	–	–	197,283
Customer accounts	2,139,580	379,749	96,352	92,688	15,610	36	–	–	–	2,724,015
Trading liabilities	–	–	–	–	–	–	–	82,623	–	82,623
Financial liabilities designated at fair value	–	–	–	–	4,751	–	8	–	–	4,759
Derivatives	–	–	–	–	–	–	–	353,712	983	354,695
Debt securities in issue	–	4,216	2,979	1,268	19,758	1,841	–	–	–	30,062
Retirement benefit liabilities	–	–	–	–	–	–	2,689	–	–	2,689
Amounts due to Group companies	65,741	42,158	10,185	1,096	701	16,286	–	19,977	–	156,144
Other liabilities and provisions	2,918	16,347	16,525	8,270	2,072	155	4,978	–	–	51,265
Current tax liabilities	204	12	351	1,462	–	–	–	–	–	2,029
Deferred tax liabilities	–	–	–	–	–	–	6,503	–	–	6,503
Subordinated liabilities	–	–	–	–	–	–	9,346	–	–	9,346
Preference shares	–	–	–	–	–	8,141	39,064	–	–	47,205
Total liabilities	2,516,680	542,923	128,192	108,678	45,903	26,687	62,588	456,312	983	3,888,946

Notes on the Financial Statements (continued)

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

The group

2012	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	332,279	360,798	252,996	165,126	–	–	–	–	–	1,111,199
Items in the course of collection from other banks	–	23,079	–	–	–	–	–	–	–	23,079
Placings with banks maturing after one month	–	–	120,034	30,470	26,231	7,976	–	–	–	184,711
Certificates of deposit	–	5,232	22,014	56,977	3,869	4,957	36	–	–	93,085
Hong Kong Government certificates of indebtedness	176,264	–	–	–	–	–	–	–	–	176,264
Trading assets	–	–	–	–	–	–	–	419,697	–	419,697
Financial assets designated at fair value	–	24	557	1,040	10,720	5,080	52,058	–	–	69,479
Debt securities	–	24	557	1,040	10,300	5,080	–	–	–	17,001
Equity shares	–	–	–	–	–	–	52,058	–	–	52,058
Other	–	–	–	–	420	–	–	–	–	420
Derivatives	–	–	–	–	–	–	–	394,787	4,169	398,956
Loans and advances to customers	138,085	255,694	250,361	433,467	651,084	630,123	(9,771)	–	–	2,349,043
Financial investments	–	18,871	34,623	83,593	343,059	136,023	9,873	–	–	626,042
Debt securities held to maturity	–	51	1,241	11,541	57,076	85,484	–	–	–	155,393
Debt securities available for sale	–	18,820	33,382	72,052	285,983	50,539	2,502	–	–	463,278
Equity shares available for sale	–	–	–	–	–	–	7,371	–	–	7,371
Amounts due from Group companies	109,567	38,664	9,378	2,912	6,476	2,297	–	6,710	–	176,004
Interests in associates and joint ventures	–	–	–	–	–	–	119,273	–	–	119,273
Goodwill and intangible assets	–	–	–	–	–	–	38,634	–	–	38,634
Property, plant and equipment	–	–	–	–	–	–	90,179	–	–	90,179
Deferred tax assets	–	–	–	–	–	–	2,629	–	–	2,629
Other assets	11,063	25,272	67,768	14,087	7,825	5,869	55,169	–	–	187,053
Total assets	767,258	727,634	757,731	787,672	1,049,264	792,325	358,080	821,194	4,169	6,065,327

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

The group

	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
2012										
Liabilities										
Hong Kong currency notes										
in circulation	176,264	–	–	–	–	–	–	–	–	176,264
Items in the course of transmission										
to other banks	–	35,525	–	–	–	–	–	–	–	35,525
Deposits by banks	128,143	100,676	8,242	1,837	4,949	288	–	–	–	244,135
Customer accounts	2,972,206	408,438	269,579	211,488	13,055	118	–	–	–	3,874,884
Trading liabilities	–	–	–	–	–	–	–	183,340	–	183,340
Financial liabilities designated										
at fair value	141	–	–	5,444	2,270	319	36,096	–	–	44,270
Derivatives	–	–	–	–	–	–	–	393,264	3,887	397,151
Debt securities in issue	–	5,315	3,492	20,927	40,177	4,736	–	–	–	74,647
Retirement benefit liabilities	–	–	–	–	–	–	6,725	–	–	6,725
Amounts due to Group companies	31,964	11,463	1,734	12,842	445	12,058	–	27,112	–	97,618
Other liabilities and provisions	7,739	30,060	28,394	18,029	2,766	196	7,607	–	–	94,791
Liabilities under insurance										
contracts issued	7,219	–	–	–	–	–	237,702	–	–	244,921
Current tax liabilities	258	249	268	3,029	38	–	–	–	–	3,842
Deferred tax liabilities	–	–	–	–	–	–	16,923	–	–	16,923
Subordinated liabilities	–	–	338	–	2,875	1,299	9,355	–	–	13,867
Preference shares	–	–	–	–	–	15,266	68,080	–	–	83,346
Total liabilities	3,323,934	591,726	312,047	273,596	66,575	34,280	382,488	603,716	3,887	5,592,249

Notes on the Financial Statements (continued)

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

The Bank

2012	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	266,622	168,717	189,400	136,448	–	–	–	–	–	761,187
Items in the course of collection from other banks	–	17,355	–	–	–	–	–	–	–	17,355
Placings with banks maturing after one month	–	–	45,276	13,570	20,881	473	–	–	–	80,200
Certificates of deposit	–	1,994	10,447	7,660	49	–	–	–	–	20,150
Hong Kong Government certificates of indebtedness	176,264	–	–	–	–	–	–	–	–	176,264
Trading assets	–	–	–	–	–	–	–	284,573	–	284,573
Financial assets designated at fair value	–	–	–	–	1,432	–	–	–	–	1,432
Debt securities	–	–	–	–	1,432	–	–	–	–	1,432
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–	388,298	3,541	391,839
Loans and advances to customers	86,889	132,086	118,459	230,952	374,239	345,644	(5,549)	–	–	1,282,720
Financial investments	–	10,051	11,789	40,131	170,746	24,115	3,485	–	–	260,317
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available for sale	–	10,051	11,789	40,131	170,746	24,115	972	–	–	257,804
Equity shares available for sale	–	–	–	–	–	–	2,513	–	–	2,513
Amounts due from Group companies	104,502	124,519	27,852	13,258	15,882	22,461	–	13,126	–	321,600
Investments in subsidiaries	–	–	–	–	–	–	58,819	–	–	58,819
Interests in associates and joint ventures	–	–	–	–	–	–	40,919	–	–	40,919
Goodwill and intangible assets	–	–	–	–	–	–	4,765	–	–	4,765
Property, plant and equipment	–	–	–	–	–	–	53,852	–	–	53,852
Deferred tax assets	–	–	–	–	–	–	1,333	–	–	1,333
Other assets	2,418	16,314	60,228	4,501	5,798	622	53,599	–	–	143,480
Total assets	636,695	471,036	463,451	446,520	589,027	393,315	211,223	685,997	3,541	3,900,805

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

The Bank

	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
2012										
Liabilities										
Hong Kong currency notes in circulation	176,264	–	–	–	–	–	–	–	–	176,264
Items in the course of transmission to other banks	–	25,766	–	–	–	–	–	–	–	25,766
Deposits by banks	104,029	89,398	5,667	1,734	3,404	288	–	–	–	204,520
Customer accounts	1,990,707	220,659	97,552	101,963	6,469	50	–	–	–	2,417,400
Trading liabilities	–	–	–	–	–	–	–	82,146	–	82,146
Financial liabilities designated at fair value	–	–	–	5,444	2,270	–	17	–	–	7,731
Derivatives	–	–	–	–	–	–	–	390,282	1,802	392,084
Debt securities in issue	–	4,855	3,347	7,537	22,763	1,904	–	–	–	40,406
Retirement benefit liabilities	–	–	–	–	–	–	3,710	–	–	3,710
Amounts due to Group companies	61,211	33,803	9,600	13,157	439	12,058	–	18,969	–	149,237
Other liabilities and provisions	3,367	20,747	20,281	7,530	2,151	97	4,714	–	–	58,887
Current tax liabilities	255	–	255	1,790	48	–	–	–	–	2,348
Deferred tax liabilities	–	–	–	–	–	–	6,194	–	–	6,194
Subordinated liabilities	–	–	–	–	–	–	9,355	–	–	9,355
Preference shares	–	–	–	–	–	15,115	68,080	–	–	83,195
Total liabilities	2,335,833	395,228	136,702	139,155	37,544	29,512	92,070	491,397	1,802	3,659,243

Notes on the Financial Statements (continued)

40 Analysis of cash flows payable under financial liabilities by remaining contractual maturities

The group

	On demand HK$m	Due within 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	Total HK$m
At 31 December 2013						
Hong Kong currency notes in circulation	**195,554**	**–**	**–**	**–**	**–**	**195,554**
Items in the course of transmission to other banks	**–**	**34,240**	**–**	**–**	**–**	**34,240**
Deposits by banks	**140,204**	**87,663**	**4,009**	**4,606**	**256**	**236,738**
Customer accounts	**3,167,882**	**846,267**	**212,681**	**39,244**	**181**	**4,266,255**
Trading liabilities	**195,032**	**–**	**–**	**–**	**–**	**195,032**
Financial liabilities designated at fair value	**164**	**22**	**83**	**5,073**	**36,848**	**42,190**
Derivatives	**362,908**	**242**	**666**	**1,536**	**108**	**365,460**
Debt securities in issue	**–**	**12,183**	**7,026**	**31,052**	**5,130**	**55,391**
Amounts due to Group companies	**62,341**	**12,309**	**1,543**	**1,492**	**16,568**	**94,253**
Other financial liabilities	**5,073**	**50,754**	**15,020**	**2,010**	**241**	**73,098**
Subordinated liabilities	**–**	**125**	**375**	**4,345**	**14,233**	**19,078**
Preference shares	**–**	**512**	**607**	**4,477**	**57,070**	**62,666**
	4,129,158	**1,044,317**	**242,010**	**93,835**	**130,635**	**5,639,955**
Loan commitments	**1,177,323**	**501,252**	**8,914**	**14,244**	**–**	**1,701,733**
Financial guarantee and credit risk related guarantee contracts	**83,647**	**–**	**–**	**–**	**–**	**83,647**
	5,390,128	**1,545,569**	**250,924**	**108,079**	**130,635**	**7,425,335**
At 31 December 2012						
Hong Kong currency notes in circulation	176,264	–	–	–	–	176,264
Items in the course of transmission to other banks	–	35,525	–	–	–	35,525
Deposits by banks	128,158	109,010	1,863	4,993	326	244,350
Customer accounts	2,972,878	680,668	215,788	14,444	204	3,883,982
Trading liabilities	183,340	–	–	–	–	183,340
Financial liabilities designated at fair value	141	120	5,525	2,338	36,482	44,606
Derivatives	393,498	186	707	2,622	(13)	397,000
Debt securities in issue	–	9,283	21,817	43,080	5,624	79,804
Amounts due to Group companies	59,786	13,195	12,853	470	11,996	98,300
Other financial liabilities	7,322	49,764	15,123	2,422	120	74,751
Subordinated liabilities	–	475	400	4,919	14,275	20,069
Preference shares	–	950	1,317	9,068	104,973	116,308
	3,921,387	899,176	275,393	84,356	173,987	5,354,299
Loan commitments	1,184,203	380,861	26,529	12,554	–	1,604,147
Financial guarantee and credit risk related guarantee contracts	59,065	–	–	–	–	59,065
	5,164,655	1,280,037	301,922	96,910	173,987	7,017,511

40 Analysis of cash flows payable under financial liabilities by remaining contractual maturities *(continued)*

The Bank

	On demand HK$m	Due within 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	Total HK$m
At 31 December 2013						
Hong Kong currency notes in circulation	**195,554**	**–**	**–**	**–**	**–**	**195,554**
Items in the course of transmission to other banks	**–**	**24,774**	**–**	**–**	**–**	**24,774**
Deposits by banks	**112,686**	**77,490**	**3,909**	**3,054**	**256**	**197,395**
Customer accounts	**2,139,622**	**476,801**	**94,222**	**17,375**	**114**	**2,728,134**
Trading liabilities	**82,623**	**–**	**–**	**–**	**–**	**82,623**
Financial liabilities designated at fair value	**–**	**18**	**72**	**5,017**	**–**	**5,107**
Derivatives	**353,651**	**74**	**354**	**995**	**42**	**355,116**
Debt securities in issue	**–**	**7,399**	**1,782**	**21,089**	**2,048**	**32,318**
Amounts due to Group companies	**85,789**	**52,380**	**1,287**	**2,184**	**16,962**	**158,602**
Other financial liabilities	**3,333**	**29,430**	**7,696**	**1,644**	**90**	**42,193**
Subordinated liabilities	**–**	**81**	**243**	**1,295**	**12,542**	**14,161**
Preference shares	**–**	**512**	**607**	**4,477**	**57,070**	**62,666**
	2,973,258	**668,959**	**110,172**	**57,130**	**89,124**	**3,898,643**
Loan commitments	**710,995**	**420,068**	**3,766**	**10,687**	**–**	**1,145,516**
Financial guarantee and credit risk related guarantee contracts	**41,783**	**–**	**–**	**–**	**–**	**41,783**
	3,726,036	**1,089,027**	**113,938**	**67,817**	**89,124**	**5,085,942**
At 31 December 2012						
Hong Kong currency notes in circulation	176,264	–	–	–	–	176,264
Items in the course of transmission to other banks	–	25,766	–	–	–	25,766
Deposits by banks	104,037	95,133	1,757	3,447	326	204,700
Customer accounts	1,990,783	318,830	103,564	7,095	121	2,420,393
Trading liabilities	82,147	–	–	–	–	82,147
Financial liabilities designated at fair value	–	116	5,513	2,270	–	7,899
Derivatives	390,424	76	515	1,373	(54)	392,334
Debt securities in issue	–	8,428	8,022	24,677	2,194	43,321
Amounts due to Group companies	81,128	43,395	13,164	462	12,115	150,264
Other financial liabilities	3,220	34,111	6,883	2,007	66	46,287
Subordinated liabilities	–	82	246	1,310	12,577	14,215
Preference shares	–	950	1,317	9,068	104,823	116,158
	2,828,003	526,887	140,981	51,709	132,168	3,679,748
Loan commitments	727,721	289,784	7,467	9,065	–	1,034,037
Financial guarantee and credit risk related guarantee contracts	32,317	–	–	–	–	32,317
	3,588,041	816,671	148,448	60,774	132,168	4,746,102

The balances in the above tables will not agree directly with the balances in the consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan commitments and financial guarantee contracts 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 payable under hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under loan commitments and financial guarantee contracts are classified on the basis of the earliest date they can be called.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. In practice, however, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments and guarantee contracts expire without being drawn upon. The group's approach to managing liquidity risk is set out in the Risk Report.

Notes on the Financial Statements (continued)

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

	2013 HK$m	2012 HK$m
Operating profit	**130,336**	89,919
Net interest income	**(87,365)**	(82,419)
Dividend income	**(1,175)**	(522)
Depreciation and amortisation	**5,663**	5,738
Amortisation of prepaid operating lease payments	**18**	18
Loan impairment charges and other credit risk provisions	**3,532**	3,578
Loans and advances written off net of recoveries	**(3,064)**	(4,924)
Other provisions for liabilities and charges	**120**	1,358
Provisions used	**(325)**	(1,362)
Surplus arising on property revaluation	**-**	(2)
Gains on investment properties	**(1,389)**	(834)
Profit on disposal of property, plant and equipment and assets held for sale	**(299)**	(30)
Profit on disposal of subsidiaries, associates and business portfolios	**(758)**	(5,247)
Gains less losses from dilution of investments in associates	**(8,157)**	-
Impairment on interests in associates and joint ventures	**1,378**	395
Gains less losses from financial investments	**(34,512)**	(2,634)
Share-based payments granted cost free	**1,185**	1,751
Movement in present value of in-force business	**(4,735)**	(4,432)
Interest received	**103,050**	101,158
Interest paid	**(27,794)**	(29,909)
Operating profit before changes in working capital	**75,709**	71,600
Change in treasury bills with original term to maturity of more than three months	**(37,399)**	(107,676)
Change in placings with banks maturing after one month	**(33,385)**	13,576
Change in certificates of deposit with original term to maturity of more than three months	**4,920**	(11,498)
Change in trading assets	**187,015**	(29,901)
Change in trading liabilities	**13,521**	13,212
Change in financial assets designated as fair value	**(20,976)**	(12,101)
Change in financial liabilities designated as fair value	**(2,412)**	3,878
Change in derivative assets	**11,118**	(21,677)
Change in derivative liabilities	**(32,849)**	13,958
Change in financial investments held for backing liabilities to long-term policyholders	**(11,721)**	(27,345)
Change in loans and advances to customers	**(246,331)**	(224,461)
Change in amounts due from Group companies	**13,823**	(23,275)
Change in other assets	**(16,518)**	(57,677)
Change in deposits by banks	**(3,296)**	21,553
Change in customer accounts	**168,383**	328,713
Change in amounts due to Group companies	**(14,473)**	(12,944)
Change in debt securities in issue	**(22,313)**	(2,503)
Change in liabilities under insurance contracts issued	**32,385**	38,390
Change in other liabilities	**87,183**	3,723
Exchange adjustments	**6,502**	1,804
Cash generated from/(used in) operations	**158,886**	(20,651)

42 Analysis of cash and cash equivalents

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

	2013 HK$m	2012 HK$m
Balance at 1 January	**707,186**	688,673
Net cash inflow before the effect of foreign exchange movements	**4,147**	19,859
Effect of foreign exchange movements	**(23,737)**	(1,346)
Balance at 31 December	**687,596**	707,186

b *Analysis of balances of cash and cash equivalents in the consolidated balance sheet*

	2013 HK$m	2012 HK$m
Cash in hand and sight balances with central banks	**158,879**	214,104
Items in the course of collection from other banks	**16,346**	23,079
Placings with banks	**460,037**	384,385
Treasury bills	**80,419**	114,937
Certificates of deposit	**4,206**	4,141
Other eligible bills	**1,949**	2,065
Less: items in the course of transmission to other banks	**(34,240)**	(35,525)
	687,596	707,186

c *Acquisition of subsidiaries and businesses*

	2013	
	Private banking businesses HK$m	**Total HK$m**
Assets		
Placing with banks maturing after one month	**2,548**	**2,548**
Trading assets	**86,886**	**86,886**
Derivatives	**1,222**	**1,222**
Loans and advances to customers	**79,401**	**79,401**
Financial investments	**3,225**	**3,225**
Amounts due from Group companies	**4,797**	**4,797**
Goodwill and intangible assets	**88**	**88**
Property, plant and equipment	**17**	**17**
Other assets	**51,615**	**51,615**
Total assets excluding cash and cash equivalents	**229,799**	**229,799**
Liabilities		
Deposits by banks	**392**	**392**
Customer accounts	**230,592**	**230,592**
Derivatives	**1,166**	**1,166**
Retirement benefit liabilities	**8**	**8**
Amounts due to Group companies	**12,274**	**12,274**
Other liabilities and provisions	**1,033**	**1,033**
Current tax liabilities	**56**	**56**
Total liabilities	**245,521**	**245,521**
Aggregate net liabilities at date of acquisition, excluding cash and cash equivalents	**15,722**	**15,722**
Premium on purchase under common control	**(17,514)**	**(17,514)**
Purchase price	**(1,792)**	**(1,792)**
Satisfied by		
Cash and cash equivalents paid	**(19,239)**	**(19,239)**
Cash and cash equivalents bought	**17,447**	**17,447**
Cash consideration paid up to 31 December 2013	**(1,792)**	**(1,792)**
Cash still to be received/(paid) at 31 December 2013	**-**	**-**
Total cash consideration	**(1,792)**	**(1,792)**

Notes on the Financial Statements (continued)

42 Analysis of cash and cash equivalents *(continued)*

d *Disposal of subsidiaries and business*

	2013			
	Banking businesses HK$m	Insurance businesses HK$m	Other HK$m	Total HK$m
Assets				
Short-term funds	8,214	-	-	8,214
Placing with banks maturing after one month	3,674	-	-	3,674
Trading assets	1,648	-	-	1,648
Financial assets designated at fair value	-	309	-	309
Derivatives	333	-	-	333
Loans and advances to customers	5,918	-	-	5,918
Financial investments	1,702	670	-	2,372
Amounts due from Group companies	5,003	-	-	5,003
Interests in associates and joint ventures	-	231	-	231
Goodwill and intangible assets	1	541	-	542
Property, plant and equipment	9	-	-	9
Deferred tax assets	18	-	-	18
Other assets	175	1,636	671	2,482
Total assets excluding cash and cash equivalents	26,695	3,387	671	30,753
Liabilities				
Deposits by banks	4,615	-	-	4,615
Customer accounts	19,107	-	-	19,107
Trading liabilities	1,829	-	-	1,829
Financial liabilities designated at fair value	-	143	-	143
Derivatives	416	-	-	416
Amounts due to Group companies	2,619	-	-	2,619
Liabilities under insurance contracts	-	1,126	-	1,126
Current tax liabilities	42	-	-	42
Other liabilities	1,311	153	19	1,483
Total liabilities	29,939	1,422	19	31,380
Aggregate net assets/(liabilities) at date of disposal, excluding cash and cash equivalents	(3,244)	1,965	652	(627)
Gain/ (loss) on disposal including costs to sell	(2)	763	(3)	758
Add back: costs to sell	-	26	-	26
Selling price	(3,246)	2,754	649	157
Satisfied by				
Cash and cash equivalents received	1,576	2,886	662	5,124
Cash and cash equivalents sold	(4,822)	(132)	-	(4,954)
Cash consideration received/(paid) up to 31 December 2013	(3,246)	2,754	662	170
Cash still to be paid at 31 December 2013	-	-	(13)	(13)
Total cash consideration	(3,246)	2,754	649	157

42 Analysis of cash and cash equivalents *(continued)*

d *Disposal of subsidiaries and business (continued)*

	2012			
	Banking businesses HK$m	Insurance businesses HK$m	Other HK$m	Total HK$m
Assets				
Loans and advances to customers	7,638	1	84	7,723
Other assets	78	3,157	5	3,240
Interests in associates and joint ventures	–	–	1,295	1,295
Total assets excluding cash and cash equivalents	7,716	3,158	1,384	12,258
Liabilities				
Customer accounts	18,830	–	–	18,830
Other liabilities	1,787	332	41	2,160
Liabilities under insurance contracts	–	3,487	–	3,487
Total liabilities	20,617	3,819	41	24,477
Aggregate net assets/(liabilities) at date of disposal, excluding cash and cash equivalents	(12,901)	(661)	1,343	(12,219)
Gain on disposal including costs to sell	1,318	1,239	2,690	5,247
Add back: costs to sell	69	77	18	164
Selling price	(11,514)	655	4,051	(6,808)
Satisfied by				
Cash and cash equivalents received/(paid)	(11,477)	723	4,018	(6,736)
Cash and cash equivalents sold	–	(120)	–	(120)
Cash consideration received/(paid) up to 31 December 2012	(11,477)	603	4,018	(6,856)
Cash still to be received/(paid) at 31 December 2012	(37)	52	33	48
Total cash consideration	(11,514)	655	4,051	(6,808)

43 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	The group		The Bank	
	2013 HK$m	2012 HK$m	**2013 HK$m**	2012 HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**254,147**	225,483	**166,884**	153,546
Other contingent liabilities	**652**	345	**660**	295
	254,799	225,828	**167,544**	153,841
Commitments				
Documentary credits and short-term trade-related transactions	**37,693**	39,902	**27,539**	32,707
Forward asset purchases and forward forward deposits placed	**5,218**	3,000	**2,570**	8
Undrawn formal standby facilities, credit lines and other commitments to lend	**1,658,822**	1,561,277	**1,115,409**	1,001,322
	1,701,733	1,604,179	**1,145,518**	1,034,037

Notes on the Financial Statements (continued)

43 Contingent liabilities and commitments *(continued)*

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. The amount of the loan commitments shown above reflects, where relevant, the expected level of take-up of pre-approved facilities. 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.

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, were as follows:

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Guarantees in favour of third parties				
Financial guarantee contracts[1]	**37,016**	34,735	**21,602**	18,896
Standby letters of credit which are financial guarantee contracts[2]	**43,927**	20,620	**15,231**	9,527
Other direct credit substitutes[3]	**49,230**	42,551	**38,599**	33,719
Performance bonds[4]	**66,388**	64,220	**47,041**	46,674
Bid bonds[4]	**2,728**	2,752	**2,130**	1,615
Standby letters of credit related to particular transactions[4]	**22,363**	20,608	**18,206**	16,007
Other transaction-related guarantees[4]	**23,944**	29,773	**12,454**	15,438
	245,596	215,259	**155,263**	141,876
Guarantees in favour of other HSBC Group entities	**8,551**	10,224	**11,621**	11,670
	254,147	225,483	**166,884**	153,546

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.*

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. Guarantees are subject to HSBC's annual credit review process.

44 Assets pledged as security for liabilities and collateral accepted as security for assets

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Assets pledged to secure liabilities				
Financial assets[1] pledged to secure liabilities	**106,077**	91,466	**79,490**	78,813
Liabilities secured by financial assets	**92,327**	85,789	**67,049**	73,309
Collateral accepted as security for assets				
Fair value of the collateral permitted to sell or repledge in the absence of default[2]	**224,360**	202,321	**200,803**	179,350
Fair value of collateral actually sold or repledged	**35,486**	27,245	**37,725**	11,838

1 *Financial assets comprise treasury bills, debt securities, equities and deposits.*

2 *These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements. The group is obliged to return equivalent securities.*

45 Capital commitments

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**2,440**	4,231	**1,952**	2,446
Expenditure authorised by the Directors but not contracted for	**376**	8	**368**	3
	2,816	4,239	**2,320**	2,449

Capital commitments mainly relate to the commitment for premises and renovation.

46 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:

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**2,931**	2,841	**1,342**	1,325
– five years or less but over one year	**4,761**	4,597	**2,463**	2,213
– over five years	**820**	821	**555**	510
	8,512	8,259	**4,360**	4,048
Equipment				
Amounts payable within				
– one year or less	**64**	92	**8**	6
– five years or less but over one year	**42**	78	**13**	10
	106	170	**21**	16

Notes on the Financial Statements (continued)

47 Offsetting of financial assets and financial liabilities

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

	Gross amounts of recognised financial assets HK$m	Gross amounts set off in the balance sheet HK$m	Amounts presented in the balance sheet HK$m	Amounts not set off in the balance sheet: Financial instruments[1] HK$m	Amounts not set off in the balance sheet: Cash collateral received HK$m	Net amount HK$m
At 31 December 2013						
Derivatives[2]	**423,336**	**(34,609)**	**388,727**	**286,782**	**34,721**	**67,224**
Reverse repurchase, securities borrowing and similar agreements classified as:						
– Trading assets	**8**	**–**	**8**	**–**	**–**	**8**
– Placings with banks	**179,748**	**–**	**179,748**	**158,775**	**95**	**20,878**
– Loans and advances to customers at amortised cost	**60,655**	**–**	**60,655**	**60,324**	**2**	**329**
Other loans and advances held at amortised cost						
– To customers	**15,039**	**(15,039)**	**–**	**–**	**–**	**–**
	678,786	**(49,648)**	**629,138[3]**	**505,881**	**34,818**	**88,439**
At 31 December 2012						
Derivatives[2]	421,656	(22,700)	398,956	324,792	22,505	51,659
Reverse repurchase, securities borrowing and similar agreements classified as:						
– Trading assets	42,516	–	42,516	40,577	–	1,939
– Placings with banks	144,956	–	144,956	136,545	–	8,411
– Loans and advances to customers at amortised cost	16,587	–	16,587	16,557	1	29
Other loans and advances held at amortised cost						
– To customers	–	–	–	–	–	–
	625,715	(22,700)	603,015[3]	518,471	22,506	62,038

1 *Including non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

3 *Amounts presented in the balance sheet includes HK$177,875m (2012: HK$173,327m) which represent balances due from Group companies.*

47 Offsetting of financial assets and financial liabilities *(continued)*

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

	Gross amounts of recognised financial liabilities HK$m	Gross amounts set off in the balance sheet HK$m	Amounts presented in the balance sheet HK$m	Amounts not set off in the balance sheet: Financial instruments[1] HK$m	Amounts not set off in the balance sheet: Cash collateral pledged HK$m	Net amount HK$m
At 31 December 2013						
Derivatives[2]	**399,661**	**(34,609)**	**365,052**	**289,076**	**24,779**	**51,197**
Repurchase, securities lending and similar agreements classified as:						
– Trading liabilities	**470**	**–**	**470**	**411**	–	**59**
– Deposits by banks	**7,741**	**–**	**7,741**	**5,703**	–	**2,038**
– Customer accounts	**24,695**	**–**	**24,695**	**23,474**	–	**1,221**
Other deposits by banks at amortised cost	**2**	**–**	**2**	–	–	**2**
Other customer accounts at amortised cost	**15,039**	**(15,039)**	–	–	–	–
	447,608	**(49,648)**	**397,960**[3]	**318,664**	**24,779**	**54,517**
At 31 December 2012						
Derivatives[2]	419,851	(22,700)	397,151	323,432	15,387	58,332
Repurchase, securities lending and similar agreements classified as:						
– Trading liabilities	15,399	–	15,399	15,356	–	43
– Deposits by banks	11,974	–	11,974	11,970	–	4
– Customer accounts	3,914	–	3,914	3,347	–	567
Other deposits by banks at amortised cost	–	–	–	–	–	–
Other customer accounts at amortised cost	–	–	–	–	–	–
	451,138	(22,700)	428,438[3]	354,105	15,387	58,946

1 *Including non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

3 *Amounts presented in the balance sheet includes HK$122,327m (2012: HK$120,936m) which represent balances due to Group companies.*

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

Derivatives and reverse repurchase/repurchase, stock borrowing/lending and other similar agreements included in amounts not set off in the balance sheet relate to transactions where:

- the counterparty has an offsetting exposure with the group and a master netting or similar arrangement is in place with a right of set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- cash and non-cash collateral received/pledged in respect of the transactions described above.

The group offsets certain loans and advances to customers and customer accounts when the offset criteria are met and the amounts presented above represent this subset of the total amounts recognised in the balance sheet. Of this subset, the loans and advances to customers and customer accounts included in amounts not set off in the balance sheet primarily relate to transactions where the counterparty has an offsetting exposure with the group and an agreement is in place with the right of offset but the offset criteria are otherwise not satisfied.

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 geographical region and by 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 HKFRS. 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 global businesses:

- Retail Banking and Wealth Management offers a broad range of products and services to meet the personal banking, consumer lending and wealth management needs of individual customers. Products typically include current and savings accounts, mortgages and personal loans, credit cards, debit cards, insurance, global asset management services, 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, and online and direct banking offerings;
- Global Banking & Markets provides tailored financial solutions to major government, corporate and institutional clients and private investors worldwide. The client-focused business lines deliver a full range of banking capabilities including financing; advisory and transaction services; a markets business that provides services in credit, rates, foreign exchange, money markets, securities services and principal investment activities; and
- Global Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

48 Segmental analysis *(continued)*

Total assets

	2013		2012	
	HK$m	**%**	HK$m	%
Hong Kong	**4,362,910**	**67.8**	3,944,090	65.0
Rest of Asia-Pacific	**2,611,188**	**40.5**	2,639,425	43.5
Intra region	**(534,743)**	**(8.3)**	(518,188)	(8.5)
	6,439,355	**100.0**	6,065,327	100.0

Total liabilities

	2013		2012	
	HK$m	**%**	HK$m	%
Hong Kong	**4,069,805**	**68.8**	3,736,637	66.8
Rest of Asia-Pacific	**2,382,069**	**40.3**	2,373,800	42.4
Intra region	**(534,743)**	**(9.1)**	(518,188)	(9.2)
	5,917,131	**100.0**	5,592,249	100.0

Interests in associates and joint ventures

	2013		2012	
	HK$m	**%**	HK$m	%
Hong Kong	**2,136**	**2.0**	1,739	1.5
Rest of Asia-Pacific	**105,716**	**98.0**	117,534	98.5
	107,852	**100.0**	119,273	100.0

Credit commitments and contingencies (contract amounts)

	2013		2012	
	HK$m	**%**	HK$m	%
Hong Kong	**975,565**	**49.9**	868,161	47.4
Rest of Asia-Pacific	**980,967**	**50.1**	961,846	52.6
	1,956,532	**100.0**	1,830,007	100.0

Additions to property, plant and equipment and other intangible assets during the year

	2013		2012	
	HK$m	**%**	HK$m	%
Hong Kong	**9,163**	**92.4**	2,103	63.9
Rest of Asia-Pacific	**758**	**7.6**	1,190	36.1
	9,921	**100.0**	3,293	100.0

Notes on the Financial Statements (continued)

48 Segmental analysis *(continued)*

Consolidated income statement

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2013				
Interest income	52,190	67,956	(3,107)	117,039
Interest expense	(6,508)	(26,227)	3,061	(29,674)
Net interest income	45,682	41,729	(46)	87,365
Fee income	33,542	18,094	(1,449)	50,187
Fee expense	(4,748)	(2,965)	1,372	(6,341)
Net trading income	11,156	5,375	46	16,577
Net income from financial instruments designated at fair value	2,008	467	–	2,475
Gains less losses from financial investments	323	119	–	442
Dividend income	1,165	10	–	1,175
Net earned insurance premiums	47,173	6,490	–	53,663
Net gain on reclassification of associates	–	8,157	–	8,157
Gain on sale of Ping An	–	34,070	–	34,070
Other operating income	13,803	2,186	(4,571)	11,418
Total operating income	150,104	113,732	(4,648)	259,188
Net insurance claims incurred and movement in liabilities to policyholders	(50,960)	(5,632)	–	(56,592)
Net operating income before loan impairment charges and other credit risk provisions	99,144	108,100	(4,648)	202,596
Loan impairment charges and other credit risk provisions	(1,032)	(2,500)	–	(3,532)
Net operating income	98,112	105,600	(4,648)	199,064
Operating expenses	(38,845)	(34,531)	4,648	(68,728)
Operating profit	59,267	71,069	–	130,336
Share of profit in associates and joint ventures	524	13,896	–	14,420
Profit before tax	59,791	84,965	–	144,756
Tax expense	(9,659)	(6,042)	–	(15,701)
Profit for the year	50,132	78,923	–	129,055
Profit attributable to shareholders	43,688	75,321	–	119,009
Profit attributable to non-controlling interests	6,444	3,602	–	10,046
Net operating income				
– external	89,322	106,563	–	195,885
– inter-company/inter-segment	8,790	(963)	(4,648)	3,179
Depreciation and amortisation included in operating expenses	(4,271)	(1,392)	–	(5,663)
Restructuring costs	(43)	(619)	–	(662)

48 Segmental analysis *(continued)*

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2012				
Interest income	47,577	71,566	(3,632)	115,511
Interest expense	(7,422)	(29,295)	3,625	(33,092)
Net interest income	40,155	42,271	(7)	82,419
Fee income	28,770	19,126	(1,675)	46,221
Fee expense	(4,100)	(3,906)	1,675	(6,331)
Net trading income	9,892	9,315	7	19,214
Net income from financial instruments designated at fair value	3,799	814	–	4,613
Gains less losses from financial investments	2,510	124	–	2,634
Dividend income	489	33	–	522
Net earned insurance premiums	46,304	6,317	–	52,621
Other operating income	14,991	4,632	(4,286)	15,337
Total operating income	142,810	78,726	(4,286)	217,250
Net insurance claims incurred and movement in liabilities to policyholders	(49,401)	(5,582)	–	(54,983)
Net operating income before loan impairment charges and other credit risk provisions	93,409	73,144	(4,286)	162,267
Loan impairment charges and other credit risk provisions	(603)	(2,975)	–	(3,578)
Net operating income	92,806	70,169	(4,286)	158,689
Operating expenses	(36,947)	(36,109)	4,286	(68,770)
Operating profit	55,859	34,060	–	89,919
Share of profit in associates and joint ventures	640	18,170	–	18,810
Profit before tax	56,499	52,230	–	108,729
Tax expense	(8,051)	(9,959)	–	(18,010)
Profit for the year	48,448	42,271	–	90,719
Profit attributable to shareholders	43,113	39,895	–	83,008
Profit attributable to non-controlling interests	5,335	2,376	–	7,711
Net operating income				
– external	84,627	72,218	–	156,845
– inter-company/inter-segment	8,179	(2,049)	(4,286)	1,844
Depreciation and amortisation included in operating expenses	(4,187)	(1,551)	–	(5,738)
Restructuring costs	(176)	(990)	–	(1,166)

48 Segmental analysis *(continued)*

Net operating income by global business

	Retail Banking and Wealth Management HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Global Private Banking HK$m	Other HK$m	Inter-Segment HK$m	Total HK$m
Year ended 31 December 2013							
External	**52,213**	**38,304**	**62,749**	**362**	**42,257**	**–**	**195,885**
Intercompany/intersegment	**11,585**	**(137)**	**(8,646)**	**286**	**7,205**	**(7,114)**	**3,179**
Year ended 31 December 2012							
External	51,777	37,800	64,408	401	2,459	–	156,845
Intercompany/intersegment	12,636	638	(11,061)	336	5,993	(6,698)	1,844

Information by country

	Net external operating income[1]		Non-current assets[2]	
	2013 HK$m	2012 HK$m	**2013 HK$m**	2012 HK$m
Hong Kong	**89,322**	84,627	**94,525**	82,780
Mainland China	**52,948**	10,941	**112,024**	121,854
Australia	**7,347**	6,952	**1,212**	1,544
India	**7,697**	8,771	**2,152**	2,362
Indonesia	**4,617**	5,069	**4,012**	5,001
Malaysia	**7,025**	7,547	**1,002**	1,109
Singapore	**8,233**	8,876	**1,548**	1,589
Taiwan	**3,311**	3,795	**2,352**	2,487
Vietnam	**2,038**	1,424	**607**	1,401
Other	**13,347**	18,843	**2,625**	3,534
Total	**195,885**	156,845	**222,059**	223,661

1 *Net external operating income is attributable to countries based on the location of the principal operations of the subsidiary or branch.*

2 *Non-current assets consist of property, plant and equipment, goodwill, other intangible assets, interests in associates and joint ventures 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 wholly owned by HSBC Asia Holdings BV. HSBC Asia Holdings BV is in turn wholly owned by HSBC Asia Holdings (UK) Limited, which is wholly owned by HSBC Holdings BV. HSBC Holdings BV is wholly owned by HSBC Finance (Netherlands), which is wholly owned by HSBC Holdings plc (incorporated in England).

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for the benefit of the group's employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

Transactions with the immediate holding company included the redemption of preference shares and the payment of interest on preference shares. As at 31 December 2013, the Bank has issued HK$47,205m of preference shares to its immediate holding company (2012: HK$83,195m). 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 2013, the Bank has issued HK$15,788m of subordinated liabilities to its ultimate holding company (2012: HK$11,905m). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**1,591**	2,386	**305**	277
Other operating income	**–**	–	**274**	243
Other operating expenses	**14**	19	**1,757**	1,394

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 4(b)) and preference shares issued (note 37).

Balances at 31 December

The group

	Immediate holding company		Ultimate holding company	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**498**	191
Amounts due to[2]	**47,862**	84,555	**16,203**	12,285

The Bank

	Immediate holding company		Ultimate holding company	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**491**	151
Amounts due to[2]	**47,862**	84,555	**16,025**	12,122

1 *Amounts due from the ultimate holding company are mainly IT cost recoveries.*

2 *Amounts due to the immediate holding company included preference shares of HK$47,205m (2012: HK$83,195m). Amounts due to the ultimate holding company included subordinated liabilities of HK$15,788m (2012: HK$11,905m).*

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK$370m (2012: HK$326m).

49 Related party transactions *(continued)*

b *Share option and share award schemes*

The group participates in various share option and share plans operated by HSBC whereby share options or shares of HSBC are granted to employees of the group. As disclosed in note 50, 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 share options is treated as a capital contribution and is recorded within 'Other reserves'. In respect of share awards, the group recognises a liability to the ultimate holding company over the vesting period. This liability is measured at the fair value of the shares at each reporting date, with changes since award date adjusted through the capital contribution account within 'Other reserves'. The balances of the capital contribution and the liability as at 31 December 2013 amounted to HK$2,877m and HK$2,303m respectively (2012: HK$2,638m and HK$2,561m respectively).

c *Pension funds*

At 31 December 2013, HK$13.7bn (2012: HK$12.6bn) 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$51m for the year (2012: HK$47m).

d *Subsidiaries and fellow subsidiaries*

The group entered into transactions with its fellow subsidiaries 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 shares the costs of 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 subsidiaries and paid professional fees for services provided by fellow subsidiaries. The commissions and fees in these transactions and services 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	
	2013	2012
	HK$m	HK$m
Interest income	**481**	429
Interest expense	**281**	872
Fee income	**3,232**	2,582
Fee expense	**876**	734
Other operating income	**2,739**	3,022
Other operating expenses[1]	**5,942**	5,843

1 *In 2013 payments were made of HK$946m (2012: HK$920m) for software costs which were capitalised as intangible assets in the balance sheet of the group.*

49 Related party transactions *(continued)*

Balances at 31 December

The group

	Fellow subsidiaries	
	2013	2012
	HK$m	HK$m
Assets		
Trading assets	**4,330**	6,710
Financial assets designated at fair value	**–**	4,966
Other assets	**157,147**	164,136
	161,477	175,812
Liabilities		
Trading liabilities	**10,804**	27,112
Financial liabilities designated at fair value	**1**	2
Other liabilities	**64,241**	57,010
	75,046	84,124
Guarantees	**8,551**	10,224
Commitments	**1,930**	5,051

The Bank

	Subsidiaries		Fellow subsidiaries	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Trading assets	**6,869**	6,537	**4,237**	6,589
Financial assets designated at fair value	**–**	–	**–**	–
Other assets	**219,457**	157,159	**135,835**	151,163
	226,326	163,696	**140,072**	157,752
Liabilities				
Trading liabilities	**9,244**	7,764	**10,733**	11,205
Financial liabilities designated at fair value	**–**	–	**–**	–
Other liabilities	**81,163**	64,856	**38,322**	51,930
	90,407	72,620	**49,055**	63,135
Guarantees	**4,399**	2,441	**7,222**	9,229
Commitments	**34,719**	36,460	**1,563**	3,885

Derivative balances

In addition, the group and the Bank had the following derivative asset and derivative liability balances with other HSBC Group entities:

	The group		The Bank	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
Derivative assets	**88,350**	83,270	**92,296**	87,291
Derivative liabilities	**96,203**	96,442	**98,439**	99,688

49 Related party transactions *(continued)*

e *Associates and joint ventures*

The group provides certain banking and financial services to associates and joint ventures, including loans, overdrafts, interest and non-interest bearing deposits and current accounts. Details of interests in associates and joint ventures are given in note 24. Transactions and balances during the year with associates and joint ventures were as follows:

The group

	2013		2012[1]	
	Highest balance during the year HK$m	**Balance at 31 December HK$m**	Highest balance during the year HK$m	Balance at 31 December HK$m
Amounts due from associates				
– unsubordinated	**41,397**	**35,348**	32,660	27,691
Amounts due from joint ventures				
– subordinated	**6**	**–**	39	6
– unsubordinated	**2**	**1**	787	1
	41,405	**35,349**	33,486	27,698
Amounts due to associates	**9,083**	**2,226**	6,655	2,062
Amounts due to joint ventures	**–**	**–**	1,034	–
	9,083	**2,226**	7,689	2,062
Commitments	**543**	**133**	2,529	349

The Bank

	2013		2012[1]	
	Highest balance during the year HK$m	**Balance at 31 December HK$m**	Highest balance during the year HK$m	Balance at 31 December HK$m
Amounts due from associates				
– unsubordinated	**19,222**	**18,999**	11,052	8,204
Amounts due from joint ventures				
– unsubordinated	**2**	**1**	787	1
	19,224	**19,000**	11,839	8,205
Amounts due to associates	**1,929**	**1,929**	1,256	739
Amounts due to joint ventures	**–**	**–**	1,032	–
	1,929	**1,929**	2,288	739
Commitments	**251**	**10**	2,164	225

1 *The prior year figures in the tables above have been adjusted to conform with the current year's presentation.*

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 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.

49 Related party transactions *(continued)*

f *Key Management Personnel*

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and the group. It includes members of the Board of Directors and Executive Committee of the Bank and the Board of Directors and Group Managing Directors of HSBC Holdings plc.

The following table shows the expense in respect of compensation for Key Management Personnel of the Bank for services rendered to the Bank:

	2013 HK$m	2012 HK$m
Salaries and other short term benefits	**200**	235
Retirement benefits		
– Defined contribution plans	**5**	11
– Defined benefit plans	**3**	1
Termination benefits	**3**	14
Share-based payments	**102**	83
	313	344

Transactions, arrangements and agreements involving Key Management Personnel

Transactions, arrangements and agreements are entered into by the group with companies that may be controlled by Key Management Personnel of the group and their immediate relatives. These transactions are primarily loans and deposits:

	2013 HK$m	2012 HK$m
During the year		
Highest average assets[1]	**27,428**	32,044
Highest average liabilities[1]	**30,281**	36,208
Contribution to the group's profit before tax	**808**	775
At the year end		
Guarantees	**6,721**	4,034
Commitments	**2,622**	7,698

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

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 or companies 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.

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.

No impairment losses have been recorded against balances outstanding during the year with Key Management Personnel, and there are no specific impairment allowances on balances with Key Management Personnel at the year end.

49 Related party transactions *(continued)*

g *Loans to officers*

Officers are defined as the Board of Directors, Executive Committee members and the Secretary of the Bank and the Boards of Directors of the ultimate holding company, HSBC Holdings plc, and intermediate holding companies. Particulars of loans to officers disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	Aggregate amount of loans outstanding at 31 December		Maximum aggregate amount of loans outstanding during the year	
	2013	2012	**2013**	2012
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**272**	80	**286**	101
By subsidiaries	**8**	10	**11**	13
	280	90	**297**	114

50 Share-based payments

a *Income statement charge*

	2013	2012
	HK$m	HK$m
Restricted share awards	**1,090**	1,497
Savings-related share awards option plans[1]	**160**	256
	1,250	1,753
Equity-settled share-based payments	**1,185**	1,751
Cash-settled share-based payments	**65**	2

1 *Includes HK$8m relating to the HSBC International Employee Share Purchase Plan. This new broad-based employee plan was launched in Hong Kong in September 2013.*

The above charge was computed from the fair values of the share-based payment transaction when contracted, that arose under employee share awards made in accordance with HSBC's reward structures.

50 Share-based payments *(continued)*

b *HSBC Share Award and Option Plans*

Award	Policy	Purpose
Restricted share awards (including Group Performance Share Plan)	· Vesting of awards generally subject to continued employment with HSBC. · Vesting often staggered over three years. GPSP awards vest after five years. · Certain shares subject to a retention requirement post-vesting. In the case of GPSP awards retention applies until cessation of employment. · Awards generally not subject to performance conditions. · Awards granted from 2010 onwards are subject to clawback provision prior to vesting.	· Rewards employee performance, potential and retention of key employees. · To defer variable pay.
Savings-related share award plan ('HSBC International Employee Share Purchase Plan')	· A new broad-based employee plan which was offered to eligible employees in Hong Kong in September 2013. · Eligible employees make contributions up to the local equivalent of £250 per month which are applied in the purchase of shares on a quarterly basis. For every three shares purchased, the employee is granted a matching award by HSBC of one share. · The matching award vests subject to continued employment with HSBC and retention of the purchased shares in the plan until the third anniversary of the start of the relevant plan year.	· To align the interests of all employees with the creation of shareholder value.
Savings-related share option plans	· Eligible employees save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or Euros), with the option to use the savings to acquire shares. · Exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively. · The exercise price is set at a 20% (2012: 20%) discount to the market value immediately preceding the date of invitation (except for the one-year options granted under the US sub-plan where a 15% discount is applied).	· To align the interests of all employees with the creation of shareholder value.
Executive Share Option Scheme ('ESOS') and Group Share Option Plan ('GSOP')	· Plan ceased in May 2005. · Exercisable between third and tenth anniversaries of the date of grant.	· Long-term incentive plan between 2000 and 2005 during which certain HSBC employees were awarded share options. · To align the interests of those higher performing employees with the creation of shareholder value.

Calculation of fair values

The fair values of share options at the date of grant of the options are calculated using a Black-Scholes model. The fair value of a share award is based on the share price at the date of the grant. When modelling options/awards with vesting dependent on HSBC's Total Shareholder Return ('TSR') over a period, the TSR performance targets are incorporated into the model using Monte Carlo simulation. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

c *Movement on HSBC share awards*

The group	Restricted share awards	
	2013 Number (000s)	2012 Number (000s)
Outstanding at 1 January	**36,040**	50,225
Additions during the year	**9,481**	17,450
Released in the year	**(20,672)**	(30,929)
Transferred in the year	**2,949**	690
Lapsed in the year	**(2,429)**	(1,396)
Outstanding at 31 December	**25,369**	36,040
Weighted average remaining vesting period (years)	**0.76**	0.75

d *HSBC Share Option Plans*

Significant weighted average assumptions used to estimate the fair value of options granted

	1-year Savings-Related Share Option Schemes	**3-year Savings-Related Share Option Schemes**	**5-year Savings-Related Share Option Schemes**
2013			
Risk-free interest rate[1] (%)	**–**	**0.9**	**1.7**
Expected life[2] (years)	**–**	**3**	**5**
Expected volatility[3] (%)	**–**	**20**	**20**
Share price at grant date (£)	**–**	**6.89**	**6.89**
2012			
Risk-free interest rate[1] (%)	0.4	0.6	1.2
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	25	25	25
Share price at grant date (£)	5.54	5.54	5.54

1 *The risk-free rate was determined from the UK gilts yield curve. A similar yield curve was used for the International Savings-Related Share Option Plans.*

2 *The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historical observable data and is not a single input parameter but a function of various behavioural assumptions.*

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

The expected US dollar denominated dividend yield was determined to be 4.5% per annum in line with consensus analyst forecasts (2012: 5%) which vested in subsequent years.

50 Share-based payments *(continued)*

Movement on HSBC share option plan

The group

	ESOS and GSOP		Savings-related option scheme with exercise price set in GBP		Savings-related option scheme with exercise price set in HK$	
	Number (000s)	**WAEP[1] £**	**Number (000s)**	**WAEP[1] £**	**Number (000s)**	**WAEP[1] HK$**
2013						
Outstanding at 1 January	**11,203**	**6.83**	**9,058**	**4.08**	**30,532**	**45.54**
Granted during the year	**–**	**–**	**18**	**5.47**	**–**	**–**
Forfeited/expired in the year	**(1,831)**	**6.18**	**(952)**	**4.25**	**(1,332)**	**50.17**
Exercised during the year	**(2,297)**	**6.16**	**(2,894)**	**4.44**	**(5,751)**	**53.95**
Transferred in the year	**183**	**7.25**	**239**	**4.16**	**440**	**46.59**
Outstanding at 31 December	**7,258**	**7.22**	**5,469**	**3.88**	**23,889**	**43.27**
Exercisable at 31 December	**7,258**	**7.22**	**109**	**5.57**	**103**	**66.82**
At 31 December 2013						
Weighted average fair value of options granted during the year		**–**		**1.20**		**–**
Weighted average share price at the date the options were exercised		**7.06**		**7.05**		**85.03**
Weighted average remaining contractual life (years)		**0.34**		**0.98**		**0.90**
Exercise price range		**7.22 – 7.54**		**3.31 – 5.94**		**37.88 – 92.59**
2012						
Outstanding at 1 January	15,554	6.95	14,587	3.93	43,733	53.06
Granted during the year	–	–	4,270	4.46	11,481	55.47
Forfeited/expired in the year	(4,222)	7.29	(2,864)	4.82	(4,134)	54.99
Exercised during the year	(48)	6.02	(6,876)	3.68	(20,449)	39.90
Transferred in the year	(81)	6.41	(59)	3.89	(99)	53.59
Outstanding at 31 December	11,203	6.83	9,058	4.08	30,532	45.54
Exercisable at 31 December	11,203	6.83	586	3.59	820	40.10
At 31 December 2012						
Weighted average fair value of options granted during the year		–		1.01		12.74
Weighted average share price at the date the options were exercised		6.08		5.57		67.85
Weighted average remaining contractual life (years)		1.00		1.40		1.60
Exercise price range		6.02 - 7.54		3.31 - 6.18		37.88 - 94.51

1 *Weighted Average Exercise Price.*

During the year, no options were granted for schemes with option prices set in euros and US dollars.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described on pages 90 to 91 and 98 to 99. The fair value of financial instruments is generally measured on the basis of the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the HKFRS offsetting criteria as described on page 103.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following table sets out the financial instruments carried at fair value.

Financial instruments carried at fair value and bases of valuation

The group

		Valuation techniques				
	Quoted market price Level 1 HK$m	Using observable inputs Level 2 HK$m	With significant unobservable inputs Level 3 HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2013						
Assets						
Trading assets[2]	**145,520**	**165,216**	**664**	**311,400**	**–**	**311,400**
Financial assets designated at fair value	**63,781**	**25,012**	**1,353**	**90,146**	**–**	**90,146**
Derivatives	**14,295**	**284,970**	**1,112**	**300,377**	**88,350**	**388,727**
Available-for-sale investments[1]	**739,792**	**449,296**	**11,218**	**1,200,306**	**–**	**1,200,306**
Assets held for sale	**–**	**–**	**4,295**	**4,295**	**–**	**4,295**
Liabilities						
Trading liabilities[2]	**53,138**	**124,065**	**17,829**	**195,032**	**–**	**195,032**
Financial liabilities designated at fair value	**–**	**41,715**	**–**	**41,715**	**–**	**41,715**
Derivatives	**15,125**	**252,279**	**1,445**	**268,849**	**96,203**	**365,052**
At 31 December 2012						
Assets						
Trading assets	219,233	200,232	232	419,697	–	419,697
Financial assets designated at fair value	46,122	21,808	1,549	69,479	–	69,479
Derivatives	5,049	309,812	825	315,686	83,270	398,956
Available-for-sale investments[1]	680,145	398,349	11,712	1,090,206	–	1,090,206
Assets held for sale	39,813	–	3,878	43,691	–	43,691
Liabilities						
Trading liabilities	62,723	109,526	11,091	183,340	–	183,340
Financial liabilities designated at fair value	–	44,270	–	44,270	–	44,270
Derivatives	6,951	290,099	3,659	300,709	96,442	397,151

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 10.*

2 *Amounts with HSBC Group entities are not reflected here.*

51 Fair value of financial instruments carried at fair value *(continued)*

The Bank

	Valuation techniques					
	Quoted market price Level 1 HK$m	Using observable inputs Level 2 HK$m	With significant unobservable inputs Level 3 HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2013						
Assets						
Trading assets[2]	**121,136**	**113,880**	**583**	**235,599**	**–**	**235,599**
Financial assets designated at fair value	**–**	**1,561**	**–**	**1,561**	**–**	**1,561**
Derivatives	**13,809**	**270,543**	**534**	**284,886**	**92,297**	**377,183**
Available-for-sale investment[1]	**582,340**	**169,370**	**6,873**	**758,583**	**–**	**758,583**
Asset held for sale	**–**	**–**	**4,295**	**4,295**	**–**	**4,295**
Liabilities						
Trading liabilities[2]	**28,348**	**49,140**	**5,135**	**82,623**	**–**	**82,623**
Financial liabilities designated at fair value	**–**	**4,759**	**–**	**4,759**	**–**	**4,759**
Derivatives	**15,010**	**240,233**	**1,013**	**256,256**	**98,439**	**354,695**
At 31 December 2012						
Assets						
Trading assets	174,057	110,353	163	284,573	–	284,573
Financial assets designated at fair value	–	1,432	–	1,432	–	1,432
Derivatives	4,653	299,456	439	304,548	87,291	391,839
Available-for-sale investments[1]	528,194	164,010	7,608	699,812	–	699,812
Assets held for sale	39,813	–	3,878	43,691	–	43,691
Liabilities						
Trading liabilities	40,295	37,994	3,857	82,146	–	82,146
Financial liabilities designated at fair value	–	7,731	–	7,731	–	7,731
Derivatives	6,795	282,067	3,534	292,396	99,688	392,084

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 10.*

2 *Amounts with HSBC Group entities are not reflected here.*

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period. Transfers from Level 1 to Level 2 reflect the reclassification of settlement balances.

51 Fair value of financial instruments carried at fair value *(continued)*

Control framework

Fair values are subject to a control framework that aims to ensure that they are either determined, or validated, by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is used. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an on-going basis.

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.

Determination of fair value of financial instruments carried at fair value

Fair values are determined according to the following hierarchy:

(a) Level 1 – Quoted market price

Financial instruments with quoted prices for identical instruments in active markets that the group can access at the measurement date.

(b) Level 2 – Valuation technique using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(c) Level 3 – Valuation technique with significant unobservable inputs

Financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities used. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price and no block discounts are applied. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

51 Fair value of financial instruments carried at fair value *(continued)*

Valuation techniques

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations. A range of valuation techniques is employed, dependent upon the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analysis, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to consideration of credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. Projection uses market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the values of some products are dependent upon more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may impact the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, the group uses a discounting curve that reflects the overnight interest rate ('OIS discounting').

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit ('day 1 gain or loss') or greater than 5% of the instrument's carrying value is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

Changes in fair value are generally subject to a profit and loss analysis process. This process disaggregates changes in fair value into three high level categories: (i) portfolio changes, such as new transactions or maturing transactions: (ii) market movements, such as changes in foreign exchange rates or equity prices: and (iii) other, such as changes in fair value adjustments, discussed below.

51 Fair value of financial instruments carried at fair value *(continued)*

Fair value adjustments

Fair value adjustments are adopted when the group considers that there are additional factors that would be considered relevant by a market participant that are not incorporated within the valuation model. The group classifies fair value adjustments as either 'risk-related' or 'model-related'. The majority of these adjustments relate to Global Banking and Markets.

Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.

Risk-related adjustments

(i) Bid-offer

HKFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer cost would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the position.

(ii) Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

(iii)Credit valuation adjustment

The credit valuation adjustment is an adjustment to the valuation of over-the-counter derivative contracts to reflect within fair value the possibility that the counterparty may default and the group may not receive the full market value of the transactions. Further detail is provided below.

(iv)Debit valuation adjustment

The debit valuation adjustment is an adjustment to the valuation of over-the-counter derivative contracts to reflect within fair value the possibility that the group may default, and that the group may not pay full market value of the transactions.

Model-related adjustments

(i) Model limitation

Models used for portfolio valuation purposes may be based upon a simplifying set of assumptions that do not capture all material market characteristics. Additionally, markets evolve, and models that were adequate in the past may require development to capture all material market characteristics in current market conditions. In these circumstances, model limitation adjustments are adopted. As model development progresses, model limitations are addressed within the valuation models and a model limitation adjustment is no longer needed.

(ii) Inception profit (Day 1 profit or loss reserves)

Inception profit adjustments are adopted where the fair value estimated by a valuation model is based on one or more significant unobservable inputs. The accounting for inception profit adjustments is discussed in note 3(i). An analysis of the movement in the deferred Day 1 profit or loss reserve is provided in note 17(c).

51 Fair value of financial instruments carried at fair value *(continued)*

Credit valuation adjustment/ debit valuation adjustment methodology

The group calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each group legal entity and, within each entity, for each counterparty to which the entity has exposure.

The group calculates the CVA by applying the probability of default ('PD') of the counterparty, conditional on the non-default of the group, to the expected positive exposure of the group to the counterparty and multiplying the result by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the PD of the group, conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the group, and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

For most products, the group uses a simulation methodology to calculate the expected positive exposure to a counterparty. This incorporates a range of potential exposures across the portfolio of transactions with the counterparty over the life of the portfolio. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default ('LGD') assumption of 60% is generally adopted for developed market exposures, and 75% for emerging market exposures. Alternative loss given default assumptions may be adopted where both the nature of the exposure and the available data support this.

For certain types of exotic derivatives, where the products are not currently supported by the simulation, or for derivative exposures in smaller trading locations, where the simulation tool is not yet available, the group adopts alternative methodologies. These may involve mapping to the results for similar products from the simulation tool or, where the mapping approach is not appropriate, using a simplified methodology, which generally follows the same principles as the simulation methodology. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than is used in the simulation methodology.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises when the underlying value of the derivative prior to any CVA is positively correlated to the probability of default by the counterparty. When there is significant wrong-way risk, a trade-specific approach is applied to reflect the wrong-way risk within the valuation.

With the exception of certain central clearing parties, the group includes all third-party counterparties in the CVA and DVA calculations and does not net these adjustments across the group entities. During the year, the group refined the methodologies used to calculate the CVA and DVA to more accurately reflect credit mitigation. The group reviews and refines the CVA and DVA methodologies on an ongoing basis.

Valuation of uncollateralised derivatives

The group values uncollateralised derivatives by discounting expected future cash flows at a benchmark interest rate, typically Libor or its equivalent. This approach has historically been adopted across the industry, and has therefore been an appropriate basis for fair value. The group, and other industry participants, are currently considering whether this approach appropriately reflects the manner in which the derivatives are funded, which may occur at rates other than interbank offer rates. No consensus has yet emerged on how such funding should be reflected in the fair value measurement for uncollateralised derivatives. In the future, and possibly in 2014, the group may adopt a 'funding fair value adjustment' to reflect funding of uncollateralised derivatives at rates other than interbank offer rates.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments carried at fair value *(continued)*

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

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

The 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	Assets held for sale HK\$m	Held for trading HK\$m	Derivatives HK\$m
At 1 January 2013	**11,712**	**232**	**1,549**	**825**	**3,878**	**11,091**	**3,659**
Total gains or losses recognised in profit or loss							
– Trading income excluding net interest income	–	37	–	653	–	(802)	3,996
– Net income from other financial instruments designated at fair value	–	–	65	–	–	–	–
– Gains less losses from financial investments	134	–	–	–	–	–	–
Total gains or losses recognised in other comprehensive income							
– Available-for-sale investments: fair value gains	1,304	–	–	–	–	–	–
– Exchange differences	(9)	–	–	(5)	–	(255)	(1)
Purchases	557	854	402	–	–	–	–
Issues	–	–	–	–	–	7,114	–
Sales	(33)	(248)	(35)	–	–	–	–
Deposits/settlements	(2,704)	(31)	(209)	(65)	–	2,883	(5,839)
Transfers out	(4,295)	(195)	(530)	(616)	(3,878)	(2,273)	(426)
Transfers in	4,552	15	111	320	4,295	71	56
At 31 December 2013	**11,218**	**664**	**1,353**	**1,112**	**4,295**	**17,829**	**1,445**
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]							
– Trading income excluding net interest income	–	93	–	583	–	18	(279)
– Net income/(expense) from other financial instruments designated at fair value	–	–	65	–	–	–	–

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

51 Fair value of financial instruments carried at fair value *(continued)*

The 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	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2012	17,085	1,230	3,481	1,408	–	14,514	1,045
Total gains or losses recognised in profit or loss	(169)	28	80	227	–	669	3,080
Total gains or losses recognised in other comprehensive income	467	32	(3)	8	–	238	(5)
Purchases	419	104	760	–	–	–	–
Issues	–	–	–	–	–	2,195	–
Sales	(37)	(689)	(303)	–	–	–	–
Deposits/settlements	(982)	(355)	(190)	(24)	–	(1,756)	(124)
Transfers out	(5,071)	(163)	(2,662)	(811)	–	(5,083)	(492)
Transfers in	–	45	386	17	3,878	314	155
At 31 December 2012	11,712	232	1,549	825	3,878	11,091	3,659
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	25	25	71	220	–	(42)	(2,893)

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

Notes on the Financial Statements (continued)

51 Fair value of financial instruments carried at fair value *(continued)*

The 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	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2013	**7,608**	**163**	**–**	**439**	**3,878**	**3,857**	**3,534**
Total gains or losses recognised in profit or loss							
– Trading income excluding net interest income	–	37	–	51	–	(420)	3,347
– Net income from other financial instruments designated at fair value	–	–	–	–	–	–	–
– Gains less losses from financial investments	8	–	–	–	–	–	–
Total gains or losses recognised in other comprehensive income							
– Available-for-sale investments: fair value gains	1,109	–	–	–	–	–	–
– Exchange differences	25	–	–	(5)	–	15	(5)
Purchases	390	835	–	–	–	–	–
Issues	–	–	–	–	–	6,168	–
Sales	(19)	(248)	–	–	–	–	–
Deposits/settlements	(1,892)	(24)	–	2	–	(3,639)	(5,836)
Transfers out	(4,295)	(195)	–	(273)	(3,878)	(846)	(83)
Transfers in	3,939	15	–	320	4,295	–	56
At 31 December 2013	**6,873**	**583**	**–**	**534**	**4,295**	**5,135**	**1,013**
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]							
– Trading income excluding net interest income	–	93	–	132	–	9	34
– Net income/(expense) from other financial instruments designated at fair value	–	–	–	–	–	–	–

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

51 Fair value of financial instruments carried at fair value *(continued)*

The Bank

	Asset					Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2012	12,773	1,164	–	1,131	–	6,240	933
Total gains or losses recognised in profit or loss	–	25	–	(87)	–	546	2,942
Total gains or losses recognised in other comprehensive income	662	32	–	5	–	95	(5)
Purchases	6	104	–	–	–	–	–
Issues	–	–	–	–	–	1,970	–
Sales	–	(689)	–	–	–	–	–
Deposits/settlements	(954)	(355)	–	(31)	–	(2,117)	(117)
Transfers out	(4,879)	(163)	–	(596)	–	(3,018)	(374)
Transfers in	–	45	–	17	3,878	141	155
At 31 December 2012	7,608	163	–	439	3,878	3,857	3,534
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	131	16	–	(25)	–	(47)	(2,788)

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

Some investments in unlisted equity shares were transferred to and out of assets held for sale during the year.

Transfers out of level 3 held for trading liabilities predominantly resulted from an increase in the observability of inputs such as correlations in pricing the instruments.

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/(expense) from financial instruments designated at fair value’.

Realised gains and losses from available-for-sale securities are presented under ‘Gains less losses from financial investments’ 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.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments carried at fair value *(continued)*

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

As discussed above, the fair values 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:

Sensitivity of fair values to reasonably possible alternative assumptions

The group

	Reflected in income statement		Reflected in other comprehensive income	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable changes HK$m
At 31 December 2013				
Derivatives/trading assets/trading liabilities	**287**	**(281)**	**–**	**–**
Financial assets/liabilities designated at fair value	**135**	**(135)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**827**	**(1,186)**
At 31 December 2012				
Derivatives/trading assets/trading liabilities	665	(642)	–	–
Financial assets/liabilities designated at fair value	155	(155)	–	–
Financial investments: available-for-sale	–	–	1,171	(1,171)

The Bank

	Reflected in income statement		Reflected in other comprehensive income	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable Changes HK$m
At 31 December 2013				
Derivatives/trading assets/trading liabilities	**239**	**(233)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**669**	**(692)**
At 31 December 2012				
Derivatives/trading assets/trading liabilities	587	(563)	–	–
Financial investments: available-for-sale	–	–	761	(761)

Favourable and unfavourable changes are determined on the basis of sensitivity analysis. The sensitivity analysis aims to measure a range of fair values consistent with the application of a 95% confidence interval. Methodologies take account of the nature of the valuation technique employed, as well as the availability and reliability of observable proxy and historical data. When the available data is not amenable to statistical analysis, the quantification of uncertainty is judgemental, but remains guided by the 95% confidence interval.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or the most unfavourable change from varying the assumptions individually.

51 Fair value of financial instruments carried at fair value *(continued)*

Quantitative information about significant unobservable inputs in Level 3 valuations

The group

At 31 December 2013 **Valuation technique**	**Key unobservable inputs**	**Assets- fair value HK$m**	**Liabilities- fair value HK$m**	**Range of inputs Lower**	**Higher**
Structured notes and deposits					
Option model	Equity correlation	–	**8,155**	**0.51**	**0.59**
Option model	Equity volatility	–	**4,783**	**7%**	**73%**
Option model	Fund volatility	–	**1,568**	**7%**	**73%**
Option model	Foreign exchange volatility	–	**2,200**	**2%**	**25%**
Corporate bonds					
Market comparable approach	Bid quotes	**3,797**	–	**100.05**	**100.62**
Private equity including strategic investments					
Market comparable approach	Equity spot	**2,775**	–	**n/a**	**n/a**
Net asset value	Equity spot	**686**	–	**n/a**	**n/a**
Net asset value	Fund valuation	**4,441**	–	**n/a**	**n/a**
Other		**6,943**	**2,568**		
		18,642	**19,274**		

The Bank

At 31 December 2013 **Valuation technique**	**Key unobservable inputs**	**Assets- fair value HK$m**	**Liabilities- fair value HK$m**	**Range of inputs Lower**	**Higher**
Structured notes and deposits					
Option model	Equity correlation	–	**776**	**0.51**	**0.59**
Option model	Equity volatility	–	**3,269**	**7%**	**73%**
Option model	Foreign exchange volatility	–	**77**	**3%**	**11%**
Corporate bonds					
Market comparable approach	Bid quotes	**3,797**	–	**100.05**	**100.62**
Private equity including strategic investments					
Market comparable approach	Equity spot	**2,434**	–	**n/a**	**n/a**
Net asset value	Equity spot	**111**	–	**n/a**	**n/a**
Net asset value	Fund valuation	**189**	–	**n/a**	**n/a**
Other		**5,754**	**2,026**		
		12,285	**6,148**		

Key unobservable inputs to Level 3 financial instruments

The table above lists key unobservable inputs to Level 3 financial instruments, and provides the range of those inputs as at 31 December 2013. A further description of the categories of key unobservable inputs is given below.

51 Fair value of financial instruments carried at fair value *(continued)*

Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that the group may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of the group's long option positions (i.e. the positions in which the group has purchased options), while the group's short option positions (i.e. the positions in which the group has sold options) will suffer losses.

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels. For example, while it is generally the case that foreign exchange volatilities are lower than equity volatilities, there may be examples in particular currency pairs or for particular equities where this is not the case.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data. For example, longer-dated volatilities may be extrapolated from shorter-dated volatilities.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference to market price. For example, foreign exchange volatilities for a pegged currency may be very low, whereas for non-managed currencies the foreign exchange volatility may be higher. As a further example, volatilities for deep-in-the money or deep-out-of-the-money equity options may be significantly higher than at-the-money options. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. For example, an equity basket option has a payout that is dependent upon the performance of a basket of single stocks, and the correlation between the price movements of those stocks will be an input to the valuation. This is referred to as equity-equity correlation. There is a wide range of instruments for which correlation is an input, and consequently a wide range of both same-asset correlations (e.g. equity-equity correlation) and cross-asset correlations (e.g. foreign exchange rate-interest rate correlation) used. In general, the range of same-asset correlations will be narrower than the range of cross-asset correlations.

Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, the group trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

51 Fair value of financial instruments carried at fair value *(continued)*

Private equity including strategic investments

The group's private equity and strategic investments are generally classified as available-for-sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. Given the bespoke nature of the analysis in respect of each holding, it is not practical to quote a range of key unobservable inputs.

Inter-relationships between key unobservable inputs

Key unobservable inputs to Level 3 financial instruments may not be independent of each other. As described above, market variables may be correlated. This correlation typically reflects the manner in which different markets tend to react to macro-economic or other events. For example, improving economic conditions may lead to a 'risk on' market, in which prices of risky assets such as equities and high yield bonds will rise, while 'safe haven' assets such as gold and US Treasuries decline. Furthermore, the impact of changing market variables upon the group portfolio will depend upon the group's net risk position in respect of each variable. For example, increasing high-yield bond prices will benefit long high-yield bond positions, but the value of any credit derivative protection held against those bonds will fall.

52 Fair values of financial instruments not carried at fair value

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 3. Fair values are determined according to the hierarchy set out in Note 51.

Fair values of financial instruments which are not carried at fair value and bases of valuation

The group

	At 31 December 2013					At 31 December 2012	
		Fair values					
			Valuation techniques				
	Carrying amount HK$m	**Quoted market price Level 1 HK$m**	**Using observable inputs Level 2 HK$m**	**With significant unobservable inputs Level 3 HK$m**	**Total HK$m**	Carrying amount HK$m	Fair value HK$m
Assets							
Placings with banks	**665,112**	**–**	**633,552**	**31,475**	**665,027**	546,908	548,115
Loans and advances to customers	**2,669,238**	**–**	**55,158**	**2,600,408**	**2,655,566**	2,349,043	2,335,254
Debt securities	**179,465**	**4,222**	**175,852**	**41**	**180,115**	163,819	176,172
Liabilities							
Deposits by banks	**236,616**	**–**	**236,616**	**–**	**236,616**	244,135	244,136
Customer accounts	**4,254,752**	**–**	**4,254,401**	**–**	**4,254,401**	3,874,884	3,875,259
Debt securities in issue	**52,334**	**1,291**	**49,969**	**1,192**	**52,452**	74,647	74,854
Subordinated liabilities	**13,107**	**–**	**2,452**	**9,834**	**12,286**	13,867	12,497
Preference shares	**47,314**	**–**	**–**	**41,500**	**41,500**	83,346	73,762

The Bank

	At 31 December 2013					At 31 December 2012	
		Fair values					
			Valuation techniques				
	Carrying amount HK$m	**Quoted market price Level 1 HK$m**	**Using observable inputs Level 2 HK$m**	**With significant unobservable inputs Level 3 HK$m**	**Total HK$m**	Carrying amount HK$m	Fair value HK$m
Assets							
Placings with banks	**318,178**	**–**	**301,596**	**16,824**	**318,420**	246,104	246,718
Loans and advances to customers	**1,503,251**	**–**	**22,156**	**1,473,508**	**1,495,664**	1,282,720	1,274,154
Debt securities	**–**	**–**	**–**	**–**	**–**	–	–
Liabilities							
Deposits by banks	**197,283**	**–**	**197,282**	**–**	**197,282**	204,520	204,520
Customer accounts	**2,724,015**	**–**	**2,724,046**	**–**	**2,724,046**	2,417,400	2,417,576
Debt securities in issue	**30,062**	**–**	**30,149**	**1**	**30,150**	40,406	40,552
Subordinated liabilities	**9,346**	**–**	**–**	**8,448**	**8,448**	9,355	7,894
Preference shares	**47,205**	**–**	**–**	**41,391**	**41,391**	83,195	73,611

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 re-price to current market rates frequently:

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission to other banks
Hong Kong Government certificates of indebtedness	Hong Kong currency notes in circulation
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	Investment contracts with discretionary participation features within 'Liabilities under insurance contracts'

52 Fair values of financial instruments not carried at fair value *(continued)*

Valuation

The fair values of financial instruments that are not carried at fair value on the balance sheet are calculated as described below.

The calculation of fair value incorporates the group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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.

Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which the group believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors.

The fair value of a loan reflects loan impairments at the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

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 the prices and future earnings streams of equivalent quoted securities.

Deposits by banks and customer accounts

For the purpose of estimating fair value, deposits by banks and customer accounts are grouped by remaining contractual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is approximated by its carrying value.

Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

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

53 Structured entities

The group enters into certain transactions with customers in the ordinary course of business which involve the use of structured entities ('SEs') to facilitate or secure customer transactions. Some of these structures are complex or non-transparent. The group's arrangements that involve SEs are authorised centrally prior to being established to ensure appropriate purpose and governance. The activities of SEs administered by the group are closely monitored by senior management. The group has involvement with both consolidated and unconsolidated SEs, which may be established by the group or by a third party. Structured entities are assessed for consolidation in accordance with the accounting policy set out in note 1c.

The group's transactions with consolidated and unconsolidated SEs are set out below.

Structured credit transactions

The group provides structured credit products to third-party professional and institutional investors who wish to obtain exposure to a reference portfolio of debt instruments.

In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SEs. The group enters into contracts with the SE, including derivatives, in order to pass the required risks and rewards of the reference portfolios to the SEs.

In certain transactions the group is exposed to risk often referred to as gap risk. Gap risk typically arises in transactions where the aggregate potential claims against the SE by the group pursuant to one or more derivatives could be greater than the value of the collateral held by the SE and securing such derivatives. The group often mitigates such gap risk by ensuring high quality collateral, hedging the risk, or incorporating features allowing managed liquidation of the portfolio.

Securitisations by the group

The group uses SEs to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and for capital efficiency purposes. The loans and advances are transferred by the group to the SEs for cash, and the SEs issue debt securities to investors to fund the cash purchases. The group may also act as a derivative counterparty or provide a guarantee. Credit enhancements to the underlying assets may be provided to obtain investment grade ratings on the senior debt issued by the SEs.

The group's exposure is the aggregate of any holdings of notes issued by these vehicles, the reserve account positions intended to provide credit support under certain pre-defined circumstances to senior note holders and any derivatives or guarantees provided. Off balance sheet financial guarantees are disclosed in note 43(b).

Third-party financing SEs

The group also transacts with third party SEs in the normal course of business for a number of purposes, for example, to provide finance to public and private sector infrastructure projects, for asset and structured finance transactions and for customers to raise finance against security.

The assets are generally ring-fenced by the SE and, in most cases, the customer, a sponsor or third party provides some credit enhancement or guarantee in the structure. The group also has interests in third-party established structured entities by holding notes issued by these entities or entering into derivatives where the group absorbs risk from the entities.

The derivative and lending exposures are generally secured by the SE's assets, with credit enhancement and/or guarantees provided by third parties. The group's risk in relation to the derivative contracts and trading positions with these SEs is managed within the group's market risk framework (see 'Market risk' in the 'Risk Report'). Credit risk is managed within the group's credit risk framework (see 'Credit risk' in the 'Risk Report').

53 Structured entities *(continued)*

Funds

The group has established and manages money market funds and non-money market investment funds to provide customers with investment opportunities. The group, as fund manager, may be entitled to receive a management and performance fee based on the assets under management.

The group purchases and holds units of HSBC managed and third party managed funds in order to facilitate both business and customer needs. The majority of these funds held relate to the insurance business. The risks of unit holding are managed under a trading mandate or the investment risks associated with the insurance business are managed through matching assets and liabilities for non-linked products. Investment strategies are set with the intention to provide sufficient investment return to satisfy policyholders' reasonable expectations. Policyholders bear the market risk for unit-linked products. This is discussed in more detail in 'Insurance Risk' within the 'Risk Report'.

Unconsolidated structured entities

The term 'unconsolidated structured entities' refers to all SEs that are not controlled by the group. It includes interests in SEs that are not consolidated.

The table below shows the total assets of unconsolidated SEs in which the group has an interest at the reporting date, as well as the group's maximum exposure to loss in relation to those interests.

The total asset values for unconsolidated SEs have been provided in the table below as an indication of their size.

The maximum exposure to loss from the group's interests in unconsolidated SEs represents the maximum loss that the group could be required to report as a result of its involvement with unconsolidated SEs regardless of the probability of the loss being incurred. They are contingent in nature, and may arise as a result of the provision of liquidity facilities and any other funding commitments provided by the group to unconsolidated SEs.

For commitments and guarantees, the maximum exposure to loss is the notional amount of potential future losses.

For retained and purchased investments in and loans to unconsolidated structured entities, the maximum exposure to loss is the carrying value of these interests at the balance sheet reporting date.

The maximum exposure to loss is stated gross of the effects of hedging and collateral arrangements entered into to mitigate the group's exposure to loss.

The income includes recurring and non-recurring fees, interest, dividends, gains or losses on the remeasurement or derecognition of interests in structured entities, any mark-to-market gains or losses on a net basis and gains or losses from the transfer of assets and liabilities to the structured entity.

53 Structured entities *(continued)*

Nature and risks associated with the group's interests in unconsolidated structured entities

	Securitisations HK$m	HSBC managed funds HK$m	Non-HSBC managed funds HK$m	Other HK$m	Total HK$m
At 31 December 2013					
Total assets	22,342	1,064,278	11,320,620	39,267	12,446,507
The group's interest- assets					
Trading assets	–	81	–	–	81
Financial assets designated at fair value	–	1,015	6,852	–	7,867
Loans and advances to customers	6,728	–	–	8,910	15,638
Financial investments	–	13,116	30,139	–	43,255
Other assets	–	–	–	481	481
Total assets in relation to the group's interests in the unconsolidated structured entities[1]	6,728	14,212	36,991	9,391	67,322
The group's interest- liabilities					
Derivatives	49	–	–	210	259
Total liabilities in relation to the group's interests in the unconsolidated structured entities	49	–	–	210	259
The group's maximum exposure	7,474	14,212	37,842	9,761	69,289

1 *Amongst the group's interests in the assets of the unconsolidated structured entities, HK$14,131m of HSBC managed funds (out of total assets of HK$14,212m) and HK$33,918m of non-HSBC managed funds (out of total assets of HK$36,991m) are held by the insurance business.*

Sponsored structured entities sponsored by the group

The definition of a sponsor is given in Note 3n. In some cases, the group does not have an interest in these entities at the reporting date.

The amount of assets transferred to and income received from sponsored entities at 31 December 2013 is not significant.

54 Legal proceedings

Anti-money laundering and sanctions-related

In October 2010, HSBC Bank USA ('HBUS') entered into a consent cease and desist order with the Office of the Comptroller of the Currency ('OCC') and the indirect parent of that company, HSBC North America Holdings Inc. ('HNAH'), entered into a consent cease and desist order with the Federal Reserve Board (the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including various issues relating to US Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. Steps continue to be taken to address the requirements of the Orders to ensure compliance, and that effective policies and procedures are maintained.

In addition, in December 2012, HSBC Holdings plc ('HSBC Holdings'), the Bank's ultimate parent company, HNAH and HBUS entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA and AML and sanctions laws. Among those agreements, HSBC Holdings and HBUS entered into a five-year deferred prosecution agreement with the US Department of Justice ('DoJ'), the US Attorney's Office for the Eastern District of New York, and the US Attorney's Office for the Northern District of West Virginia (the 'US DPA'), HSBC Holdings entered into a two-year deferred prosecution agreement with the New York County District Attorney (the 'DANY DPA'), and HSBC Holdings consented to a cease and desist order and HSBC Holdings and HNAH consented to a monetary penalty order with the Federal Reserve Board ('FRB'). In addition, HBUS entered into a monetary penalty consent order with FinCEN and a separate monetary penalty order with the OCC. HSBC Holdings also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions and an undertaking with the UK Financial Services Authority, now a Financial Conduct Authority ('FCA') Direction, to comply with certain forward-looking AML- and sanctions-related obligations.

Under these agreements, HSBC Holdings and HBUS made payments totalling US$1,921m to US authorities and are continuing to comply with on-going obligations. On 1 July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of the same. Under the agreements with the DoJ, FCA, and the FRB, an independent monitor (who is, for FCA purposes, a 'skilled person' under Section 166 of the Financial Services and Markets Act) will evaluate and regularly assess the effectiveness of HSBC's AML and sanctions compliance function and HSBC's progress in implementing its remedial obligations under the agreements. The monitorship, which began on 22 July 2013, is proceeding as anticipated and consistent with the timelines and requirements set forth in the relevant agreements.

If HSBC Holdings and HBUS fulfil all of the requirements imposed by the US DPA, the DoJ's charges against those entities will be dismissed at the end of the five-year period of that agreement. Similarly, if HSBC Holdings fulfils all of the requirements imposed by the DANY DPA, DANY's charges against it will be dismissed at the end of the two-year period of that agreement. The DoJ may prosecute HSBC Holdings or HBUS in relation to the matters which are the subject of the US DPA if HSBC Holdings or HBUS breaches the terms of the US DPA, and DANY may prosecute HSBC Holdings in relation to the matters which are subject of the DANY DPA if HSBC Holdings violates the terms of the DANY DPA.

HBUS also entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC's then most recent report of examination and imposing certain restrictions on HBUS directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HBUS also entered into a separate consent order with the OCC requiring it to adopt an enterprise wide compliance programme.

The settlement with US and UK authorities does not preclude private litigation relating to, among other things, HSBC's compliance with applicable AML, BSA and sanctions laws or other regulatory or law enforcement actions for AML/BSA or sanctions matters not covered by the various agreements.

54 Legal proceedings *(continued)*

US Tax investigation

As at 31 December 2013, the Bank is cooperating with US authorities in connection with an investigation regarding whether the Bank in India and certain employees acted appropriately in relation to certain US-based clients who had US tax reporting requirements. Based on the facts currently known in respect of this investigation, there is a high degree of uncertainty as to the terms on which the ongoing investigation will be resolved and the timing of such resolution, including the amounts of fines and/or penalties. As matters progress, it is possible that fines and/or penalties could be significant.

Investigations and reviews into the setting of benchmark rates

On 14 June 2013, the Bank was censured by the Monetary Authority of Singapore ('MAS') for deficiencies in governance, risk management, internal controls and surveillance systems in connection with its participation in the contributing panel with respect to certain foreign exchange spot benchmarks that are commonly used to settle non-deliverable forward foreign exchange contracts. The Bank was directed to adopt measures to address the identified deficiencies, to appoint a party to ensure the robustness of its remedial measures, and to maintain additional statutory reserves with the MAS at zero interest for a period of one year. The Bank was one of twenty banks subjected to supervisory action by the MAS as a result of its review.

The group has also been cooperating with authorities in a number of jurisdictions including Hong Kong, Thailand and South Korea, in relation to investigations into the setting of benchmark interest and foreign exchange rates. Based on the facts currently known in respect of these investigations, there is a high degree of uncertainty as to the terms on which the ongoing investigations will be resolved and the timing of such resolutions, including the amounts of fines and/or penalties. As matters progress, it is possible that fines and/or penalties can be significant.

Other matters

The group is party to legal proceedings, investigations and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described above, the Bank considers that none of these matters is material, either individually or in the aggregate. The Bank recognises a provision for a liability in relation to these matters when it is probable that an outflow of economic benefits will be required to settle an obligation which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation. Any provision recognised does not constitute an admission of wrongdoing or legal liability. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings and regulatory matters as at 31 December 2013.

55 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 HSBC Group's web site at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

56 Nature of business

The group provides domestic and international banking and related financial services, principally in the Asia-Pacific region.

57 Events after the balance sheet date

There have been no events after the balance sheet date that would require disclosure in these financial statements.

58 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 24 February 2014.

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