

The Hongkong and Shanghai Banking
Corporation Limited
Annual Report and Accounts 2012



Annual Report and Accounts 2012

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Certain defined terms

This document comprises the *Annual Report and Accounts 2012* 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《年報及賬目》備有中譯本，如欲查閱可向下址索取：香港皇后大道中 1 號滙豐總行大廈 32 樓企業傳訊部（亞太區）。本年報之中英文本亦載於本行之網址 www.hsbc.com.hk。

Financial Highlights

	2012	2011
	HK\$m	HK\$m
For the year		
Net operating income before loan impairment charges	162,267	147,170
Profit before tax	108,729	91,370
Profit attributable to shareholders	83,008	67,591
At the year-end		
Shareholders' equity	437,399	340,824
Total equity	473,078	371,343
Total capital base	272,892	246,206
Customer accounts	3,874,884	3,565,001
Total assets	6,065,327	5,607,480
Ratios		
	%	%
Return on average shareholders' equity	21.9	21.6
Post-tax return on average total assets	1.54	1.34
Cost efficiency ratio	42.4	46.1
Net interest margin	1.96	1.91
Capital adequacy ratios		
– core capital	13.7	12.4
– total capital	14.3	14.6

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 Bank and its subsidiaries provide 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 – and in six other countries around the world. Employing some 65,600 people, of whom 34,000 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2012 of HK\$6,065bn.

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 81 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

Telephone: (852) 2822 1111 Facsimile: (852) 2810 1112 Web: www.hsbc.com.hk Telex: 73201 HKBG HX

Report of the Directors

Principal Activities

The Bank and its subsidiaries and associates 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 acknowledged as the world's leading international bank. As a subsidiary of the HSBC Group, the Bank applies a disciplined approach in managing its portfolio of businesses to focus on areas where it has a clear and competitive advantage. The Bank is simplifying its structures and processes to improve efficiency and achieve sustainable cost saves.

The Bank'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 the rest of the world.

Corporate Governance

A corporate governance report is set out on pages 5 to 9.

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 31 to 200.

Share Capital

To fund a capital injection into HSBC Bank (China) Company Limited ("HBCN"), a wholly-owned subsidiary, and to fund the redemption of preference shares, the Bank issued 780m ordinary shares at par value of HK\$2.50 each to the existing shareholder, HSBC Asia Holdings BV ("HAHB"), on 29 March 2012. To fund the subscription of new H-shares in Bank of Communications Co., Ltd., the Bank issued 5,305.58m ordinary shares at par value of HK\$2.50 each to HAHB on 2 May 2012. To fund a capital injection into HBCN, the Bank issued 775.76m ordinary shares at par value of HK\$2.50 each to HAHB on 16 August 2012. The Bank also issued 4,650m ordinary shares at par value of HK\$2.50 each to HAHB on 26 November 2012 to fund the redemption of preference shares.

Reserves and Dividends

Profits attributable to shareholders, before dividends, of HK\$83,008m have been transferred to reserves. During the year, a surplus of HK\$6,060m, 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 2012 are set out in note 9 to the financial statements. The Directors do not recommend the payment of a final dividend.

Directors

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

Stuart T Gulliver, <i>Chairman</i>	Zia Mody*
Dr William Fung Kwok Lun*, SBS, OBE, <i>Deputy Chairman</i>	Christopher D Pratt*
Laura Cha May Lung*, GBS, <i>Deputy Chairman</i>	James Riley*
Peter Wong Tung Shun, <i>Chief Executive</i>	Andreas Sohlen-Pao*
Graham John Bradley*	T Brian Stevenson*, SBS
Dr Raymond Ch'ien Kuo Fung*, GBS, CBE	Dr Rosanna Wong Yick-ming*, DBE
Naina L Kidwai	Marjorie Yang Mun Tak*
Rose Lee Wai Mun	Tan Sri Dr Francis Yeoh Sock Ping*, CBE
Victor Li Tzar Kuoi*	

* non-executive Director

Report of the Directors (continued)

All the Directors served throughout the year save for Rose Lee Wai Mun, Francis Yeoh Sock Ping and Graham John Bradley who were appointed on 21 May, 1 July and 26 November 2012 respectively. Margaret Leung Ko May Yee and Dr Lo Ka Shui resigned on 11 May and 21 May 2012 respectively. Dr Patrick Wang Shui Chung and Paul Anthony Thurston resigned with effect from 31 December 2012.

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, certain Directors have been granted options and conditional awards over HSBC Holdings plc ordinary shares by that company (being the ultimate holding company) pursuant to the HSBC Holdings Group Share Option Plan ('GSOP'), the HSBC Holdings Savings-Related Share Option Plans ('SRSOP'), the HSBC Share Plan or the HSBC Share Plan 2011.

Under the GSOP, discretionary awards of share options, with vesting subject to the attainment of a pre-determined corporate performance condition, were made to employees at all levels of HSBC. The exercise price of options granted under the GSOP is the higher of the average market value on the five dealing days prior to the grant of the option and the middle market quotation of a share on the date of grant of the option or the nominal value of a share. No options have been granted under the GSOP since 26 May 2005. Under the SRSOPs, eligible employees, including Directors, may be granted options over HSBC Holdings plc shares at a price per share which is fixed at the average of the middle market quotations derived from the London Stock Exchange Daily Official List for the five dealing days preceding the date of the invitation to participate in the plan, discounted by 20%. The vesting of conditional awards of HSBC Holdings plc ordinary shares granted to Directors under the HSBC Share Plan and the HSBC Share Plan 2011 are generally subject to the individual remaining an employee on the vesting date. The Performance Share awards under the HSBC Share Plan, which are subject to the attainment of corporate performance conditions, have been replaced by the Group Performance Share Plan which is the long-term incentive plan under the HSBC Share Plan 2011.

During the year, Stuart T Gulliver, Naina L Kidwai, Margaret Leung Ko May Yee, Rose Lee Wai Mun, Paul A Thurston and Peter Wong Tung Shun acquired or were awarded shares in HSBC Holdings plc under the terms of the HSBC Share Plan and/or 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\$208m (2011: HK\$107m).

Compliance with the Banking (Disclosure) Rules

The Directors are of the view that the Accounts and Supplementary Notes for the year ended 31 December 2012, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance.

Auditors

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.

Corporate Governance Report

The Hongkong and Shanghai Banking Corporation Limited is committed to high standards of corporate governance. As an Authorised Institution, the Bank is subject to the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions' ('HKMA SPM CG-1'). The Bank has followed the HKMA SPM CG-1 during 2012. On 3 August 2012, a revised SPM CG-1 was issued. Authorised Institutions are expected to align their policies and practices as soon as practicable and within 12 months of the issue date. The Bank has undertaken a review and steps to bring relevant policies and practices into line with the revised module are progressing and will be completed within the implementation guidelines.

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. It is collectively responsible for the long-term success of the Bank and delivery of sustainable value to shareholders. It sets the strategy and risk appetite for the Bank and its subsidiaries 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. As at 4 March, 2013, the Board comprised the Chairman, Chief Executive, two other Directors with executive responsibilities for the Bank's or a subsidiary's operations and thirteen non-executive Directors (including two Deputy Chairmen).

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.

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.

Report of the Directors (continued)

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 the Bank and its subsidiaries, 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 Chief Executive, Peter Wong Tung Shun, is Chairman of the Committee. The current members of the Committee are: Louisa Cheang Wai Wan (*Head of Retail Banking and Wealth Management Asia-Pacific*), Raymond Cheng Siu Hong (*Chief Operating Officer Asia-Pacific*), Rhydian H Cox (*Chief Risk Officer*), Anita Fung Yuen Mei (*Chief Executive Officer Hong Kong*), Guy D Harvey-Samuel (*Head of International*), Alexander C Hungate (*Chief Executive Officer Singapore*), Mukhtar M Hussain (*Deputy Chairman, HSBC Bank Malaysia Berhad*), Sarah C Legg (*Chief Financial Officer*), Stuart P Milne (*Chief Executive Officer India*), Robin C Phillips (*Head of Global Banking and Markets Asia-Pacific*), Noel P Quinn (*Regional Head of Commercial Banking Asia-Pacific*), Donna Wong Ka Yuk (*Head of Human Resources Asia-Pacific*), Helen Wong Pik Kuen (*President and Chief Executive Officer, HSBC Bank (China) Company Limited*). P A Stafford (*Corporation Secretary*) is the Committee Secretary. In attendance are: P M Chan (*Chief Compliance Officer*), G W French (*Head of Global Markets Asia-Pacific*), T Grimmer (*Head of Communications Asia*), K S Y Ng (*General Counsel Asia-Pacific*), B J Rennell (*Chief Executive Officer, Private Bank North Asia and Global Head Private Wealth Solutions*), J Rikhye (*Head of Strategy & Planning Asia-Pacific*) and W S M Tam (*Deputy Secretary*).

Asset and Liability Management Committee

The Asset and Liability Management Committee is chaired by the 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 and Risk Committee

Until October 2012, a non-executive Audit and Risk Committee combined the oversight of audit and risk. The revised HKMA SPM CG-1 strongly encourages establishment of a non-executive risk committee and separate committees for different key control functions. Accordingly, the Board established a Risk Committee separate from the Audit Committee on 18 October 2012. The roles and memberships of the Audit Committee and Risk Committee are described below.

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 and T Brian Stevenson.

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 T Brian Stevenson (Chairman of the Committee), Graham John Bradley, 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.

Risk management

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. As part of the monitoring process, the Risk Committee requires risk management reports from management which enable the Risk Committee to assess the risks involved in the group's business and how they are controlled and monitored by management. It also requires reports that give clear, explicit and dedicated focus to current and forward-looking aspects of risk exposure which may require a complex assessment of the group's vulnerability to previously unknown or unidentified risks. Furthermore, it also reviews all meeting minutes of subsidiaries' Risk Committees and the Risk Management Committee.

The Risk Management Committee, which consists of senior executives, formulates high-level risk policies, exercises delegated risk management authority, oversees implementation of risk appetite and controls, monitors all categories of risk and determines appropriate mitigating action.

The Executive Committee supports the Risk Management Committee and the Chief Risk Officer in providing strategic direction for the risk function, sets priorities and oversees their execution. It also oversees a consistent approach to accountability for, and mitigation of, risk across the risk function.

Risk appetite

The Board is responsible for approving risk appetite, strategy and performance targets for the Bank while approving the appointment of senior risk officers and delegating authority for risk management.

The Risk Committee advises the Board on risk appetite and alignment with strategy, as well as risks associated with proposed strategic acquisitions and disposals. 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 Bank is willing to accept in order to achieve its medium and long-term strategic goals. Across the Bank, each country and regional Global Business is required to prepare a Risk Appetite Statement ('RAS'). The regional Risk function tracks the RAS development and performance across sites on a regular basis.

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

Report of the Directors (continued)

Stress testing

The Bank uses an enterprise-wide approach to test the sensitivities of its capital plans against a number of scenarios. A range of stress testing scenarios is conducted including, but not limited to, severe global economic downturn, country, sector and counterparty failures and a variety of projected major operational risk events. The outcomes of the stress scenarios are used to assess the potential impact on demand for regulatory capital against its supply. The Bank also participates, where necessary, in scenario analyses requested by regulatory bodies.

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. 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. The Bank's approach to identify and monitor top and emerging risks is informed by the risk factors. 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.

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 Dr William Fung Kwok Lun. 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 approving 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 our Group. The establishment of 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, which is applicable to the Bank, has been approved by the Group Remuneration Committee. It 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 'Guideline on a Sound Remuneration System'.

In accordance with the HKMA Supervisory Policy Manual CG-5 'Guideline on a Sound Remuneration System', details of the remuneration strategy are contained within the Annual Report and Accounts 2012 and Capital and Risk Management Pillar 3 Disclosures as at 31 December 2012 of HSBC Holdings plc.

On behalf of the Board
Stuart T Gulliver, *Chairman*
4 March 2013

Financial Review

Summary of Financial Performance

Results for 2012

Profit attributable to shareholders for 2012 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') increased by HK\$15,417m, or 23%, to HK\$83,008m in 2012. Profit before tax increased by HK\$17,359m, or 19%, to HK\$108,729m.

Profit before tax

	2012 HK\$m	2011 HK\$m
Hong Kong	56,499	43,197
Rest of Asia-Pacific	52,230	48,173
Total	108,729	91,370

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
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
2011				
Net interest income	35,274	40,396	2	75,672
Net fee income	22,860	15,435	–	38,295
Net trading income	7,691	12,510	(2)	20,199
Net expense from financial instruments designated at fair value .	(4,230)	(293)	–	(4,523)
Gains less losses from financial investments	310	(182)	–	128
Dividend income	723	6	–	729
Net earned insurance premiums	39,738	5,932	–	45,670
Other operating income	13,229	2,674	(4,514)	11,389
Total operating income	115,595	76,478	(4,514)	187,559
Net insurance claims incurred and movement in liabilities to policyholders	(35,778)	(4,611)	–	(40,389)
Net operating income before loan impairment charges and other credit risk provisions	79,817	71,867	(4,514)	147,170
Loan impairment charges and other credit risk provisions	(938)	(2,121)	–	(3,059)
Net operating income	78,879	69,746	(4,514)	144,111
Operating expenses	(36,106)	(36,232)	4,514	(67,824)
Operating profit	42,773	33,514	–	76,287
Share of profit in associates and joint ventures	424	14,659	–	15,083
Profit before tax	43,197	48,173	–	91,370

Financial Review (continued)

Geographical Regions (continued)

Hong Kong

Hong Kong reported pre-tax profits were HK\$56,499m compared with HK\$43,197m in 2011, an increase of 31%. Reported profits included gains on the sale of our shares in Global Payments Asia-Pacific Ltd of HK\$1,647m and both the HSBC and Hang Seng Bank general insurance businesses of HK\$905m and HK\$354m respectively.

Excluding these gains, profit increased by 24% driven by higher net interest income in CMB and RBWM, the gain of HK\$2,441m on the sale of our shares in four Indian banks, higher trading revenues in GB&M, increased fee income in both CMB and GB&M and a reduction in loan impairment charges. These favourable movements were partly offset by higher operating expenses.

In RBWM, we continue to develop our wealth management services for our retail customers and launched new investment funds, including the Global High Yield Bond Fund. We completed the sale of both the HSBC and Hang Seng Bank general insurance businesses, enabling us to focus on life insurance manufacturing, where we maintained our market leadership position. We also led the market in deposits, mortgages, mandatory provident funds and credit cards. We maintained our prudent lending approach, with average loan to value ratios of 48% on new mortgage drawdowns and an estimated 32% on the portfolio as a whole.

In CMB, we capitalised on our international connectivity and our standing as a leading trade finance bank to grow trade-related revenues by 10%. The collaboration between CMB and GB&M continued to strengthen, with revenue growth of 13%, most notably from the provision of foreign exchange products to our corporate customers. We won the FinanceAsia award for Best Commercial Bank 2012 and 10 AsiaMoney awards for Payments and Cash Management, including the “Best Local Cash Management Bank” for small, medium and large corporates.

In GB&M we led the market in Hong Kong dollar bond issuance and were the leading bookrunner for corporate high yield bonds in Asia excluding Japan. We continued to lead the market in offshore renminbi bond issuance. We reinforced our position as a leading international bank for offshore renminbi products, winning the Asia Risk Renminbi House of the Year award and all seven product categories in Asiamoney’s Offshore Renminbi Survey.

Net interest income was 14% higher than in 2011, notably in CMB and RBWM, driven by increased customer loans and deposit balances and by growth in the insurance portfolio.

In RBWM we continued to grow our average mortgage balances, reflecting continued strength in the property market. In CMB, average term and trade-related lending balances were higher as we capitalised on trade and capital flows.

Asset spreads were marginally wider in CMB compared with 2011 on trade-related and other lending due to repricing, though they began to narrow towards the end of the year.

Net interest income also rose due to higher average deposit balances, notably in RBWM, in part reflecting reduced net outflows from customer accounts in to investments. In addition, deposit spreads widened.

Net fee income of HK\$24,670m was 8% higher than in 2011. Fees rose from increased transaction volumes in trade services, remittances and account services as we continued to facilitate international trade and capital flows. Fee income also increased in both CMB and GB&M as we arranged debt issues for our customers to satisfy their funding requirements. In RBWM fees from unit trusts rose reflecting increased sales volumes, despite customers increasingly preferring lower risk products with lower fees. These increases were offset by a reduction in brokerage income from lower market turnover as a result of weaker investor sentiment.

Geographical Regions *(continued)*

Net trading income increased by 29%, from lower adverse fair value movements on derivatives relating to certain provident funds, following reductions in long term investment return assumptions in 2011. There was also a strong performance in GB&M, notably in Rates trading activities, which reflected increased client demand for risk management products, particularly in yen and renminbi, in part from increased cross-currency debt issuance by corporates. Credit trading revenues also rose in part due to increased client activity. This was partly offset by a net charge as a result of a change in estimation methodology in respect of the valuation adjustments on derivatives.

Net income from financial instruments designated at fair value was HK\$3,799m compared with an expense of HK\$4,230m in 2011, due to net investment gains on assets held by the insurance business compared with net losses in the prior year, as a result of more favourable equity market conditions. To the extent that these investment gains were attributed to policyholders of unit-linked insurance policies and insurance contracts with discretionary participation features, there was a corresponding increase in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Gains less losses from financial investments were HK\$2,510m compared with HK\$310m in 2011, largely from the gain of HK\$2,694m on the sale of our shares in four non-strategic investments in banks in India.

Net earned insurance premiums grew by 17% following increased new sales and renewals of life insurance products. The growth in premiums resulted in a corresponding increase in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Other operating income of HK\$14,991m was HK\$1,762m higher than in 2011. We completed the sales of Global Payments Asia-Pacific Ltd and both the HSBC and Hang Seng general insurance businesses, realising gains of HK\$1,647m, HK\$905m and HK\$354m respectively. While the value of the present value of in-force long term insurance business ('PVIF') asset rose, this was not to the same extent as in 2011 as increased insurance sales in 2012 were more than offset by unfavourable assumption updates and the non-recurrence of the benefit from the refinement to the PVIF asset calculation in 2011. There was also a lower gain on the revaluation of investment properties compared with 2011.

Loan impairment charges and other credit risk provisions reduced to HK\$603m from HK\$938m in 2011, largely due lower specific impairment charges in CMB.

Operating expenses increased by 2%, primarily due to higher systems implementation and processing costs as we continued to invest in our technology infrastructure, as well as increased property rental and maintenance costs. Salaries and wages were broadly unchanged as wage inflation was largely offset by reduced average staff numbers as we continued to focus on efficiency.

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
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
2011							
Net interest income/(expense)	20,114	10,251	8,189	–	(3,613)	333	35,274
Net fee income	13,551	5,501	3,693	–	115	–	22,860
Net trading income/(expense)	753	1,322	6,916	–	(965)	(335)	7,691
Net expense from financial instruments designated at fair value	(3,612)	(565)	(39)	–	(16)	2	(4,230)
Gains less losses from financial investments	19	78	162	–	51	–	310
Dividend income	1	10	118	–	594	–	723
Net earned insurance premiums ..	33,626	5,968	144	–	–	–	39,738
Other operating income	3,928	1,359	606	–	9,212	(1,876)	13,229
Total operating income	68,380	23,924	19,789	–	5,378	(1,876)	115,595
Net insurance claims incurred and movement in liabilities to policyholders	(30,243)	(5,429)	(106)	–	–	–	(35,778)
Net operating income before loan impairment charges and other credit risk provisions	38,137	18,495	19,683	–	5,378	(1,876)	79,817
Loan impairment (charges)/releases and other credit risk provisions	(601)	(513)	176	–	–	–	(938)
Net operating income	37,536	17,982	19,859	–	5,378	(1,876)	78,879
Operating expenses	(14,121)	(5,540)	(9,700)	–	(8,621)	1,876	(36,106)
Operating profit/(loss)	23,415	12,442	10,159	–	(3,243)	–	42,773
Share of profit in associates and joint ventures	47	69	32	–	276	–	424
Profit/(loss) before tax	23,462	12,511	10,191	–	(2,967)	–	43,197

Geographical Regions *(continued)*

Rest of Asia-Pacific

Rest of Asia-Pacific reported pre-tax profits of HK\$52,230m compared with HK\$48,173m in 2011, an increase of 8%. Reported profits included gains from the sale of our RBWM business in Thailand of HK\$811m, our GPB business in Japan of HK\$520m and our interest in a property company in the Philippines of HK\$1,009m.

Excluding the above gains, pre-tax profit increased by 4%. Net interest income increased, notably from Balance Sheet Management in GB&M in mainland China and strong growth in average lending balances across most of the region. We also benefited from increased profits from our associates in mainland China. These factors were partly offset by adverse fair value movements of HK\$2,694m on the contingent forward sale contract related to the disposal of our shares in Ping An Insurance (Group) Company of China, Ltd. ('Ping An'), the effect of which was offset in 2013 on completion of the transaction, and higher operating expenses, in part due to restructuring costs of HK\$990m arising from the ongoing strategic review of our businesses and support functions in the region. Loan impairment charges also rose from a small number of specific corporate impairment charges, but remained low.

We maintained our focus on our key priority growth markets in the region. In mainland China, we continued to invest in our branch network and at the end of the year had 141 HSBC China outlets, 20 HSBC rural bank outlets and 46 Hang Seng Bank outlets. We invested a further HK\$13,264m in Bank of Communications Co., Ltd. ('BoCom') to maintain our interest of 19.03% in this strategically important associate and reinforce our position as the leading foreign bank in mainland China.

Net interest income increased by 5%, notably in mainland China from Balance Sheet Management arising from growth in the debt securities portfolio and improved yields, as well as from increased trade-related and term lending in CMB and GB&M in mainland China and India.

We grew deposit balances, notably in GB&M and CMB from new Payments and Cash Management mandates and deposit acquisition, as well as in RBWM. The benefit of this growth was partly offset by narrower liability spreads reflecting rate cuts and liquidity easing measures by central banks.

In RBWM, residential mortgage balances grew primarily in Singapore, Australia, Malaysia and mainland China, reflecting the continued strength of property markets and expansion of our distribution network. Net interest income was broadly unchanged, however, due to the effect of the sale of the RBWM business in Thailand and narrower asset spreads in a number of countries, attributable to competitive pricing pressures.

Net fee income reduced by HK\$215m. In GB&M, fee income increased from our participation in more debt capital markets transactions across the region, as well as from lower regulatory fee expenses on Foreign Exchange and Rates transactions in mainland China. In RBWM we reported higher income from cards in Australia from increased card issuance and wealth management fees in mainland China. This was more than offset by the discontinuation of our Premier business in Japan and the sale of our RBWM business in Thailand, as well as a fall in fund management fees as we saw a move in to lower yielding products reflecting investor's lower risk appetite.

Net trading income decreased by 26% compared with 2011, mainly from adverse fair value movements on the contingent forward sale contract relating to the sale of our shares in Ping An of HK\$2,694m. Trading income was also lower, primarily in mainland China due to lower GB&M revenues in Foreign Exchange reflecting reduced volatility, and from growth in structured, deposits where the related income is recorded under 'Net interest income'. These were partly offset by a net favourable movement as a result of a change in estimation methodology in respect of the valuation adjustments on derivatives.

Net income from financial instruments designated at fair value was HK\$814m in 2012 compared with a net expense of HK\$293m in the prior year, driven by net investment gains on assets held by the insurance business, primarily in Singapore, due to positive equity market movements. To the extent that these investment gains were attributed to policyholders of unit-linked insurance policies and insurance contracts with discretionary participation features, there was a corresponding increase in '*Net insurance claims incurred and movement in liabilities to policyholders*'.

Financial Review (continued)**Geographical Regions** (continued)

On 7 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%. The group ceased to account for the investment as an associate from that date.

Gains less losses from financial investments were HK\$124m compared with net losses of HK\$182m in 2011, due to a disposal gain on investments managed by a private equity fund, and a gain on the sale of government debt securities in India.

Net earned insurance premiums rose by 6% to HK\$6,317m, as a result of increased renewals and new business volumes in mainland China, Singapore and Taiwan. The growth in premiums resulted in a corresponding increase in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Other operating income increased by HK\$1,958m, due to gains on the sale of our RBWM business in Thailand of HK\$811m, our GPB business in Japan of HK\$520m and our interest in a property company in the Philippines of HK\$1,009m.

Loan impairment charges and other credit risk provisions increased by HK\$854m as a result of individually assessed impairments on a single corporate exposure in Australia and a small number of corporate exposures in other countries in the region. These were partly offset by an impairment release in Singapore compared with a charge in 2011.

Operating expenses were broadly unchanged. We incurred restructuring and other related costs of HK\$990m in several countries as part of the ongoing strategic review of our businesses and support functions in the region. This resulted in a net reduction of more than 4,700 staff numbers, which was offset by inflationary pressures and business growth, including branch expansion in mainland China and Malaysia. Costs also increased from a litigation provision of HK\$760m made in respect of a long-standing court case and the write down by HK\$395m of our interest in a joint venture.

Share of profit from associates and joint ventures increased by HK\$3,511m, driven by higher profits from BoCom and Industrial Bank Co., Ltd. ('Industrial Bank') reflecting loan growth and higher fee income partly offset by increased operating expenses and 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
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
2011							
Net interest income	14,312	9,757	16,835	176	831	(1,515)	40,396
Net fee income/(expense)	6,753	3,992	4,613	155	(78)	–	15,435
Net trading income/(expense)	714	1,222	9,492	58	(491)	1,515	12,510
Net income/(expense) from financial instruments designated at fair value	(295)	12	7	–	(17)	–	(293)
Gains less losses from financial investments	(3)	16	(190)	–	(5)	–	(182)
Dividend income	(1)	1	–	–	6	–	6
Net earned insurance premiums ..	3,840	2,092	–	–	–	–	5,932
Other operating income	1,121	562	511	10	955	(485)	2,674
Total operating income	26,441	17,654	31,268	399	1,201	(485)	76,478
Net insurance claims incurred and movement in liabilities to policyholders	(2,727)	(1,884)	–	–	–	–	(4,611)
Net operating income before loan impairment charges and other credit risk provisions	23,714	15,770	31,268	399	1,201	(485)	71,867
Loan impairment (charges)/releases and other credit risk provisions	(1,731)	53	(443)	2	(2)	–	(2,121)
Net operating income	21,983	15,823	30,825	401	1,199	(485)	69,746
Operating expenses	(18,504)	(7,367)	(9,594)	(470)	(782)	485	(36,232)
Operating profit/(loss)	3,479	8,456	21,231	(69)	417	–	33,514
Share of profit in associates and joint ventures	1,887	8,994	3,756	–	22	–	14,659
Profit/(loss) before tax	5,366	17,450	24,987	(69)	439	–	48,173

Financial Review (continued)**Net interest income**

Net interest income increased as a result of loan and deposit growth across key countries, as well as improved deposit spreads, notably in Hong Kong. The insurance business also contributed to increased net interest income as the portfolio grew from increased sales.

Average interest-earning assets increased by HK\$247,332m, or 6% compared with last year. Average customer lending increased by 8%, with notable growth in term lending and mortgages, while financial investments increased by 5%.

	2012 HK\$m	2011 HK\$m
Average interest-earning assets	4,199,329	3,951,997

Net interest margin increased by five basis points to 1.96% compared with last year. The net interest spread increased by four basis points, while the contribution from net free funds increased by one basis point.

Net interest margin (%)

	2012 %	2011 %
Spread	1.85	1.81
Contribution from net free funds	0.11	0.10
Total	1.96	1.91

Net interest margin (%)

	2012 %	2011 %
Hong Kong:		
The Bank	1.46	1.35
Hang Seng Bank	2.10	1.97
Rest of Asia-Pacific	2.14	2.10

In **Hong Kong**, the Bank recorded an increase in net interest margin of 11 basis points to 1.46% compared with 2011. The net interest spread increased by 10 basis points as asset spreads on mortgages remained broadly stable and deposit spreads improved. Asset spreads on other lending increased marginally, narrowing towards the end of the year.

At **Hang Seng Bank**, the net interest margin increased by 13 basis points to 2.10% compared with last year. This was driven by improved loan pricing, increased deployment of funds towards customer lending and a wider range of investment opportunities for renminbi deposits.

In the **Rest of Asia-Pacific**, the net interest margin was 2.14%, four basis points higher than 2011. Both loan and deposit spreads reduced in key markets across the region from competitive pressures and central bank rate cuts. This was more than offset by improved spreads in Balance Sheet Management in mainland China and deployment of more of the commercial surplus to customer lending.

Net fee income

Net fee income increased by HK\$1,595m, or 4% in 2012.

Fees from unit trusts rose by 18%, notably in Hong Kong, as increased volumes more than offset the impact of customer preference shifting to lower risk, lower fee products.

Fees from imports/exports and remittances increased by 7% and 8% respectively, driven by growing trade activities from both existing and new-to-bank customers, with larger increases noted in Hong Kong, Singapore and Bangladesh.

Underwriting fees were 39% higher than 2011, driven by the growth of debt capital market transactions in Hong Kong, Singapore and the Philippines, which included our participation in several high-profile deals during the year.

Insurance fees increased by 46% in 2012, primarily due to fees received from external insurance providers from selling non-life products in Hong Kong, coupled with higher broking commissions earned in mainland China and Taiwan.

Fees from securities/stockbroking decreased by 17% as turnover reduced following stock market declines in the latter half of 2011. Fees from funds under management decreased by 8%, notably in Japan and Singapore as we saw customer preference moving towards lower risk products with lower fees and a reduction in client assets due to adverse movements in financial markets in the latter half of 2011.

	2012 HK\$m	2011 HK\$m
Account services	2,772	2,686
Credit facilities	2,797	2,812
Import/export	5,115	4,793
Remittances	3,066	2,839
Securities/stockbroking	6,824	8,234
Cards	6,858	6,709
Insurance	1,042	712
Unit trusts	4,523	3,832
Funds under management	4,089	4,442
Underwriting	1,689	1,219
Other	7,446	6,888
Fee income	46,221	45,166
Fee expense	(6,331)	(6,871)
Net fee income	39,890	38,295

Net trading income

Net trading income decreased by HK\$985m, or 5% compared to 2011.

Dealing profits increased, driven by favourable Rates and Foreign Exchange income, notably in Hong Kong, Australia, India and Indonesia, reflecting increased client activity. Trading income was lower in mainland China due to lower Foreign Exchange revenues reflecting reduced volatility.

Net interest income on trading assets and liabilities rose by 14% on the back of expanded debt securities portfolios in Hong Kong, India, mainland China and Singapore. This was offset by higher interest paid on structured deposits, primarily in mainland China, where the related income is recorded under 'Net interest income'.

	2012 HK\$m	2011 HK\$m
Dealing profits	16,633	15,590
Loss from hedging activities ..	(31)	(71)
Net interest income	4,520	3,958
Dividend income from trading securities	786	722
Ping An contingent forward sale contract	(2,694)	–
Net trading income	19,214	20,199

Financial Review (continued)**Gains less losses from financial investments**

Gains on disposal of available-for-sale securities include the gain of HK\$2,441m on the sale of our shares in four non-strategic investments in banks in India.

	2012	2011
	HK\$m	HK\$m
Gains on disposal of available-for-sale securities	2,809	470
Impairment of available-for-sale equity investments	(175)	(342)
Gains less losses from financial investments	2,634	128

Other operating income

The value of the present value of in-force insurance business ("PVIF") asset rose, though not to the same extent as in 2011 as increased insurance sales in 2012 were more than offset by unfavourable assumption updates and the non-recurrence of the benefit from the refinement to the PVIF asset calculation in 2011.

Reflecting property market conditions in Hong Kong, the value of investment properties rose in 2012, though not to the same extent as 2011.

The gains on disposal of business portfolios include the gains on sale of both the HSBC and Hang Seng Bank general insurance businesses of HK\$905m and HK\$354m respectively, our RBWM business in Thailand of HK\$811m and our Global Private Banking business in Japan of HK\$520m. The gain on disposal of associates includes the gains on sale of Global Payments Asia-Pacific Ltd of HK\$1,647m and a property investment company in the Philippines of HK\$1,009m.

	2012	2011
	HK\$m	HK\$m
Rental income from investment properties	216	191
Movement in PVIF	4,432	5,524
Gains on investment properties	834	1,033
Gain/(loss) on disposal of property, plant and equipment, and assets held for sale	30	(3)
Gain/(loss) on disposal of subsidiaries, associates and business portfolios	5,246	(9)
Surplus arising on property revaluation	2	8
Other	4,577	4,645
Other operating income	15,337	11,389

Insurance income

Net interest income increased by 16% as funds under management grew, reflecting net inflows from new and renewal insurance business.

Net income from financial instruments designated at fair value was of HK\$4,538m compared with a loss of HK\$4,460m in 2011, from investment gains on assets held by the insurance business, mainly due to movements in equity markets. To the extent that revaluation is due to policyholders, there is an offsetting movement reported under 'Net insurance claims incurred and movement in liabilities to policyholders'.

Net insurance premiums rose by 15% as a result of higher premiums received from policy renewals and successful sales initiatives for annuity products. The growth in premiums resulted in a corresponding increase in 'Net insurance claims incurred and movement in liabilities to policy holders'.

The value of the PVIF asset rose, though not to the same extent as in 2011 as increased insurance sales in 2012 were more than offset by unfavourable assumption updates and the non-recurrence of the benefit from the refinement to the PVIF asset calculation in 2011.

Other operating income includes the gains on sale of both the HSBC and Hang Seng general insurance businesses of HK\$905m and HK\$354m respectively.

Insurance income

	2012 HK\$m	2011 HK\$m
Net interest income	7,864	6,779
Net fee income	1,216	692
Net trading income/(loss)	56	(386)
Net income/(expense) from financial instruments designated at fair value	4,538	(4,460)
Net earned insurance premiums	52,621	45,670
Movement in PVIF	4,432	5,524
Other operating income	1,308	237
	72,035	54,056
Net insurance claims incurred and movement in liabilities to policyholders	(54,983)	(40,389)
Net operating income	17,052	13,667

Financial Review (continued)**Loan impairment charges and other credit risk provisions**

Loan impairment charges and other credit risk provisions increased by HK\$519m in 2012.

The net charge for individually assessed impairment allowances increased by HK\$40m in 2012, due to impairment of a corporate exposure in Australia, coupled with higher individual impairment charges in a number of countries including India, mainland China, New Zealand and Vietnam. These increases were offset by an impairment release in Singapore compared with a charge in 2011, coupled with lower new impairment charges in Hong Kong.

The net charge for collectively assessed impairment allowances rose by HK\$195m, or 8%, in 2012, reflecting the increase in loans and advances to customers.

The net charge for other credit risk provisions was HK\$284m higher, following charges against a corporate exposure in Australia, noted above.

Net charge for loan impairment by region

	2012	2011
	HK\$m	HK\$m
Hong Kong	658	922
Rest of Asia-Pacific	2,672	2,173
Total	3,330	3,095

Net charge for loan impairment and other credit risk provisions

	2012	2011
	HK\$m	HK\$m
Net charge for impairment of customer loans and advances		
– Individually assessed impairment allowances:		
New allowances	2,201	2,254
Releases	(1,230)	(1,204)
Recoveries	(237)	(356)
	734	694
– Net charge for collectively assessed impairment allowances	2,596	2,401
	3,330	3,095
Net charge/(release) for other credit risk provisions	248	(36)
Net charge for loan impairment and other credit risk provisions	3,578	3,059

Operating Expenses

Employee compensation and benefits were broadly unchanged compared with 2011.

As part of the ongoing strategic review of our business and support functions, wages and salaries included termination benefits of HK\$849m, incurred in several countries across the region, compared with HK\$459m in 2011. This has resulted in a net reduction of more than 5,800 staff numbers since last year, or 8%. Excluding termination benefits, wages and salaries were 2% lower, as reduced staff numbers were partially offset by wage inflation. In mainland China, wages and salaries expenses rose as a result of branch expansion during 2012.

Staff numbers by region (full time equivalent)

	At 31 December	
	2012	2011
Hong Kong:		
The bank and wholly owned subsidiaries	18,966	19,770
Hang Seng Bank		
Hong Kong	7,746	8,003
Total Hong Kong	26,712	27,773
Rest of Asia-Pacific:		
Australia	1,675	1,839
Mainland China	8,444	8,235
Malaysia	4,523	4,839
India	5,347	6,560
Indonesia	5,113	5,609
Singapore	2,656	3,064
Taiwan	2,557	3,230
Sri Lanka	1,488	1,777
Others	7,078	8,494
Total Rest of Asia-Pacific	38,881	43,647
Total	65,593	71,420

General and administrative expenses increased by HK\$1,659m, or 7% in 2012.

Premises and equipment costs increased by HK\$321m, or 5%, with higher expenditure in Hong Kong from increased technology development and property rental and maintenance costs. Premises and equipment costs increased in both mainland China and Malaysia from branch expansion.

Other administrative expenses rose by HK\$1,729m, or 13%, in 2012. This included litigation expenses of HK\$760m in Australia and Singapore in respect of a legacy case and the write-down of a joint venture of HK\$395m. Higher costs were incurred in Hong Kong from intercompany expenses, compliance fees and higher corporate donations.

Marketing and advertising expenses decreased by HK\$391m, or 10%, following the implementation of cost control initiatives in a number of countries.

	2012	2011
	%	%
Cost efficiency ratio	42.4	46.1

Operating expenses

	2012	2011
	HK\$m	HK\$m
Employee compensation and benefits	37,021	37,834
General and administrative expenses	26,011	24,352
Depreciation of property plant and equipment	4,014	3,878
Amortisation of intangible assets	1,724	1,760
Total	68,770	67,824
Of which: restructuring costs..	1,166	864

Share of profit in associates and joint ventures

Share of profit in associates and joint ventures principally includes the group's share of post-tax profits from Bank of Communications and Industrial Bank.

	2012	2011
	HK\$m	HK\$m
Share of profit in associates and joint ventures	18,810	15,083

Financial Review (continued)**Tax expense**

The effective rate of tax for 2012 was 16.6% compared with 19.1% in 2011.

	2012	2011
	%	%
Effective tax rate	16.6	19.1

Assets

Loans and advances to customers in Hong Kong increased by HK\$113bn, or 10%, during 2012 largely through growth in corporate and commercial lending of HK\$57bn, reflecting increased demand in international trade and commercial real estate. Residential mortgage lending increased by HK\$41bn as the property market remained active.

In the Rest of Asia-Pacific, loans and advances to customers increased by HK\$105bn, or 11%, including foreign exchange translation effects of HK\$16bn. The underlying increase of HK\$89bn was mainly from growth in corporate and commercial lending of HK\$48bn, supported by trade flows in mainland China, Indonesia, India and Australia. Residential mortgage lending increased by HK\$28bn, notably in Singapore, mainland China, Australia and Malaysia.

*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	<u>5,889,063</u>	<u>100.0</u>

*Assets 2011*¹

	HK\$m	%
Cash and short term funds	919,906	16.9
Placings with banks maturing after one month and certificates of deposit	286,978	5.2
Trading assets	447,968	8.2
Loans and advances to customers	2,130,871	39.2
Financial investments	722,433	13.3
Other	936,800	17.2
Total	<u>5,444,956</u>	<u>100.0</u>

¹ Excluding Hong Kong Government certificates of indebtedness.

Customer accounts

Customer accounts increased by HK\$310bn, or 9%, during 2012. In Hong Kong, customer accounts increased by HK\$235bn, or 10%, and in the Rest of Asia-Pacific customer accounts increased by HK\$75bn or 6% compared with 31 December 2011.

Customer accounts by region

	2012 HK\$m	2011 HK\$m
Hong Kong excluding Hang Seng Bank	1,805,417	1,640,369
Hang Seng Bank Hong Kong	726,207	656,843
Rest of Asia-Pacific	1,343,260	1,267,789
Total	3,874,884	3,565,001

The group's advances-to-deposits ratio increased to 60.6% at 31 December 2012, from 59.8% at 31 December 2011, as more of the commercial surplus was deployed to customer lending.

	2012 %	2011 %
Advances-to-deposits ratio	60.6	59.8

Customer accounts by type

	2012 HK\$m	2011 HK\$m
Current accounts	831,256	696,435
Savings accounts	2,063,565	1,826,893
Other deposit accounts	980,063	1,041,673
Total	3,874,884	3,565,001

Equity

Equity increased by HK\$102bn, or 27%, to HK\$473bn. The increase came from retained profits, the issue of additional share capital and an increase in the property revaluation reserve. In addition, the value of available-for-sale securities rose, largely from the group's investment in Ping An Insurance.

Basel III

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 group has estimated the pro-forma impact of the Basel III rules on the group's capital position at 31 December 2012. The capital requirements that came in to effect on 1 January 2013 are estimated to result in capital ratios that are above the minimum requirements.

The pro-forma capital position prepared in accordance with the Basel III rules would be higher than the 31 December 2012 position under the existing rules, for the following reasons:

- introduction of concessionary thresholds for deduction of capital investments in non-consolidated financial institutions;

- the timing of the recognition of dividends;
- the removal of the cap on unrealised gains on own-use and investment properties; and
- the full recognition of unrealised gains on 'available-for-sale' and 'designated at fair value' securities.

Following the implementation, capital ratios for the half-year ending 30 June 2013 will be calculated in accordance with the Basel III rules.

Financial Review (continued)**Capital Adequacy**

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

The methods for calculating risk weighted assets for each type of risk are discussed in note 52(f) to the Financial Statements on page 197.

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

Capital structure at 31 December

	2012 HK\$m	2011 HK\$m
Core capital:		
Share capital per balance sheet	58,969	30,190
Revaluation reserve capitalisation issue	(1,454)	(1,454)
Paid-up ordinary share capital	57,515	28,736
Paid-up irredeemable non-cumulative preference shares	51,570	51,681
Reserves per balance sheet	378,430	310,634
Proposed dividend	(20,000)	(10,000)
Unconsolidated subsidiaries	(40,088)	(32,672)
Cash flow hedging reserve	(210)	(51)
Regulatory reserve	(19,426)	(17,108)
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities	(86,111)	(73,570)
Unrealised gains on equities and debt securities designated at fair value	(20)	(77)
Own credit spread	(218)	(429)
Total reserves included in core capital	212,357	176,727
Non-controlling interests per balance sheet	35,679	30,519
Non-controlling interests in unconsolidated subsidiaries	(3,478)	(2,838)
Regulatory adjustments to non-controlling interests	(3,291)	(2,976)
Non-controlling interests	28,910	24,705
Goodwill, intangible assets and valuation adjustments	(21,191)	(19,663)
50% of unconsolidated investments	(67,692)	(53,749)
50% of securitisation positions and other deductions	(16)	(140)
Deductions	(88,899)	(73,552)
Total core capital	261,453	208,297
Supplementary capital:		
Paid-up irredeemable cumulative preference shares	16,510	16,546
Perpetual subordinated debt	9,355	9,386
Paid-up term preference shares	15,115	28,742
Term subordinated debt	16,418	16,327
Property revaluation reserves ¹	7,977	7,977
Unrealised gains on available-for-sale equities and debt securities ²	2,534	2,318
Unrealised gains on equities and debt securities designated at fair value	9	35
Regulatory reserve ³	2,333	2,267
Collective impairment allowances ³	496	545
Excess impairment allowances over expected losses ⁴	8,400	7,655
Supplementary capital before deductions	79,147	91,798
50% of unconsolidated investments	(67,692)	(53,749)
50% of securitisation positions and other deductions	(16)	(140)
Deductions	(67,708)	(53,889)
Total supplementary capital	11,439	37,909
Capital base	272,892	246,206

Capital Adequacy (continued)

Risk weighted assets at 31 December

	2012 HK\$m	2011 HK\$m
Risk weighted assets		
Credit risk	1,455,675	1,350,467
Counterparty credit risk	81,409	71,270
Market risk	116,911	38,585
Operational risk	250,139	221,429
Total	1,904,134	1,681,751

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

	2012	2011
Core capital ratio	13.7%	12.4%
Capital adequacy ratio	14.3%	14.6%

Reserves and deductible items

	2012 HK\$m	2011 HK\$m
Published reserves	177,631	146,357
Profit and loss account	34,726	30,370
Total reserves included in core capital	212,357	176,727

	2012 HK\$m	2011 HK\$m
Total of items deductible 50% from core capital and 50% from supplementary capital	135,416	107,778

- 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.
- 2 Includes adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.
- 3 Total regulatory reserve and collective impairment allowances are apportioned between the standardised approach and internal ratings-based approach in accordance with the Banking (Capital) Rules issued by the HKMA. Those apportioned to the standardised approach are included in supplementary capital. Those apportioned to the internal ratings-based approach are excluded from supplementary capital.
- 4 Excess impairment allowances over expected losses are applicable to non-securitisation exposures calculated by using the internal ratings based approach.

Risk Management

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

The HSBC Group Head Office formulates high-level risk management policies for the HSBC Group

worldwide. The group's risk management policies and procedures are subject to a high degree of oversight and guidance to ensure that all types of risk are systematically identified, measured, analysed and actively managed.

Credit risk, liquidity risk, market risk, operational risk, insurance risk and capital management are discussed in detail in Note 52 to the Financial Statements on pages 164 to 198.

Financial Review (continued)

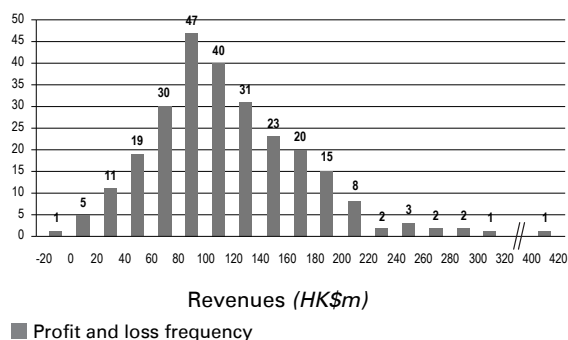
Market Risk Management

The nature of market risk and the principal tool used to monitor and limit market risk exposure (value at risk) are discussed in Note 52 on the Financial Statements on pages 181 to 184.

The average daily revenue earned from market risk-related treasury activities in 2012, including accrual book net interest income and funding related to dealing positions, was HK\$117m compared with HK\$113m in 2011. The standard deviation of these daily revenues was HK\$58m (HK\$53m for 2011).

Daily distribution of market risk revenues 2012

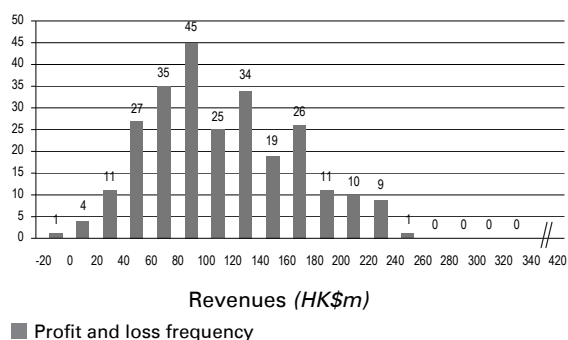
Number of days



An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 1 day in 2012. The most frequent result was a daily revenue of between HK\$80m and HK\$100m with 47 occurrences. The highest daily revenue was HK\$417m. The most frequent result in 2011 was a daily revenue of between HK\$80m and HK\$100m with 45 occurrences. The highest daily revenue in 2011 was HK\$241m.

Daily distribution of market risk revenues 2011

Number of days



Reputational Risk Management

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

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

Internal controls are an integral part of how the group conducts its business. HSBC's manuals and

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

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

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 30, 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 ('HKFRSs') 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:

- the consolidated financial statements, which have been prepared in accordance with HKFRSs, 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 has been prepared, and includes 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

4 March 2013

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 31 to 200, which comprise the consolidated and the Bank's balance sheets as at 31 December 2012, 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 2012 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

4 March 2013

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Financial Statements (continued)**Consolidated income statement for the year ended 31 December 2012**

	<i>Note</i>	2012 HK\$m	2011 HK\$m
Interest income	<i>4a</i>	115,511	107,458
Interest expense	<i>4b</i>	(33,092)	(31,786)
Net interest income		82,419	75,672
Fee income		46,221	45,166
Fee expense		(6,331)	(6,871)
Net fee income	<i>4c</i>	39,890	38,295
Net trading income	<i>4d</i>	19,214	20,199
Net income / (expense) from financial instruments designated at fair value	<i>4e</i>	4,613	(4,523)
Gains less losses from financial investments	<i>4f</i>	2,634	128
Dividend income	<i>4g</i>	522	729
Net earned insurance premiums	<i>5b</i>	52,621	45,670
Other operating income	<i>4h</i>	15,337	11,389
Total operating income		217,250	187,559
Net insurance claims incurred and movement in liabilities to policyholders	<i>5c</i>	(54,983)	(40,389)
Net operating income before loan impairment charges and other credit risk provisions		162,267	147,170
Loan impairment charges and other credit risk provisions	<i>4i</i>	(3,578)	(3,059)
Net operating income		158,689	144,111
Employee compensation and benefits	<i>6a</i>	(37,021)	(37,834)
General and administrative expenses	<i>4j</i>	(26,011)	(24,352)
Depreciation of property, plant and equipment	<i>26</i>	(4,014)	(3,878)
Amortisation and impairment of intangible assets	<i>25c</i>	(1,724)	(1,760)
Total operating expenses		(68,770)	(67,824)
Operating profit		89,919	76,287
Share of profit in associates and joint ventures		18,810	15,083
Profit before tax		108,729	91,370
Tax expense	<i>7</i>	(18,010)	(17,466)
Profit for the year		90,719	73,904
Profit attributable to shareholders		83,008	67,591
Profit attributable to non-controlling interests		7,711	6,313

Consolidated statement of comprehensive income for the year ended 31 December 2012

	2012 HK\$m	2011 HK\$m
Profit for the year	90,719	73,904
Other comprehensive income		
Available-for-sale investments:		
– fair value changes taken to equity	14,153	(25,410)
– fair value changes transferred to the income statement on disposal	(2,753)	(231)
– amounts transferred to the income statement on (impairment)/ reversal of impairment	5	(208)
– fair value changes transferred to the income statement on hedged items due to hedged risk	(287)	(1,124)
– income taxes	(768)	119
Cash flow hedges:		
– fair value changes taken to equity	3,858	303
– fair value changes transferred to the income statement	(3,662)	(399)
– income taxes	(33)	15
Property revaluation:		
– fair value changes taken to equity	7,221	12,940
– income taxes	(1,161)	(2,068)
Share of other comprehensive income / (expense) of associates and joint ventures	638	(1,259)
Exchange differences	925	(1,235)
Actuarial gains / (losses) on post-employment benefits:		
– before income taxes	1,080	(3,518)
– income taxes	(198)	575
Other comprehensive income / (expense) for the year, net of tax	19,018	(21,500)
Total comprehensive income for the year, net of tax	109,737	52,404
Total comprehensive income for the year attributable to:		
– shareholders	100,814	45,428
– non-controlling interests	8,923	6,976
	109,737	52,404

Financial Statements (continued)**Consolidated balance sheet at 31 December 2012**

	<i>Note</i>	2012 HK\$m	2011 HK\$m
ASSETS			
Cash and short-term funds	11	1,111,199	919,906
Items in the course of collection from other banks		23,079	34,546
Placings with banks maturing after one month	12	184,711	198,287
Certificates of deposit	13	93,085	88,691
Hong Kong Government certificates of indebtedness	14	176,264	162,524
Trading assets	15	419,697	447,968
Financial assets designated at fair value	16	69,479	57,670
Derivatives	17	398,956	377,296
Loans and advances to customers	18	2,349,043	2,130,871
Financial investments	21	626,042	722,433
Amounts due from Group companies		176,004	152,730
Interests in associates and joint ventures	24	119,273	91,785
Goodwill and intangible assets	25	38,634	34,839
Property, plant and equipment	26	90,179	85,294
Deferred tax assets	7	2,629	2,325
Other assets	28	187,053	100,315
Total assets		6,065,327	5,607,480
LIABILITIES			
Hong Kong currency notes in circulation	14	176,264	162,524
Items in the course of transmission to other banks		35,525	47,163
Deposits by banks		244,135	222,582
Customer accounts	29	3,874,884	3,565,001
Trading liabilities	30	183,340	171,431
Financial liabilities designated at fair value	31	44,270	40,392
Derivatives	17	397,151	383,252
Debt securities in issue	32	74,647	77,472
Retirement benefit liabilities	6	6,725	8,097
Amounts due to Group companies		97,618	108,423
Other liabilities and provisions	33	94,791	108,314
Liabilities under insurance contracts issued	34	244,921	209,438
Current tax liabilities	7	3,842	4,126
Deferred tax liabilities	7	16,923	14,712
Subordinated liabilities	36	13,867	16,114
Preference shares	37	83,346	97,096
Total liabilities		5,592,249	5,236,137
EQUITY			
Share capital	38	58,969	30,190
Other reserves		133,790	112,218
Retained profits		224,640	188,416
Proposed fourth interim dividend	9	20,000	10,000
Total shareholders' equity		437,399	340,824
Non-controlling interests		35,679	30,519
Total equity		473,078	371,343
Total equity and liabilities		6,065,327	5,607,480

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 2012

	2012										
	Share capital HK\$m	Retained profits and proposed dividend HK\$m	Other reserves						Total shareholders' equity HK\$m	Non-controlling interests HK\$m	Total equity HK\$m
			Property revaluation reserve HK\$m	Available-for-sale investment reserve HK\$m	Cash flow hedge reserve HK\$m	Foreign exchange reserve HK\$m	Other HK\$m	Total share-holders' 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 gains 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	—	(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	

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2012 (continued)

2011

	Other reserves							Total share- holders' equity HK\$'m	Non- controlling interests HK\$'m	Total equity HK\$'m
	Share capital HK\$'m	Retained profits and proposed dividend HK\$'m	Property revaluation reserve HK\$'m	Available- for-sale investment reserve HK\$'m	Cash flow hedge reserve HK\$'m	Foreign exchange reserve HK\$'m	Other HK\$'m			
At 1 January	22,494	173,254	29,980	57,553	106	15,789	20,954	320,130	27,305	347,435
Profit for the year	—	67,591	—	—	—	—	—	67,591	6,313	73,904
Other comprehensive income (net of tax)	—	(2,578)	9,828	(27,760)	(55)	(1,524)	(74)	(22,163)	663	(21,500)
Available-for-sale investments	—	—	—	(26,579)	—	—	—	(26,579)	(275)	(26,854)
Cash flow hedges	—	—	—	—	(56)	—	—	(56)	(25)	(81)
Property revaluation	—	(137)	9,828	—	—	—	—	9,691	1,181	10,872
Actuarial losses on defined benefit plans	—	(2,437)	—	—	—	—	—	(2,437)	(506)	(2,943)
Share of other comprehensive income of associates and joint ventures	—	(6)	—	(1,181)	—	—	(72)	(1,259)	—	(1,259)
Exchange differences	—	2	—	—	1	(1,524)	(2)	(1,523)	288	(1,235)
Total comprehensive income for the year	—	65,013	9,828	(27,760)	(55)	(1,524)	(74)	45,428	6,976	52,404
Shares issued	7,696	—	—	—	—	—	—	7,696	—	7,696
Dividends paid	—	(33,000)	—	—	—	—	—	(33,000)	(3,764)	(36,764)
Movement in respect of share-based payment arrangements	—	91	—	—	—	—	694	785	26	811
Other movements	—	(3)	—	(7)	—	—	(205)	(215)	(24)	(239)
Transfers	—	(6,939)	(869)	—	—	—	7,808	—	—	—
At 31 December	30,190	198,416	38,939	29,786	51	14,265	29,177	340,824	30,519	371,343

Consolidated statement of cash flows for the year ended 31 December 2012

	Note	2012 HK\$m	2011 HK\$m
Operating activities			
Cash (used in)/generated from operations	42	(20,651)	16,583
Interest received on financial investments		14,349	13,269
Dividends received on financial investments		464	723
Dividends received from associates		2,297	935
Taxation paid		(17,423)	(15,790)
Net cash (outflow)/inflow from operating activities		(20,964)	15,720
Investing activities			
Purchase of financial investments		(262,280)	(495,823)
Proceeds from sale or redemption of financial investments		350,945	588,409
Purchase of property, plant and equipment		(1,990)	(2,870)
Proceeds from sale of property, plant and equipment and assets held for sale		35	215
Purchase of other intangible assets		(1,303)	(1,804)
Net cash outflow in respect of the acquisition of and increased shareholding in subsidiaries	43	–	(143)
Net cash inflow in respect of the sale of subsidiaries	43	1,416	1
Net cash outflow in respect of the purchase of interests in associates and joint ventures		(13,521)	(263)
Net cash (outflow)/inflow from the sale of interests in business portfolios	43	(12,242)	5,649
Proceeds from the sale of interests in associates	43	3,970	19
Net cash inflow from investing activities		65,030	93,390
Net cash inflow before financing		44,066	109,110
Financing			
Issue of ordinary share capital		28,779	7,696
Issue of preference shares		29	–
Redemption of preference shares		(13,566)	(4,280)
Repayment of subordinated liabilities		(2,326)	(5,152)
Issue of subordinated liabilities		2,328	3,502
Ordinary dividends paid	9	(32,500)	(33,000)
Dividends paid to non-controlling interests		(3,766)	(3,764)
Interest paid on preference shares		(2,301)	(2,421)
Interest paid on subordinated liabilities		(884)	(793)
Net cash outflow from financing		(24,207)	(38,212)
Increase in cash and cash equivalents	43	19,859	70,898

Financial Statements (continued)**Bank balance sheet at 31 December 2012**

	<i>Note</i>	2012 HK\$m	2011 HK\$m
ASSETS			
Cash and short-term funds	11	761,187	612,265
Items in the course of collection from other banks		17,355	29,821
Placings with banks maturing after one month	12	80,200	108,873
Certificates of deposit	13	20,150	23,987
Hong Kong Government certificates of indebtedness	14	176,264	162,524
Trading assets	15	284,573	317,321
Financial assets designated at fair value	16	1,432	2,283
Derivatives	17	391,839	370,678
Loans and advances to customers	18	1,282,720	1,176,602
Financial investments	21	260,317	362,307
Amounts due from Group companies		321,600	248,001
Investments in subsidiaries	23	58,819	57,724
Interests in associates and joint ventures	24	40,919	28,139
Goodwill and intangible assets	25	4,765	4,831
Property, plant and equipment	26	53,852	51,876
Deferred tax assets	7	1,333	1,098
Other assets	28	143,480	57,011
Total assets		3,900,805	3,615,341
LIABILITIES			
Hong Kong currency notes in circulation	14	176,264	162,524
Items in the course of transmission to other banks		25,766	38,577
Deposits by banks		204,520	158,746
Customer accounts	29	2,417,400	2,220,072
Trading liabilities	30	82,146	78,959
Financial liabilities designated at fair value	31	7,731	5,910
Derivatives	17	392,084	377,165
Debt securities in issue	32	40,406	46,360
Retirement benefit liabilities	6	3,710	4,150
Amounts due to Group companies		149,237	152,906
Other liabilities and provisions	33	58,887	71,585
Current tax liabilities	7	2,348	2,748
Deferred tax liabilities	7	6,194	5,884
Subordinated liabilities	36	9,355	9,386
Preference shares	37	83,195	96,969
Total liabilities		3,659,243	3,431,941
EQUITY			
Share capital	38	58,969	30,190
Other reserves		62,219	49,278
Retained profits		100,374	93,932
Proposed fourth interim dividend	9	20,000	10,000
Total equity		241,562	183,400
Total equity and liabilities		3,900,805	3,615,341

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 2012

	2012							Total equity HK\$m
	Share capital HK\$m	Retained profits and proposed dividend HK\$m	Property revaluation reserve HK\$m	Available-for-sale investment reserve HK\$m	Cash flow hedge reserve HK\$m	Foreign exchange reserve HK\$m	Other 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 gains 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

Financial Statements (continued)

Bank statement of changes in equity for the year ended 31 December 2012 (continued)

	2011							Total equity HK\$m
	Share Capital HK\$m	Retained profits and proposed dividend HK\$m	Property revaluation reserve HK\$m	Available- for-sale investment reserve HK\$m	Cash flow hedge reserve HK\$m	Foreign exchange reserve HK\$m	Other HK\$m	
At 1 January	22,494	100,086	18,437	50,551	70	1,304	1,567	194,509
Profit for the year	—	37,812	—	—	—	—	—	37,812
Other comprehensive income (net of tax)	—	(1,533)	6,378	(24,538)	(7)	(4,456)	—	(24,156)
Available-for-sale investments	—	—	—	(24,538)	—	—	—	(24,538)
Cash flow hedges	—	—	—	—	(7)	—	—	(7)
Property revaluation	—	(79)	6,378	—	—	—	—	6,299
Actuarial losses on defined benefit plans	—	(1,454)	—	—	—	—	—	(1,454)
Exchange differences	—	—	—	—	—	(4,456)	—	(4,456)
Total comprehensive income	—	36,279	6,378	(24,538)	(7)	(4,456)	—	13,656
Shares issued	7,696	—	—	—	—	—	—	7,696
Dividends paid	—	(33,000)	—	—	—	—	—	(33,000)
Movement in respect of share-based payment arrangements	—	52	—	—	—	—	551	603
Other movements	—	(4)	—	—	—	—	(60)	(64)
Transfers	—	519	(519)	—	—	—	—	—
At 31 December	30,190	103,932	24,296	26,013	63	(3,152)	2,058	183,400

Notes on the Financial Statements

1 Basis of preparation

- a** The consolidated financial statements comprise the accounts of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') as of 31 December 2012.

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

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

During 2012 the group adopted a number of interpretations and amendments to standards, all of which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of the Bank.

Following the amendment to HKAS 12 'Income Taxes' issued by the HKICPA in December 2010, deferred taxes on investment property, carried under the fair value model in HKAS 40, are measured based on the rebuttable presumption that an investment property is recovered entirely through sale. The application of the amendment to HKAS 12 did not have a material effect on the group's consolidated financial statements and, consequently, has been applied prospectively.

- b** The consolidated financial statements 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 2012.

c Future Accounting Developments

At 31 December 2012, 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 2012. In addition to the projects to complete financial instrument accounting, there are other projects on insurance, revenue recognition and lease accounting which, together with the standards described below, will represent significant changes to accounting requirements from 2015 and later.

Standards applicable in 2013

In June 2011, the HKICPA issued HKFRS 10 'Consolidated Financial Statements' ('HKFRS 10'), HKFRS 11 'Joint Arrangements' ('HKFRS 11') and HKFRS 12 'Disclosure of Interests in Other Entities' ('HKFRS 12'). In July 2012, HKICPA issued amendments to HKFRS 10, HKFRS 11 and HKFRS 12 'Transition Guidance'. The standards are effective for annual periods beginning on or after 1 January 2013. HKFRSs 10 and 11 are to be applied retrospectively.

Under HKFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal control or exposure to risks and rewards, depending on the nature of the entity. HKFRS 11 places more focus on the investors' rights and obligations than on the structure of an arrangement, and introduces the concept of a joint operation. HKFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities.

Based on our assessment to date, while the consolidation status of some entities may change because the group has control but not the majority of risks and rewards, or vice versa, we do not expect the overall impact of HKFRS 10 and HKFRS 11 on the financial statements to be material.

In June 2011, the HKICPA issued HKFRS 13 'Fair Value Measurement' ('HKFRS 13'). This standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. 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.

Notes on the Financial Statements (continued)

1 Basis of preparation (continued)

HKFRS 13 establishes a single source of guidance for all fair value measurements required or permitted by HKFRSs. The standard clarifies the definition of fair value as an exit price, which is defined as a price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions, and enhances disclosures about fair value measurement.

Based on our current assessment, we do not expect the impact of HKFRS 13 on the financial statements to be material.

In July 2011, the HKICPA issued amendments to HKAS 19 'Employee Benefits' ('HKAS 19 revised'). The revised standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. HKAS 19 revised is to be applied retrospectively.

The most significant amendment for the group is the replacement of interest cost and expected return on plan assets by a finance cost component comprising the net interest on the net defined benefit liability or asset.

This finance cost component is determined by applying the same discount rate used to measure the defined benefit obligation to the net defined benefit liability or asset. The difference between the actual return on plan assets and the return included in the finance cost component in the income statement will be presented in other comprehensive income. The effect of this change is to increase the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

Based on our estimate of the impact of this particular amendment on the 2012 consolidated financial statements, the change would decrease pre-tax profit, with no effect on the pension liability. The effect on total operating expenses and pre-tax profit is not material. The effect at the date of adoption on 1 January 2013 was not material to the group.

In December 2011, the HKICPA issued amendments to HKFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' which requires disclosures about the effect or potential effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. The amendments are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendments are required to be applied retrospectively.

Standards applicable in 2014

In December 2011, the HKICPA issued amendments to HKAS 32 'Financial Instruments: Presentation' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32. 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.

The group is currently assessing the impact of these clarifications but it is not practical to quantify their effect as at the date of publication of these consolidated financial statements.

In December 2012, HKICPA issued amendments to HKFRS 10, HKFRS 12 and HKAS 27, which introduced an exception for investment entities to the principle that all subsidiaries shall be consolidated. We do not expect the amendments to have any material impact on the group's financial statements.

Standards applicable in 2015

In November 2009, the HKICPA issued HKFRS 9 'Financial Instruments' ('HKFRS 9') 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 planned replacement of HKAS 39 'Financial Instruments: Recognition and Measurement' ('HKAS 39').

Following the HKICPA's decision in December 2011 to defer the effective date, the standard is effective for annual periods beginning on or after 1 January 2015.

The second and third phases in the HKAS 39 replacement project will address the impairment of financial assets measured at amortised cost and hedge accounting.

1 Basis of preparation *(continued)*

As a result of uncertainties with regard to the final HKFRS 9 requirements for classification and measurement and impairment, the group remains unable to provide a date by which it will apply HKFRS 9 as a whole and it remains impracticable to quantify the effect of HKFRS 9 as at the date of the publication of these financial statements.

Enhanced Disclosure Task Force

In accordance with the group's policy to provide meaningful disclosures that help stakeholders understand the group's performance, financial position and changes thereto, the group intends to implement the recommendations of the Enhanced Disclosure Task Force ('EDTF') report 'Enhancing the Risk Disclosures of Banks' (issued on 29 October 2012), which are relevant. The EDTF was established in May 2012 at the initiative of the Financial Stability Board. Its objective was to develop recommendations for enhancing risk and regulatory disclosures by banks. The report's recommendations are voluntary and help financial institutions identify areas that need better and more transparent information about risks and how these relate to performance measurement and reporting.

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(d), 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(h) and is discussed further within note 17 'Derivatives' and note 51 'Fair value of financial instruments'.

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

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

Notes on the Financial Statements (continued)

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 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.

Impairment of interests in associates

The group's accounting policy for impairment of interests in associates is set out in note 3m. When an investment in an associate is tested in accordance with HKAS 36 'Impairment of Assets' to determine whether it is impaired, significant judgement is required in selecting and applying appropriate assumptions and estimates to determine the recoverable amount.

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.

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. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in note 52.

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 (other than debt securities issued by the group and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest 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.

Net income 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. Interest income and expense and dividend income arising on these financial instruments are also included, except for interest arising from debt securities issued, 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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

c *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 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 for the hedged risk only.

Loans and advances are reclassified to 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 3ac); however, such loans and advances continue to be measured in accordance with the policy described above.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit or loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit or loss. Where it is not the group's intention to trade but 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 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 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.

d *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 expected from future events are not recognised.

Individually assessed loans and advances

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

- the size of the loan;
- the number of loans in the portfolio;
- the importance of the individual loan relationship, and how this is managed; and
- whether volumes of defaults and losses are sufficient to enable a collective assessment methodology to be applied.

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;
- past due 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
- deterioration in the financial condition or outlook of the borrower such that the 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 at its 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:

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

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 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.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss 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.

3 Summary of significant accounting policies *(continued)*

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 judgment 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.

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 or should be considered past due. The carrying amounts of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

e *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, loans and advances to and from banks, debt securities, structured deposits, equity shares, own debt issued and short positions in securities which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as held for trading. 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'.

f *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; examples include unit-linked investment contracts, and certain portfolios of securities and debt issuances that are managed in conjunction with financial assets or liabilities measured on a fair value basis;
- applies to a group of financial assets, financial liabilities, or both, that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel; examples include financial assets held to back certain insurance contracts, and certain asset-backed securities; or
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, and which would otherwise be required to be accounted for separately; examples include certain debt issuances and debt securities held.

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'.

g *Financial investments*

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

3 Summary of significant accounting policies (continued)

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.

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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if, there is objective evidence of impairment 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;
- 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.

h *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.

i *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.

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'.

3 Summary of significant accounting policies (continued)

j *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.

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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

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”.

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’.

3 Summary of significant accounting policies (continued)

k *Derecognition of financial assets and liabilities*

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

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

l *Offsetting financial assets and financial liabilities*

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

m *Subsidiaries, associates and joint ventures*

The group classifies investments in entities which it controls as subsidiaries. Where the group is a party to a contractual arrangement whereby, together with one or more parties, it undertakes an economic activity that is subject to joint control, the group classifies its interest in the venture as a joint venture. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

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.

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.

The group's policy for impairment testing on goodwill arising on acquisition of subsidiaries is included under note 3(n). 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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

n Goodwill and intangible assets

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

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 ('CGUs') for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the CGU may be impaired, by comparing the recoverable amount 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(w).

3 Summary of significant accounting policies (continued)

o 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 is depreciated over the unexpired terms of the leases; and
- buildings and improvements thereto are depreciated at the greater of 2% per annum on the straight line basis or over the unexpired terms of the leases or over the remaining useful lives of the buildings.

(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, primarily on the basis of capitalisation of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation, or both, are classified and accounted for as investment properties on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 3(p)).

(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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

p Finance and operating leases

- (i) Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. Where the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in '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.

q Income tax

- (i) Income tax for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in the statement of comprehensive income, in which case it is recognised in the statement of comprehensive income.
- (ii) Current tax is the expected tax payable on the taxable income for the year, calculated using tax rates enacted or substantively enacted at the period end date, and any adjustment to tax payable in respect of previous years. 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.
- (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.

3 Summary of significant accounting policies (continued)

r Pension and other post-retirement benefits

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

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

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

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

s Share-based payments

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

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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

t 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.

u Provisions

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

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.

v Financial guarantee contracts

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

w Insurance contracts

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

Insurance contracts are accounted for as follows:

3 Summary of significant accounting policies *(continued)*

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.

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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

x 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'.

y Dividends

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

z Debt securities in issue and subordinated liabilities

Debt securities issued for trading purposes or designated at fair value are reported under the appropriate balance sheet captions. Other debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest method and are reported under 'Debt securities in issue' or 'Subordinated liabilities'.

aa Cash and cash equivalents

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

ab Share capital

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

ac 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 HKFRSs. 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 HKFRSs 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.

4 Operating profit

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

a Interest Income

	2012 HK\$m	2011 HK\$m
Interest income on listed securities	7,708	8,004
Interest income on unlisted securities	19,458	17,989
Other interest income	97,465	89,699
	124,631	115,692
Less: interest income classified as 'Net trading income' (note 4(d))	(9,064)	(8,183)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 4(e))	(56)	(51)
	115,511	107,458

Included in the above is interest income accrued on impaired financial assets of HK\$174m (2011: HK\$308m), including the unwinding of discounts on loan impairment losses of HK\$152m (2011: HK\$294m).

b Interest expense

	2012 HK\$m	2011 HK\$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	726	831
Interest expense on preference shares	2,386	2,337
Other interest expense	34,547	32,867
	37,659	36,035
Less: interest expense classified as 'Net trading income' (note 4(d))	(4,544)	(4,225)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	(23)	(24)
	33,092	31,786

c Net fee income

	2012 HK\$m	2011 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	15,315	15,081
– fee expense	(1,542)	(1,415)
	13,773	13,666
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	8,287	8,862
– fee expense	(1,069)	(1,213)
	7,218	7,649

Notes on the Financial Statements (continued)**4 Operating profit** (continued)**d Net trading income**

	2012 HK\$m	2011 HK\$m
Dealing profits	16,633	15,590
– Foreign exchange	14,002	15,313
– Interest rate derivatives	2,145	400
– Debt securities	2,322	1,300
– Equities and other trading	(1,836)	(1,423)
Loss from hedging activities	(31)	(71)
Fair value hedges		
– Net gain on hedged items attributable to the hedged risk	345	1,050
– Net loss on hedging instruments	(376)	(1,147)
– Other	–	26
Interest on trading assets and liabilities	4,520	3,958
– Interest income (note 4(a))	9,064	8,183
– Interest expense (note 4(b))	(4,544)	(4,225)
Dividend income from trading securities	786	722
– Listed investments	653	608
– Unlisted investments	133	114
Ping An contingent forward sale contract (note 28)	(2,694)	–
	19,214	20,199

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

	2012 HK\$m	2011 HK\$m
Income/(expense) on assets designated at fair value which back insurance and investment contracts	6,670	(4,542)
Change in fair value of liabilities to customers under investment contracts	(2,209)	30
	4,461	(4,512)
Net change in fair value of other financial assets/liabilities designated at fair value ¹	119	(38)
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	56	51
– Interest expense (note 4(b))	(23)	(24)
	4,613	(4,523)

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 2012 the group recognised a HK\$22m loss on changes in the fair value of these instruments arising from changes in own credit risk (2011:HK\$15m gain).

f Gains less losses from financial investments

	2012 HK\$m	2011 HK\$m
Gains on disposal of available-for-sale securities	2,809	470
Impairment of available-for-sale equity investments	(175)	(342)
	2,634	128

There are no gains or losses on the disposal of held-to-maturity investments in the year (2011: nil).

4 Operating profit (continued)

g Dividend income

	2012 HK\$m	2011 HK\$m
Listed investments	325	431
Unlisted investments	197	298
	522	729

h Other operating income

	2012 HK\$m	2011 HK\$m
Rental income from investment properties	216	191
Movement in present value of in-force insurance business	4,432	5,524
Gains on investment properties	834	1,033
Gain/(loss) on disposal of property, plant and equipment, and assets held for sale	30	(3)
Gain/(loss) on disposal of subsidiaries, associates and business portfolios	5,246	(9)
Surplus arising on property revaluation	2	8
Other	4,577	4,645
	15,337	11,389

Other largely comprises recoveries of IT and other operating costs from shared services activities incurred on behalf of fellow Group companies. Other also includes recoveries against initial fair value on acquired loan portfolios of HK\$650m (2011: HK\$558m). There are no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2011: nil).

i Loan impairment charges and other credit risk provisions

	2012 HK\$m	2011 HK\$m
Net charge for impairment of loans and advances to customers		
– Individually assessed impairment allowances:		
New allowances	2,201	2,254
Releases	(1,230)	(1,204)
Recoveries	(237)	(356)
	734	694
– Net charge for collectively assessed impairment allowances	2,596	2,401
Net charge/(release) for other credit risk provisions	248	(36)
Net charge for loan impairment and other credit risk provisions	3,578	3,059

Included in the net charge for other credit risk provisions is an impairment release of HK\$82m against available-for-sale debt securities (2011: impairment release of HK\$4m). There are no impairment losses or provisions relating to held-to-maturity investments (2011: nil).

Notes on the Financial Statements (continued)**4 Operating profit** (continued)**j General and administrative expenses**

	2012 HK\$m	2011 HK\$m
Premises and equipment		
– Rental expenses	3,292	3,102
– Amortisation of prepaid operating lease payments	18	18
– Other premises and equipment expenses	3,941	3,810
	7,251	6,930
Marketing and advertising expenses	3,578	3,969
Other administrative expenses	15,182	13,453
	26,011	24,352

Included in operating expenses are direct operating expenses of HK\$23m (2011: HK\$19m) 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 (2011: HK\$2m).

Included in operating expenses are minimum lease payments under operating leases of HK\$3,361m (2011: HK\$3,170m).

k Auditors' remuneration

Auditors' remuneration amounted to HK\$77m (2011: HK\$77m), of which HK\$29m (2011: HK\$29m) related to the Bank.

5 Insurance income

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

a Insurance income

	2012 HK\$m	2011 HK\$m
Net interest income	7,864	6,779
Net fee income	1,216	692
Net trading income/(loss)	56	(386)
Net income/(expense) from financial instruments designated at fair value	4,538	(4,460)
Net earned insurance premiums (note 5(b)).....	52,621	45,670
Movement in present value of in-force business	4,432	5,524
Other operating income	1,308	237
	72,035	54,056
Net insurance claims incurred and movement in liabilities to policyholders (note 5(c)).....	(54,983)	(40,389)
Net operating income	17,052	13,667

5 Insurance income

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
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
2011					
Gross written premiums	3,318	36,000	7,312	–	46,630
Movement in unearned premiums	(183)	–	–	–	(183)
Gross earned premiums	3,135	36,000	7,312	–	46,447
Gross written premiums ceded to reinsurers	(455)	(311)	(10)	–	(776)
Reinsurers' share of movement in unearned premiums	(1)	–	–	–	(1)
Reinsurers' share of gross earned premiums	(456)	(311)	(10)	–	(777)
Net earned premiums	2,679	35,689	7,302	–	45,670

Notes on the Financial Statements (continued)**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
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
2011					
Claims, benefits and surrenders paid ...	1,420	6,399	1,958	85	9,862
Movement in provision	(33)	30,598	1,192	(84)	31,673
Gross claims incurred and movement in liabilities to policyholders	1,387	36,997	3,150	1	41,535
Reinsurers' share of claims, benefits and surrenders paid	(147)	(178)	(385)	–	(710)
Reinsurers' share of movement in provision	(14)	(5)	(417)	–	(436)
Reinsurers' share of claims incurred and movement in liabilities to policyholders	(161)	(183)	(802)	–	(1,146)
Net insurance claims incurred and movement in liabilities to policyholders	1,226	36,814	2,348	1	40,389

6 Employee compensation and benefits

a Employee compensation and benefits

	2012 HK\$m	2011 HK\$m
Wages and salaries	34,233	35,020
Social security costs	935	912
Retirement benefit costs		
– Defined contribution plans	1,063	1,043
– Defined benefit plans (note 6(c)(v))	790	859
	37,021	37,834

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\$74m (2011: HK\$71m). This comprises fees of HK\$8m (2011: HK\$6m) and other emoluments of HK\$66m (2011: HK\$66m) which includes pension benefits of HK\$1m (2011: HK\$1m).

c Retirement benefit pension plans

The group operates 85 (2011: 80) retirement benefit plans, with a total cost of HK\$1,853m (2011: HK\$1,902m), of which HK\$658m (2011: HK\$587m) relates to overseas plans and HK\$19m (2011: HK\$30m) to a plan sponsored by HSBC Asia Holdings BV.

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

The group's defined benefit plans, which cover 26% (2011: 35%) of employees, are predominantly funded plans with assets which, in the case of the larger plans, are held either under insurance policies or in trust funds separate from the group. The cost relating to the funded plans was HK\$722m (2011: HK\$804m) which was assessed in accordance with the advice of qualified actuaries; the plans are reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the projected benefit obligations of the group's retirement benefit plans vary according to the economic conditions of the countries in which they are situated.

(i) Defined benefit plan principal actuarial assumptions

The principal actuarial assumptions used to calculate the assets and liabilities of the major defined benefit pension plans were:

	2012 % p.a.	2011 % p.a.
Discount rate	0.60	1.47
Expected rates of return on plan assets ¹		
– equities	8.4	7.5
– bonds	2.8	3.9
– other	4.5	3.9
Rate of pay increase		
– long term	4.0	5.0
Mortality table	HKLT2011 ²	HKLT2001 ³

¹ The expected rates of return in 2011 were used to measure the expected return on plan assets in the subsequent year, i.e. 2012. The rates under 2012, however, are for reference only as starting from 2013, the interest cost and the expected return on plan assets will be replaced by the net interest component on the net defined benefit liability or asset under HKAS 19 (revised) 'Employee Benefits'. Details are included under note 1c 'Future Accounting Developments'. The expected rates of return as shown above are weighted on the basis of the fair value of the plan assets.

² HKLT2011 – Hong Kong Life Tables 2011.

³ HKLT2001 – Hong Kong Life Tables 2001.

Notes on the Financial Statements (continued)**6 Employee compensation and benefits** (continued)

The overall expected long-term rate of return on assets as at 31 December 2012 was 4.6% (2011: 4.7%). The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based on historical market returns adjusted for additional factors such as the current rate of inflation and interest rates.

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of the Bank and certain other local employees of HSBC Group. The scheme 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. The latest valuation of the defined benefit scheme was made at 31 December 2010 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\$8,611m. On an ongoing basis, the actuarial value of the scheme's assets represented 104% of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK\$319m. On a wind-up basis, the scheme's assets represents 110% of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK\$808m. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 6% per annum and long-term salary increases of 5% per annum.

(ii) Value recognised in the balance sheet

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Equities	3,977	3,162	2,176	1,483
Bonds	9,050	9,357	6,106	6,600
Other	1,549	1,594	1,047	1,269
Fair value of plan assets	14,576	14,113	9,329	9,352
Present value of funded obligations	20,835	21,699	12,772	13,186
Present value of unfunded obligations	402	402	243	247
Defined benefit obligations	21,237	22,101	13,015	13,433
Past service (credit)/ cost not recognised ..	(2)	3	–	5
Effect of limit on plan surpluses	1	1	1	1
Net defined benefit liability	(6,664)	(7,986)	(3,687)	(4,077)
Reported as 'Assets'	61	111	23	73
Reported as 'Liabilities'	(6,725)	(8,097)	(3,710)	(4,150)
Net defined benefit liability	(6,664)	(7,986)	(3,687)	(4,077)

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

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
At 1 January	22,101	19,308	13,433	12,156
Current service cost	1,126	1,024	706	658
Interest cost	398	591	265	390
Contributions by employees	2	2	–	–
Actuarial (gains)/losses	(385)	2,641	(92)	1,263
Benefits paid	(1,694)	(1,203)	(1,167)	(848)
Past service cost – vested immediately	1	28	–	27
Liabilities extinguished on settlements	(186)	(195)	–	(128)
Exchange and other movements	(126)	(95)	(130)	(85)
At 31 December	21,237	22,101	13,015	13,433

6 Employee compensation and benefits (continued)

(iv) Changes in the fair value of plan assets

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
At 1 January	14,113	14,887	9,352	9,859
Expected return	674	754	460	510
Contributions by the group/the Bank	876	718	394	436
Contributions by employees	2	2	–	–
Actuarial gains/(losses)	694	(880)	323	(471)
Benefits paid	(1,541)	(1,140)	(1,065)	(808)
Assets distributed on settlement	(113)	(153)	–	(101)
Exchange and other movements	(129)	(75)	(135)	(73)
At 31 December	14,576	14,113	9,329	9,352

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

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Equities	155	341	80	284
Others	65	179	14	132
	220	520	94	416

The group's actual gain on plan assets for the year ended 31 December 2012 was HK\$1,369m (2011: HK\$157m loss). The Bank's actual gain on plan assets for the year ended 31 December 2012 was HK\$783m (2011: HK\$8m).

The group expects to make HK\$669m of contributions to defined benefit pension plans during 2013. Contributions to be made by the Bank are expected to be HK\$378m.

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

	2012 HK\$m	2011 HK\$m
Current service cost	1,126	1,024
Interest cost	398	591
Expected return on plan assets	(674)	(754)
Past service costs	5	37
Gains on settlements/curtailments	(65)	(39)
Total net expense	790	859

The total net actuarial gains recognised in total equity during 2012 in respect of defined benefit pension plans was HK\$1,079m (2011: HK\$3,518m loss). After deduction of non-controlling interests, a gain of HK\$850m (2011: HK\$2,912m loss) was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date are HK\$9,219m (2011: HK\$10,298m). After deduction of non-controlling interests, the total net actuarial losses recognised in total shareholders' equity to date are HK\$7,979m (2011: HK\$8,829m).

The total net actuarial gain recognised in the Bank's retained profits during 2012 in respect of defined benefit pension plans was HK\$415m (2011: HK\$1,727m loss). Total net actuarial losses recognised outside of the income statement to date are HK\$5,573m (2011: HK\$5,988m).

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2012 was nil (2011: nil).

Notes on the Financial Statements (continued)**6 Employee compensation and benefits** (continued)

(vi) Amounts for the current and previous years

	The group					The Bank				
	2012 HK\$m	2011 HK\$m	2010 HK\$m	2009 HK\$m	2008 HK\$m	2012 HK\$m	2011 HK\$m	2010 HK\$m	2009 HK\$m	2008 HK\$m
Defined benefit obligations	21,237	22,101	19,308	17,948	20,954	13,015	13,433	12,156	11,437	12,841
Plan assets	14,576	14,113	14,887	14,318	13,588	9,329	9,353	9,859	9,627	9,379
Net deficit	(6,661)	(7,988)	(4,421)	(3,630)	(7,366)	(3,686)	(4,080)	(2,297)	(1,810)	(3,462)
Experience gains/(losses) on plan liabilities	374	(344)	(214)	408	(132)	154	(230)	(175)	60	(363)
Experience gains/(losses) on plan assets	694	(911)	2	368	(3,591)	323	(502)	(59)	(47)	(1,400)

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% (2011: 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 2012. Deferred taxation is provided for in accordance with the group's accounting policy in note 3(q).

The charge for taxation in the income statement comprises:

	2012 HK\$m	2011 HK\$m
Current income tax		
– Hong Kong profits tax – on current year profit	7,810	6,395
– Hong Kong profits tax – adjustments in respect of prior years	(20)	145
– Overseas taxation – on current year profit	10,631	9,593
– Overseas taxation – adjustments in respect of prior years	(203)	(219)
	18,218	15,914
Deferred tax		
– Origination and reversal of temporary differences	35	1,494
– Effect of changes in tax rates	65	8
– Adjustments in respect of prior years	(308)	50
	(208)	1,552
	18,010	17,466

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 and short term timing differences HK\$m	Leasing transactions HK\$m	Impairment allowances on financial assets HK\$m	Revaluation of properties HK\$m	Other HK\$m	Total HK\$m
2012						
At 1 January	1,154	–	782	(740)	1,129	2,325
Exchange and other adjustments	415	–	(404)	(65)	(225)	(279)
Credit to income statement	98	–	516	4	197	815
Credit/(charge) to reserves	–	–	–	1	(233)	(232)
At 31 December	1,667	–	894	(800)	868	2,629
2011						
At 1 January	1,669	–	896	(852)	802	2,515
Exchange and other adjustments	(611)	–	98	102	170	(241)
Credit/(charge) to income statement	96	–	(212)	(1)	134	17
Credit to reserves	–	–	–	11	23	34
At 31 December	1,154	–	782	(740)	1,129	2,325

The Bank

	Accelerated capital allowances and short term timing differences HK\$m	Leasing transactions HK\$m	Impairment allowances on financial assets HK\$m	Revaluation of properties HK\$m	Other HK\$m	Total HK\$m
2012						
At 1 January	522	–	544	(723)	755	1,098
Exchange and other adjustments	120	–	(83)	(21)	(95)	(79)
Credit to income statement	72	–	125	2	273	472
Credit/(charge) to reserves	–	–	–	12	(170)	(158)
At 31 December	714	–	586	(730)	763	1,333
2011						
At 1 January	616	–	846	(797)	439	1,104
Exchange and other adjustments	(289)	–	(67)	59	109	(188)
Credit/(charge) to income statement	195	–	(235)	(2)	169	127
Credit to reserves	–	–	–	17	38	55
At 31 December	522	–	544	(723)	755	1,098

Notes on the Financial Statements (continued)**7 Tax expense** (continued)(ii) *Deferred tax liabilities**The group*

	Accelerated capital allowances and short term timing differences HK\$m	Leasing transactions HK\$m	Impairment allowances on financial assets HK\$m	Revaluation of properties HK\$m	Other HK\$m	Total HK\$m
2012						
At 1 January	5,734	(30)	5	9,608	(605)	14,712
Exchange and other adjustments	(654)	–	(293)	(99)	797	(249)
Charge/(credit) to income statement	1,700	–	26	(867)	(252)	607
Charge to reserves	–	–	–	1,162	691	1,853
At 31 December	6,780	(30)	(262)	9,804	631	16,923
2011						
At 1 January	4,680	(31)	(295)	7,456	103	11,913
Exchange and other adjustments	(278)	(1)	(56)	57	74	(204)
Charge/(credit) to income statement	1,332	2	356	16	(137)	1,569
Charge/(credit) to reserves	–	–	–	2,079	(645)	1,434
At 31 December	5,734	(30)	5	9,608	(605)	14,712

The Bank

	Accelerated capital allowances and short term timing differences HK\$m	Leasing transactions HK\$m	Impairment allowances on financial assets HK\$m	Revaluation of properties HK\$m	Other HK\$m	Total HK\$m
2012						
At 1 January	962	(30)	(236)	5,359	(171)	5,884
Exchange and other adjustments	(625)	–	(12)	(57)	631	(63)
Charge/(credit) to income statement	(36)	–	18	(98)	(353)	(469)
Charge to reserves	–	–	–	601	241	842
At 31 December	301	(30)	(230)	5,805	348	6,194
2011						
At 1 January	1,124	(31)	(211)	4,230	413	5,525
Exchange and other adjustments	(140)	–	(5)	15	14	(116)
(Credit)/charge to income statement	(22)	1	(20)	(76)	(184)	(301)
Charge/(credit) to reserves	–	–	–	1,190	(414)	776
At 31 December	962	(30)	(236)	5,359	(171)	5,884

7 Tax expense (continued)

(iii) Net deferred tax liabilities

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Deferred tax liabilities recognised on the balance sheet	16,923	14,712	6,194	5,884
Deferred tax assets recognised on the balance sheet	(2,629)	(2,325)	(1,333)	(1,098)
	14,294	12,387	4,861	4,786

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK\$3,891m (2011: HK\$3,777m). Of this amount, HK\$2,041m (2011: HK\$2,062m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK\$2,084m (2011: HK\$1,164m) 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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Hong Kong profits tax	1,168	658	215	251
Overseas taxation	2,674	3,468	2,133	2,497
Current tax liabilities	3,842	4,126	2,348	2,748
Deferred tax liabilities	16,923	14,712	6,194	5,884
	20,765	18,838	8,542	8,632

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

	2012 HK\$m	2011 HK\$m
Profit before tax	108,729	91,370
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	21,376	18,633
Adjustments in respect of prior years	(531)	(24)
Deferred tax temporary differences (previously not recognised) / not recognised	(17)	58
Effects of profits in associates and joint ventures	(3,104)	(2,489)
Non taxable income and gains	(2,381)	(1,654)
Permanent disallowables	1,609	928
Change in tax rates	65	8
Local taxes and overseas withholding taxes	970	632
Others	23	1,374
	18,010	17,466

Notes on the Financial Statements (continued)**8 Profit attributable to shareholders**

The consolidated profit attributable to shareholders includes a profit of HK\$48,377m (2011: HK\$37,812m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2012		2011	
	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	0.83	10,000	1.33	12,000
– first interim dividend paid	0.58	7,500	0.78	7,000
– second interim dividend paid	0.41	7,500	0.78	7,000
– third interim dividend paid	0.40	7,500	0.68	7,000
	2.22	32,500	3.57	33,000

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2012 of HK\$20,000m (HK\$0.85 per ordinary share).

10 Analysis of financial assets and liabilities by measurement basis

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

Notes on the Financial Statements (continued)

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

The group

	At 31 December 2011								
	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	-	-	-	456,294	353,505	110,107	-	-	919,906
Items in the course of collection from other banks	-	-	-	-	-	34,546	-	-	34,546
Placings with banks maturing after one month	-	-	-	198,287	-	-	-	-	198,287
Certificates of deposit	-	-	8,342	-	80,349	-	-	-	88,691
Hong Kong Government certificates of indebtedness	-	-	-	-	-	162,524	-	-	162,524
Trading assets	447,968	-	-	-	-	-	-	-	447,968
Financial assets designated at fair value	-	57,670	-	-	-	-	-	-	57,670
Derivatives	376,636	-	-	-	-	-	389	271	377,296
Loans and advances to customers	-	-	-	2,130,871	-	-	-	-	2,130,871
Financial investments	-	-	134,720	-	587,713	-	-	-	722,433
Amounts due from Group companies	11,121	5,390	-	-	-	136,219	-	-	152,730
Other assets	-	-	-	-	-	77,521	-	-	77,521
Total financial assets	835,725	63,060	143,062	2,785,452	1,021,567	520,917	389	271	5,370,443
Liabilities									
Hong Kong currency notes in circulation	-	-	-	-	-	162,524	-	-	162,524
Items in the course of transmission to other banks	-	-	-	-	-	47,163	-	-	47,163
Deposits by banks	-	-	-	-	-	222,582	-	-	222,582
Customer accounts	-	-	-	-	-	3,565,001	-	-	3,565,001
Trading liabilities	171,431	-	-	-	-	-	-	-	171,431
Financial liabilities designated at fair value	-	40,392	-	-	-	-	-	-	40,392
Derivatives	379,989	-	-	-	-	-	3,045	218	383,252
Debt securities in issue	-	-	-	-	-	77,472	-	-	77,472
Amounts due to Group companies	37,675	5	-	-	-	70,743	-	-	108,423
Other liabilities	-	-	-	-	-	102,321	-	-	102,321
Subordinated liabilities	-	-	-	-	-	16,114	-	-	16,114
Preference shares	-	-	-	-	-	97,096	-	-	97,096
Total financial liabilities	589,095	40,397	-	-	-	4,361,016	3,045	218	4,993,771

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	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

Notes on the Financial Statements (continued)

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

The Bank

At 31 December 2011

	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	-	-	-	232,654	299,701	79,910	-	-	612,265
Items in the course of collection from other banks	-	-	-	-	-	29,821	-	-	29,821
Placings with banks maturing after one month	-	-	-	108,873	-	-	-	-	108,873
Certificates of deposit	-	-	-	-	23,987	-	-	-	23,987
Hong Kong Government certificates of indebtedness	-	-	-	-	-	162,524	-	-	162,524
Trading assets	317,321	-	-	-	-	-	-	-	317,321
Financial assets designated at fair value	-	2,283	-	-	-	-	-	-	2,283
Derivatives	370,361	-	-	-	-	-	150	167	370,678
Loans and advances to customers	-	-	-	1,176,602	-	-	-	-	1,176,602
Financial investments	-	-	-	-	362,307	-	-	-	362,307
Amounts due from Group companies	14,455	-	-	-	-	233,546	-	-	248,001
Other assets	-	-	-	-	-	43,059	-	-	43,059
Total financial assets	702,137	2,283	-	1,518,129	685,995	548,860	150	167	3,457,721
Liabilities									
Hong Kong currency notes in circulation	-	-	-	-	-	162,524	-	-	162,524
Items in the course of transmission to other banks	-	-	-	-	-	38,577	-	-	38,577
Deposits by banks	-	-	-	-	-	158,746	-	-	158,746
Customer accounts	-	-	-	-	-	2,220,072	-	-	2,220,072
Trading liabilities	78,959	-	-	-	-	-	-	-	78,959
Financial liabilities designated at fair value	-	5,910	-	-	-	-	-	-	5,910
Derivatives	375,712	-	-	-	-	-	1,343	110	377,165
Debt securities in issue	-	-	-	-	-	46,360	-	-	46,360
Amounts due to Group companies	33,258	-	-	-	-	119,648	-	-	152,906
Other liabilities	-	-	-	-	-	67,758	-	-	67,758
Subordinated liabilities	-	-	-	-	-	9,386	-	-	9,386
Preference shares	-	-	-	-	-	96,969	-	-	96,969
Total financial liabilities	487,929	5,910	-	-	-	2,920,040	1,343	110	3,415,332

11 Cash and short-term funds

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Cash in hand	17,925	15,204	11,139	7,888
Sight balances with central banks	196,179	94,903	164,799	72,022
Placings with banks with remaining maturity of one month or less	362,197	456,294	165,904	232,654
Treasury bills and other eligible bills	534,898	353,505	419,345	299,701
	1,111,199	919,906	761,187	612,265

As at 31 December 2012, included within notes 11 and 12, the total amount placed with central banks by the group, including sight balances, amounted to HK\$356,880m (2011: HK\$350,823m). Placings with central banks made by the Bank amounted to HK\$230,427m (2011: HK\$211,307m).

Treasury bills and other eligible bills are analysed as follows:

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Treasury bills and other eligible bills – available-for-sale – subject to repledge or resale by counterparties	512	498	512	498
– not subject to repledge or resale by counterparties	534,386	353,007	418,833	299,203
	534,898	353,505	419,345	299,701

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Gross placings with banks maturing after one month but not more than one year	150,504	173,498	58,846	93,098
Gross placings with banks maturing after one year	34,207	24,789	21,354	15,775
Total placings with banks	184,711	198,287	80,200	108,873

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

13 Certificates of deposit

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Held-to-maturity	8,426	8,342	–	–
Available-for-sale	84,659	80,349	20,150	23,987
	93,085	88,691	20,150	23,987

Certificates of deposit held are largely unlisted. There were no disposals of held-to-maturity certificates of deposit during the year (2011: 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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Debt securities	176,757	168,849	125,372	120,575
Equity shares	30,401	15,060	30,250	14,978
Treasury bills and other eligible bills	155,464	230,959	116,214	160,911
Other	57,075	33,100	12,737	20,857
	419,697	447,968	284,573	317,321
Trading assets				
– which may be repledged or resold by counterparties	651	281	651	281
– not subject to repledge or resale by counterparties	419,046	447,687	283,922	317,040
	419,697	447,968	284,573	317,321

The amount of listed treasury bills and other eligible bills amounted to HK\$2,838m at both group and Bank level as at 31 December 2012 (2011: HK\$4,427m).

‘Other’ trading assets primarily includes reverse repos, settlement accounts and stock borrowing transactions with banks and customers.

a Debt securities

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	11,377	17,880	8,330	13,329
– listed outside Hong Kong	62,102	54,897	61,791	54,180
	73,479	72,777	70,121	67,509
Unlisted	103,278	96,072	55,251	53,066
	176,757	168,849	125,372	120,575
Issued by public bodies				
– central governments and central banks	128,866	114,322	89,724	77,477
– other public sector entities	7,160	6,651	6,760	6,544
	136,026	120,973	96,484	84,021
Issued by				
– banks	16,870	23,984	12,922	19,811
– corporate entities	23,861	23,892	15,966	16,743
	176,757	168,849	125,372	120,575

b Equity shares

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	10,543	4,494	10,513	4,487
– listed outside Hong Kong	13,884	7,211	13,884	7,211
	24,427	11,705	24,397	11,698
Unlisted	5,974	3,355	5,853	3,280
	30,401	15,060	30,250	14,978
Issued by				
– banks	2,986	2,192	2,986	2,192
– corporate entities	27,415	12,868	27,264	12,786
	30,401	15,060	30,250	14,978

16 Financial assets designated at fair value

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Debt securities	17,001	16,762	1,432	2,283
Equity shares	52,058	40,268	–	–
Other	420	640	–	–
	69,479	57,670	1,432	2,283

a Debt securities

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	1,884	1,780	576	587
– listed outside Hong Kong	4,365	4,578	856	1,696
	6,249	6,358	1,432	2,283
Unlisted	10,752	10,404	–	–
	17,001	16,762	1,432	2,283
Issued by public bodies				
– central governments and central banks	2,135	2,298	576	587
– other public sector entities	1,586	1,992	–	–
	3,721	4,290	576	587
Issued by other bodies				
– banks	5,330	5,153	–	–
– corporate entities	7,950	7,319	856	1,696
	17,001	16,762	1,432	2,283

b Equity shares

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	5,790	3,354	–	–
– listed outside Hong Kong	19,682	14,732	–	–
	25,472	18,086	–	–
Unlisted	26,586	22,182	–	–
	52,058	40,268	–	–
Issued by				
– banks	2,365	1,386	–	–
– corporate entities	49,693	38,882	–	–
	52,058	40,268	–	–

Notes on the Financial Statements (continued)

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(j).

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 in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

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

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

	2012			2011		
	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	12,166,808	182,941	185,274	10,996,534	172,868	181,560
– spot and forward	8,062,408	80,839	75,494	7,347,246	81,683	74,197
– swaps	3,219,733	98,168	106,514	2,983,663	82,852	100,711
– options purchased	394,957	3,205	119	250,711	7,862	360
– options written	429,401	372	2,861	285,008	368	6,064
– other	60,309	357	286	129,906	103	228
Interest rate contracts	18,115,892	200,790	193,208	17,283,126	174,078	169,313
– forward and future	639,265	311	92	898,955	143	173
– swaps	16,919,103	195,781	189,097	15,544,934	168,767	164,062
– options purchased	222,359	2,468	28	378,709	3,707	80
– options written	282,512	3	2,988	423,074	–	3,865
– other	52,653	2,227	1,003	37,454	1,461	1,133
Equity derivatives	818,543	29,824	33,607	785,433	29,729	31,066
Credit derivatives	335,214	2,631	2,655	465,174	5,000	4,784
Commodity and other	114,226	1,173	1,175	87,764	2,713	1,054
Total held for trading	31,550,683	417,359	415,919	29,618,031	384,388	387,777
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	546	5	–	546	3	–
Interest rate contracts	6,573	123	45	4,835	128	95
	7,119	128	45	5,381	131	95
Cash flow hedging derivatives						
Exchange rate contracts	40,044	3,740	151	2,679	–	79
Interest rate contracts	40,216	70	110	101,069	271	139
	80,260	3,810	261	103,748	271	218
Fair value hedging derivatives						
Interest rate contracts	114,887	359	3,626	109,477	389	3,045
Gross total derivatives	31,752,949	421,656	419,851	29,836,637	385,179	391,135
Netting	–	(22,700)	(22,700)	–	(7,883)	(7,883)
Total	31,752,949	398,956	397,151	29,836,637	377,296	383,252

Notes on the Financial Statements (continued)**17 Derivatives** (continued)*The Bank*

	2012			2011		
	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	10,989,189	177,543	182,472	10,080,072	168,229	178,375
– spot and forward	7,181,287	76,898	73,425	6,643,385	78,232	71,804
– swaps	3,190,866	97,084	106,156	2,964,442	82,177	100,445
– options purchased	270,035	2,926	119	152,018	7,352	376
– options written	301,789	307	2,504	189,536	369	5,529
– other	45,212	328	268	130,691	99	221
Interest rate contracts	17,697,104	199,813	192,287	16,979,848	172,438	167,860
– forward and future	635,628	311	90	889,170	142	169
– swaps	16,488,092	194,643	188,302	15,244,353	166,827	162,635
– options purchased	221,674	2,426	15	377,556	3,707	80
– options written	280,675	–	2,874	421,639	–	3,844
– other	71,035	2,433	1,006	47,130	1,762	1,132
Equity derivatives	827,109	29,844	33,752	791,046	30,013	30,959
Credit derivatives	339,873	2,675	2,655	465,174	5,024	4,797
Commodity and other	82,557	999	1,771	68,406	2,409	1,512
Total held for trading	29,935,832	410,874	412,937	28,384,546	378,113	383,503
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	546	5	–	546	3	–
Interest rate contracts	6,573	119	45	4,695	128	92
	7,119	124	45	5,241	131	92
Cash flow hedging derivatives						
Exchange rate contracts	35,781	3,461	148	2,679	–	79
Interest rate contracts	19,587	15	22	41,253	167	31
	55,368	3,476	170	43,932	167	110
Fair value hedging derivatives						
Interest rate contracts	51,689	65	1,632	53,767	150	1,343
Gross total derivatives	30,050,008	414,539	414,784	28,487,486	378,561	385,048
Netting	–	(22,700)	(22,700)	–	(7,883)	(7,883)
Total	30,050,008	391,839	392,084	28,487,486	370,678	377,165

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 2013 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

	2012 HK\$m	2011 HK\$m
Gains/(losses):		
On hedging instruments	(376)	(1,147)
On the hedged items attributable to hedged risk	345	1,050
	<u>(31)</u>	<u>(97)</u>

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 2012, the amount transferred to the income statement comprised HK\$352m (2011: HK\$324m) included in net interest income.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2012, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2011: insignificant amount).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2012 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 2012			
Cash inflows from assets	43,626	50,643	37,167
Cash outflows from liabilities	(3,661)	(2,896)	(2,640)
Net cash inflows	<u>39,965</u>	<u>47,747</u>	<u>34,527</u>
At 31 December 2011			
Cash inflows from assets	80,782	68,488	22,613
Cash outflows from liabilities	(1,022)	(1,656)	(2,406)
Net cash inflows	<u>79,760</u>	<u>66,832</u>	<u>20,207</u>

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

	2012 HK\$m	2011 HK\$m
Balance at 1 January	137	101
Deferrals on new transactions	169	225
Reduction due to amortisation	(96)	(86)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	(89)	(101)
Exchange differences and others	3	(2)
Balance at 31 December	124	137

The Bank

	2012 HK\$m	2011 HK\$m
Balance at 1 January	124	91
Deferrals on new transactions	117	195
Reduction due to amortisation	(75)	(71)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	(58)	(89)
Exchange differences and others	2	(2)
Balance at 31 December	110	124

18 Loans and advances to customers**a Loans and advances to customers**

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Gross loans and advances to customers	2,358,814	2,142,172	1,288,269	1,184,316
Impairment allowances (note 19(a))	(9,771)	(11,301)	(5,549)	(7,714)
	2,349,043	2,130,871	1,282,720	1,176,602

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

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
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
2011			
Residential mortgages ¹	360,368	247,767	608,135
Credit card advances	41,200	31,849	73,049
Other personal	51,339	38,093	89,432
Total personal	452,907	317,709	770,616
Commercial, industrial and international trade	295,729	365,579	661,308
Commercial real estate	158,222	74,041	232,263
Other property-related lending	134,910	49,659	184,569
Government	22,669	7,471	30,140
Other commercial	96,398	117,205	213,603
Total corporate and commercial	707,928	613,955	1,321,883
Non-bank financial institutions	24,799	23,300	48,099
Settlement accounts	1,236	338	1,574
Total financial	26,035	23,638	49,673
Gross loans and advances to customers	1,186,870	955,302	2,142,172
Individually assessed impairment allowances	(2,174)	(4,720)	(6,894)
Collectively assessed impairment allowances	(2,254)	(2,153)	(4,407)
Net loans and advances to customers	1,182,442	948,429	2,130,871

1 Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK\$24,426m (2011: HK\$25,640m).

Notes on the Financial Statements (continued)**18 Loans and advances to customers** (continued)*The Bank*

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
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	<u>302,651</u>	<u>145,387</u>	<u>448,038</u>
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	<u>483,955</u>	<u>310,557</u>	<u>794,512</u>
Non-bank financial institutions	28,771	16,814	45,585
Settlement accounts	–	134	134
Total financial	<u>28,771</u>	<u>16,948</u>	<u>45,719</u>
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	<u>812,895</u>	<u>469,825</u>	<u>1,282,720</u>
2011			
Residential mortgages ¹	222,219	95,004	317,223
Credit card advances	22,653	11,966	34,619
Other personal	32,651	18,684	51,335
Total personal	<u>277,523</u>	<u>125,654</u>	<u>403,177</u>
Commercial, industrial and international trade	207,990	166,072	374,062
Commercial real estate	113,104	36,160	149,264
Other property-related lending	43,206	23,190	66,396
Government	22,124	2,166	24,290
Other commercial	66,345	66,804	133,149
Total corporate and commercial	<u>452,769</u>	<u>294,392</u>	<u>747,161</u>
Non-bank financial institutions	21,256	12,607	33,863
Settlement accounts	–	115	115
Total financial	<u>21,256</u>	<u>12,722</u>	<u>33,978</u>
Gross loans and advances to customers	751,548	432,768	1,184,316
Individually assessed impairment allowances	(1,377)	(3,608)	(4,985)
Collectively assessed impairment allowances	(1,633)	(1,096)	(2,729)
Net loans and advances to customers	<u>748,538</u>	<u>428,064</u>	<u>1,176,602</u>

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\$10,540m (2011: HK\$11,235m).

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

	2012			2011		
	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	2,965	684	3,649	3,022	686	3,708
– After one year but within five years	7,667	2,005	9,672	7,241	1,701	8,942
– After five years	14,506	2,042	16,548	13,198	1,661	14,859
	25,138	4,731	29,869	23,461	4,048	27,509
Impairment allowances	(47)			(54)		
Net investment in finance leases and hire purchase contracts	25,091			23,407		

The Bank

	2012			2011		
	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	1,590	321	1,911	1,640	272	1,912
– After one year but within five years	4,058	924	4,982	3,938	764	4,702
– After five years	10,217	1,586	11,803	8,871	1,207	10,078
	15,865	2,831	18,696	14,449	2,243	16,692
Impairment allowances	(9)			(10)		
Net investment in finance leases and hire purchase contracts	15,856			14,439		

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*

	Individually assessed allowances HK\$m	Collectively assessed allowances HK\$m	Total HK\$m
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(i))	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))	<u>5,245</u>	<u>4,526</u>	<u>9,771</u>
2011			
At 1 January	8,259	4,735	12,994
Amounts written off	(2,150)	(3,792)	(5,942)
Recoveries of loans and advances written off in previous years	356	1,448	1,804
Net charge to income statement (note 4(i))	694	2,401	3,095
Unwinding of discount of loan impairment	(78)	(216)	(294)
Exchange and other adjustments	(187)	(169)	(356)
At 31 December (note 18(a))	<u>6,894</u>	<u>4,407</u>	<u>11,301</u>

The Bank

	Individually assessed allowances HK\$m	Collectively assessed allowances HK\$m	Total HK\$m
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))	<u>2,897</u>	<u>2,652</u>	<u>5,549</u>
2011			
At 1 January	5,946	3,027	8,973
Amounts written off	(1,545)	(2,216)	(3,761)
Recoveries of loans and advances written off in previous years	198	845	1,043
Net charge to income statement	612	1,358	1,970
Unwinding of discount of loan impairment	(53)	(149)	(202)
Exchange and other adjustments	(173)	(136)	(309)
At 31 December (note 18(a))	<u>4,985</u>	<u>2,729</u>	<u>7,714</u>

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 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	<u>1,299,064</u>	<u>1,059,750</u>	<u>2,358,814</u>
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	<u>1,295,479</u>	<u>1,053,564</u>	<u>2,349,043</u>
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances	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%
At 31 December 2011			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	3,881	8,490	12,371
Collectively assessed	1,182,989	946,812	2,129,801
– Impaired loans and advances	657	823	1,480
– Non-impaired loans and advances	1,182,332	945,989	2,128,321
Total gross loans and advances to customers	<u>1,186,870</u>	<u>955,302</u>	<u>2,142,172</u>
Impairment allowances	(4,428)	(6,873)	(11,301)
– Individually assessed	(2,174)	(4,720)	(6,894)
– Collectively assessed	(2,254)	(2,153)	(4,407)
Net loans and advances	<u>1,182,442</u>	<u>948,429</u>	<u>2,130,871</u>
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances	1,403	3,252	4,655
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.3%	0.9%	0.6%
Total allowances as a percentage of total gross loans and advances	0.4%	0.7%	0.5%

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 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%
At 31 December 2011			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	2,520	5,472	7,992
Collectively assessed	749,028	427,296	1,176,324
– Impaired loans and advances	566	393	959
– Non-impaired loans and advances	748,462	426,903	1,175,365
Total gross loans and advances to customers	751,548	432,768	1,184,316
Impairment allowances	(3,010)	(4,704)	(7,714)
– Individually assessed	(1,377)	(3,608)	(4,985)
– Collectively assessed	(1,633)	(1,096)	(2,729)
Net loans and advances	748,538	428,064	1,176,602
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,032	1,167	2,199
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.3%	1.3%	0.7%
Total allowances as a percentage of total gross loans and advances	0.4%	1.1%	0.7%

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 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
At 31 December 2011						
Residential mortgages	608,135	2,369	(372)	(166)	29	47
Commercial, industrial and international trade	661,308	6,970	(5,184)	(2,049)	919	1,435
Commercial real estate	232,263	580	(268)	(69)	134	47

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 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
At 31 December 2011						
Residential mortgages	317,223	598	(98)	(72)	7	8
Commercial, industrial and international trade	374,062	5,115	(3,897)	(1,256)	703	999
Commercial real estate	149,264	357	(117)	(32)	84	4

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.

Notes on the Financial Statements (continued)**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 2012						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– 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
At 31 December 2011						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– more than three months but less than six months	616	0.1	3,446	0.4	4,062	0.2
– more than six months but less than one year	234	0.0	720	0.1	954	0.0
– more than one year	1,807	0.2	2,880	0.3	4,687	0.2
	2,657	0.3	7,046	0.8	9,703	0.4
Individually assessed impairment allowances made in respect of amounts overdue	(1,614)		(4,106)		(5,720)	
Fair value of collateral held in respect of amounts overdue	825		2,030		2,855	
Rescheduled loans and advances to customers	1,257	0.1	1,938	0.2	3,195	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 2012						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– 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
At 31 December 2011						
Gross amounts which have been overdue with respect to either principal or interest for periods of						
– more than three months but less than six months	390	0.1	2,315	0.5	2,705	0.2
– more than six months but less than one year	181	0.0	270	0.1	451	0.0
– more than one year	1,131	0.2	1,780	0.4	2,911	0.3
	1,702	0.3	4,365	1.0	6,067	0.5
Individually assessed impairment allowances made in respect of amounts overdue	(871)		(3,090)		(3,961)	
Fair value of collateral held in respect of amounts overdue	675		643		1,318	
Rescheduled loans and advances to customers	1,149	0.2	543	0.1	1,692	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 'Overdue and rescheduled loans and advances to customers'.

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 2012 and 31 December 2011. Information relating to overdue balances can be found in note 52.

Notes on the Financial Statements (continued)**21 Financial investments**

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Debt securities				
– held-to-maturity	155,393	134,720	–	–
– available-for-sale	463,278	542,536	257,804	325,136
Equity shares				
– available-for-sale	7,371	45,177	2,513	37,171
	626,042	722,433	260,317	362,307
Financial investments				
– which may be repledged or resold by counterparties	985	847	897	325
– not subject to repledge or resale by counterparties	625,057	721,586	259,420	361,982
	626,042	722,433	260,317	362,307

a Held-to-maturity debt securities*The group*

	Book value		Fair value	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	4,174	2,932	4,644	3,209
– listed outside Hong Kong	39,217	31,017	42,814	32,847
	43,391	33,949	47,458	36,056
Unlisted	112,002	100,771	119,873	106,618
	155,393	134,720	167,331	142,674
Issued by public bodies				
– central governments and central banks	3,538	2,551	4,189	3,049
– other public sector entities	20,660	20,703	22,646	22,347
	24,198	23,254	26,835	25,396
Issued by				
– banks	75,744	72,303	80,819	75,309
– corporate entities	55,451	39,163	59,677	41,969
	155,393	134,720	167,331	142,674

21 Financial Investments (continued)

b Available-for-sale debt securities

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	21,587	23,333	5,235	2,872
– listed outside Hong Kong	166,320	169,312	126,066	131,216
	187,907	192,645	131,301	134,088
Unlisted	275,371	349,891	126,503	191,048
	463,278	542,536	257,804	325,136
Issued by public bodies				
– central governments and central banks	263,466	295,436	158,035	182,580
– other public sector entities	70,715	78,901	41,214	51,118
	334,181	374,337	199,249	233,698
Issued by				
– banks	94,758	136,388	46,467	74,434
– corporate entities	34,339	31,811	12,088	17,004
	463,278	542,536	257,804	325,136

c Available-for-sale equity shares

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Listed				
– listed in Hong Kong	663	31,794	–	31,372
– listed outside Hong Kong	26	129	15	89
	689	31,923	15	31,461
Unlisted	6,682	13,254	2,498	5,710
	7,371	45,177	2,513	37,171
Issued by				
– banks	42	7,140	31	3,716
– corporate entities	7,329	38,037	2,482	33,455
	7,371	45,177	2,513	37,171

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*

	2012		2011	
	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	15,223	15,202	33,961	33,675
Securities lending agreements	2,090	2,085	4,269	3,793
	17,313	17,287	38,230	37,468

The Bank

	2012		2011	
	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	26,415	26,451	19,281	19,350
Securities lending agreements	2,002	2,085	4,113	3,793
	28,417	28,536	23,394	23,143

23 Investments in subsidiaries

	The Bank	
	2012 HK\$m	2011 HK\$m
Investments in subsidiaries:		
Unlisted investments	57,954	56,859
Listed investment	865	865
	58,819	57,724

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	RMB12,400m	Ordinary	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	RM\$115m	Ordinary	100%
HSBC Bank Australia Limited ²	Australia	Banking	A\$751m	Ordinary	100%
			A\$60m	Preference	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\$2,778m	Ordinary	100%

¹ *People's Republic of China*

² *Held indirectly*

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

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

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

Notes on the Financial Statements (continued)

24 Interests in associates and joint ventures

	The group	
	2012 HK\$m	2011 HK\$m
Share of net assets	113,415	84,493
Goodwill	5,191	5,544
Intangible assets	1,409	2,216
Deferred tax on intangible assets	(347)	(468)
Impairment	(395)	–
	119,273	91,785

At 31 December 2012, the group's interests in associates amounted to HK\$117,946m (2011: HK\$90,130m).

	The Bank	
	2012 HK\$m	2011 HK\$m
Listed investments	39,824	26,561
Unlisted investments	1,095	1,578
	40,919	28,139

Shareholdings in associates held by the Bank include listed investments of HK\$39,824m (2011: HK\$26,561m). As at the balance sheet date, the fair value of these investments held by the group, based on quoted market prices, was HK\$110,820m (2011: HK\$87,107m).

a Principal associates

The principal associates of the group are:

	At 31 December 2012		At 31 December 2011	
	Carrying value HK\$m	Fair value HK\$m	Carrying value HK\$m	Fair value HK\$m
Listed				
Bank of Communications Co., Ltd.	91,840	82,411	66,704	63,964
Industrial Bank Co., Ltd. ³	22,099	28,409	17,199	21,307
Bao Viet Holdings ³	–	–	1,409	1,836
	113,939	110,820	85,312	87,107

	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%
Industrial Bank Co., Ltd. ³	PRC ¹	Banking	RMB10,786m	Ordinary	12.80%
Unlisted					
Barrowgate Limited ³	Hong Kong	Property investment	– ²	Ordinary	24.64%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND8,848bn	Ordinary	19.48%
Yantai Bank Co., Limited ³	PRC ¹	Banking	RMB2,000m	Ordinary	20.00%

1 People's Republic of China

2 Nominal value of issued share capital is less than HK\$1m

3 Held indirectly

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

24 Interests in associates and joint ventures *(continued)*

The group's interests in Bank of Communications Co., Ltd. ('BoCom') and Vietnam Technological and Commercial Joint Stock Bank ('TechCom Bank') are accounted for as associates as the group has representation on the Board of Directors of each, whilst for BoCom, the Bank also has representation on the strategy committee. The group has entered into Technical Support and Assistance Agreements with BoCom, TechCom Bank, Hana HSBC Life Insurance and Canara HSBC Oriental Bank of Commerce Life Insurance to provide technical support and assistance in relation to their banking and insurance business.

Until 20 December 2012, the group's interest in Bao Viet Holdings ('Bao Viet') was accounted for as an associate as the group had representation on the Board of Directors. On 20 December 2012, the group announced that it had entered into an agreement to sell its entire 18% shareholding in Bao Viet to Sumitomo Life Insurance Company, a transaction which is expected to complete during the first quarter of 2013. At 31 December 2012, the group's interest in Bao Viet was classified as 'Held For Sale'.

For the year ended 31 December 2012, Hang Seng Bank Limited's ('Hang Seng') interest in Industrial Bank Co., Ltd. ('Industrial Bank') was accounted for as an associate as Hang Seng had representation on the Board of Directors and the executive committee. On 7 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 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. Thereafter, the holding is recognised as an available-for-sale financial investment.

In respect of the year ended 31 December 2012, BoCom, Industrial Bank, TechCom Bank and Bao Viet were included in these financial statements based on financial statements drawn up to 30 September 2012, but taking into account the financial effect of significant transactions or events in the subsequent period from 1 October 2012 to 31 December 2012. The group has taken advantage of the provision contained in HKAS 28 'Investments in Associates' whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference is no greater than three months.

Interests in associates include intangible assets recognised on acquisition with respect to customer relationships and brand names which are amortised over a period of 10 years.

During 2012, the market value of the investment in BoCom had been below the carrying amount in the group's consolidated balance sheet for a period of approximately ten months. An impairment test was performed as at 31 December 2012 on the carrying amount of the investment in BoCom.

The result confirmed that there was no impairment. 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 calculation of VIU used discounted cash flow projections based on management's estimates. Cash flows beyond the next five years were then extrapolated in perpetuity using a long-term growth rate. The discount rate used was based on a cost of capital used to evaluate investments in mainland China.

Management judgement is required in estimating the future cash flows of BoCom. These values are sensitive to the cash flows projected in the short and medium term, and also to the key assumptions regarding the long term sustainable cash flows thereafter. The key assumptions are consistent with external sources of information.

Notes on the Financial Statements (continued)**24 Interests in associates and joint ventures** (continued)**b Summarised aggregate financial information on associates and joint ventures**

	Assets HK\$m	Liabilities HK\$m	Equity HK\$m	Revenue HK\$m	Expenses HK\$m	Profit HK\$m
2012						
100%	10,184,199	9,539,491	644,708	290,621	176,997	113,624
The group's effective interest ¹	1,537,471	1,433,597	103,874	44,579	27,476	17,103
2011						
100%	8,127,975	7,647,933	480,042	223,952	133,979	89,973
The group's effective interest ¹	1,265,356	1,188,011	77,345	36,318	22,342	13,976

¹ The group's effective interest is stated net of non-controlling interests.

At 31 December 2012, the group's share of associates and joint ventures' contingent liabilities was HK\$357,664m (2011: HK\$266,530m).

c The principal joint ventures of the group are:

	Place of incorporation	Principal activity	Nominal value of issued share capital	Class of share	The group's interest in issued share capital
Listed					
Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited	India	Insurance manufacturing	INR9,500m	Ordinary	26.00%
Hana HSBC Life Insurance Co., Ltd	South Korea	Insurance manufacturing	KRW110,201m	Ordinary	49.99%

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Goodwill	7,237	7,629	1,180	1,177
Present value of in-force long-term insurance business	24,425	20,232	–	–
Other intangible assets	6,972	6,978	3,585	3,654
	38,634	34,839	4,765	4,831

a Goodwill

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Cost at 1 January	7,629	7,891	1,177	1,167
Disposals	(67)	–	(2)	–
Exchange and other movements	(325)	(262)	5	10
Net book value at 31 December	7,237	7,629	1,180	1,177

Segmental analysis of goodwill

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Hong Kong – Retail Banking and Wealth Management	–	12	–	–
Hong Kong – Commercial Banking	24	36	24	24
Hong Kong – Global Banking and Markets	750	755	498	498
Rest of Asia-Pacific – Retail Banking and Wealth Management	1,192	1,430	80	78
Rest of Asia-Pacific – Commercial Banking	4,184	4,275	–	–
Rest of Asia-Pacific – Global Banking and Markets	1,087	1,121	578	577
Total goodwill in the CGUs listed	7,237	7,629	1,180	1,177

During 2012 there was no impairment of goodwill (2011: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2012 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 percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement.

Notes on the Financial Statements (continued)**25 Goodwill and intangible assets** (continued)

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 2012 was 11% (2011: in the range of 10% to 11%) across different CGUs. The nominal long-term growth rates used in the impairment test in 2012 for Hong Kong and Rest of Asia-Pacific were 4.7% and 5.0% respectively (2011: 7.9% and 7.8%).

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:

	2012	2011
Risk free rate	0.60%	1.47%
Risk discount rate	7.46%	8.00%
Expenses inflation	3.00%	3.00%
Lapse rate	0%-20% for all years	0%-20% for the first policy year and 0%-15% for renewal years

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

	The group	
	2012	2011
	HK\$m	HK\$m
At 1 January	20,232	14,767
Value of new business written during the year	5,559	4,982
Movements arising from in-force business:		
– expected return	(1,077)	(1,277)
– experience variances	162	55
– changes in operating assumptions	(153)	(748)
Investment return variances	(94)	(232)
Changes in investment assumptions	133	1,871
Other adjustments	(98)	873
Changes in PVIF of long-term insurance business	4,432	5,524
Exchange differences and other	(239)	(59)
At 31 December	24,425	20,232

25 Goodwill and intangible assets (continued)

c Other intangible assets

The group

	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
	2011			
	Computer software HK\$m	Customer/ merchant relationships HK\$m	Other ¹ HK\$m	Total HK\$m
Cost				
At 1 January	8,208	1,905	2,318	12,431
Additions	1,767	–	37	1,804
Disposals/amounts written-off	(173)	(2)	(4)	(179)
Exchange and other movements	(26)	(14)	(98)	(138)
At 31 December	9,776	1,889	2,253	13,918
Accumulated amortisation and impairment				
At 1 January	4,640	727	32	5,399
Amortisation charge for the year	1,283	202	11	1,496
Impairment	264	–	–	264
Disposals/amounts written-off	(173)	(2)	(4)	(179)
Exchange and other movements	(23)	(12)	(5)	(40)
At 31 December	5,991	915	34	6,940
Net book value at 31 December	3,785	974	2,219	6,978

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

	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	<u>9,049</u>	<u>1,286</u>	<u>78</u>	<u>10,413</u>
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	<u>6,079</u>	<u>719</u>	<u>30</u>	<u>6,828</u>
Net book value at 31 December	<u>2,970</u>	<u>567</u>	<u>48</u>	<u>3,585</u>
	2011			
	Computer software HK\$m	Customer/ merchant relationships HK\$m	Other HK\$m	Total HK\$m
Cost				
At 1 January	6,424	1,269	12	7,705
Additions	1,371	–	37	1,408
Disposals/amounts written-off	(74)	(2)	(5)	(81)
Exchange and other movements	(6)	(3)	–	(9)
At 31 December	<u>7,715</u>	<u>1,264</u>	<u>44</u>	<u>9,023</u>
Accumulated amortisation and impairment				
At 1 January	3,647	503	9	4,159
Amortisation charge for the year	1,019	105	1	1,125
Impairment	173	–	–	173
Disposals/amounts written-off	(74)	(2)	(5)	(81)
Exchange and other movements	(5)	(2)	–	(7)
At 31 December	<u>4,760</u>	<u>604</u>	<u>5</u>	<u>5,369</u>
Net book value at 31 December	<u>2,955</u>	<u>660</u>	<u>39</u>	<u>3,654</u>

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 2012. 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.

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

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the long-term growth rate. The discount rate used during 2012 was 13% (2011: in the range of 12% to 13%). The long-term growth rate used in the impairment testing during 2012 was 3% (2011: 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 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

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 2011	63,148	3,503	20,530	41,423	126	13,149
Exchange and other adjustments	11	–	(212)	(9)	–	(222)
Additions	545	–	2,325	505	–	1,397
Disposals	(7)	–	(697)	(3)	–	(456)
Elimination of accumulated depreciation on revalued land and buildings	(1,593)	–	–	(1,001)	–	–
Surplus on revaluation	12,948	1,033	–	7,477	21	–
Reclassifications	38	80	(24)	(74)	–	(6)
At 31 December 2011	75,090	4,616	21,922	48,318	147	13,862
Accumulated depreciation						
At 1 January 2011	2	–	14,832	–	–	9,637
Exchange and other adjustments	–	–	(181)	–	–	(182)
Charge for the year	1,615	–	2,263	1,004	–	1,382
Disposals	(3)	–	(599)	(3)	–	(384)
Elimination of accumulated depreciation on revalued land and buildings	(1,593)	–	–	(1,001)	–	–
Reclassifications	–	–	(2)	–	–	(2)
At 31 December 2011	21	–	16,313	–	–	10,451
Net book value at 31 December 2011	75,069	4,616	5,609	48,318	147	3,411
Total at 31 December 2011			85,294			51,876

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Cost less accumulated depreciation	18,847	19,575	14,031	14,541

c An analysis of land and buildings carried at valuation or cost (before deduction of accumulated depreciation) is as follows:

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Land and buildings carried at valuation	80,094	74,901	50,895	48,318
Other land and buildings stated at cost	10	189	–	–
Land and buildings before deduction of accumulated depreciation	80,104	75,090	50,895	48,318

26 Property, plant and equipment (continued)

d The net book value of land and buildings and investment properties comprises:

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
In Hong Kong:				
Long leaseholds (over fifty years)	35,604	34,787	30,216	29,818
Medium-term leaseholds (between ten and fifty years)	38,716	34,182	11,985	10,004
Short leaseholds (less than ten years)	76	90	76	90
	74,396	69,059	42,277	39,912
Outside Hong Kong:				
Freehold	4,562	4,444	3,537	3,489
Long leaseholds (over fifty years)	174	157	126	112
Medium-term leaseholds (between ten and fifty years)	6,157	5,978	5,058	4,905
Short leaseholds (less than ten years)	37	47	37	47
	10,930	10,626	8,758	8,553
	85,326	79,685	51,035	48,465
Analysed as follows:				
Land and buildings	80,044	75,069	50,838	48,318
Investment properties	5,282	4,616	197	147
	85,326	79,685	51,035	48,465

The group's land and buildings and investment properties were revalued at 30 November 2012 and updated for any material changes at 31 December 2012. 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(o). 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\$10,108m (2011: HK\$9,384m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK\$8,057m (2011: HK\$13,981m). Amounts of HK\$5,327m (2011: HK\$9,656m) and HK\$836m (2011: HK\$1,041m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK\$5,327m (2011: HK\$9,656m) is stated after deduction of non-controlling interests of HK\$841m (2011: HK\$1,412m) and deferred tax of HK\$1,053m (2011: HK\$1,872m). The amount credited to the income statement comprises the surplus of HK\$834m (2011: HK\$1,033m) on revaluation of investment properties, and HK\$2m (2011: HK\$8m) relating to the reversal of previous revaluation deficits that arose when the value of certain land and buildings fell below depreciated historical cost or surrender value.

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.

Notes on the Financial Statements (continued)**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\$216m (2011: HK\$191m) 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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Within one year	181	163	18	9
After one but within five years	98	92	8	18
	279	255	26	27

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
In Hong Kong:				
Medium-term leaseholds (between ten and fifty years)	313	330	75	77

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 28).

28 Other assets

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Current taxation recoverable	1,029	676	823	550
Assets held for sale	48,280	8,117	44,669	8,005
Prepayments and accrued income	3,823	3,135	1,926	1,558
Accrued interest receivable	14,992	14,524	5,806	5,774
Acceptances and endorsements	31,965	31,750	21,191	21,001
Other	86,964	42,113	69,065	20,123
	187,053	100,315	143,480	57,011

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:

On 5 December 2012, we entered into an agreement to dispose of our entire shareholding in Ping An, consisting of 613,929,279 shares, at a fixed price of HK\$59 per share. The fixing of the sale price gave rise to a contingent forward sale contract, the fair value of which at year end was based on the difference between the agreed sale price and the market price for the shares, adjusted for an assessment of the probability of the transaction being completed. The adverse fair value of this contract was HK\$2,694m at 31 December 2012, recorded in net trading income. The investment in Ping An is accounted for as an available-for-sale investment and carried at fair value with unrealised gains or losses recorded in other comprehensive income.

At 31 December 2012, the fair value of our investment in Ping An was HK\$39,813m, included in 'Assets held for sale', with HK\$31,701m accumulated unrealised gains in other comprehensive income. These unrealised gains include HK\$3,591m of gains which arose after the date of the sale agreement and represent the difference between Ping An's share price at the year end and the agreed sale price. The gain from this transaction is HK\$28,110m, 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. The income statement impact of this transaction is a loss of HK\$2,694m in 2012 and a net gain in 2013 of HK\$30,804m.

On 26 October 2012, the group entered into an agreement to sell the assets and liabilities, other than the statutory deposits, of the Taiwan branch of HSBC Life (International) Limited to Allianz Taiwan Life Insurance Company Limited. The transaction is subject to regulatory approvals and is expected to complete during the first half of 2013.

On 20 December 2012, the group entered into an agreement to sell its entire 18% shareholding in Bao Viet Holdings ('Bao Viet') to Sumitomo Life Insurance Company. The transaction is subject to regulatory approvals and is expected to complete during the first quarter of 2013.

Gold bullion balances were reclassified from 'Loans and Advances to customers' to 'Other assets' during the year to reflect better the substance of the gold lending business.

Notes on the Financial Statements (continued)**29 Customer accounts**

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Current accounts	831,256	696,435	509,183	410,911
Savings accounts	2,063,565	1,826,893	1,433,809	1,275,503
Other deposit accounts	980,063	1,041,673	474,408	533,658
	3,874,884	3,565,001	2,417,400	2,220,072

30 Trading liabilities

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Certificates of deposit in issue	3,470	5,790	796	1,379
Other debt securities in issue	15,479	15,738	15,159	14,999
Short positions in securities	48,116	44,891	26,519	18,780
Deposits by banks	7,982	6,642	7,430	5,911
Customer accounts	108,293	98,370	32,242	37,890
	183,340	171,431	82,146	78,959

31 Financial liabilities designated at fair value

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Deposits by banks	271	302	271	302
Customer accounts	1,366	1,618	1,366	1,618
Debt securities in issue	6,414	3,990	6,094	3,990
Liabilities to customers under investment contracts	36,219	34,482	–	–
	44,270	40,392	7,731	5,910

At 31 December 2012, the carrying amount of financial liabilities designated at fair value was HK\$81m higher than the contractual amount at maturity (2011: the carrying amount was HK\$56m higher than the contractual amount). At 31 December 2012, the accumulated loss in fair value attributable to changes in credit risk was HK\$13m (2011: the accumulated gain was HK\$9m).

32 Debt securities in issue

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Certificates of deposit	29,066	37,281	9,243	18,871
Other debt securities	45,581	40,191	31,163	27,489
	74,647	77,472	40,406	46,360

33 Other liabilities and provisions

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Accruals and deferred income	24,705	23,286	15,013	13,441
Liabilities of business held for sale	4,811	21,970	3,451	21,970
Provisions for liabilities and charges (note 35)	2,144	1,686	1,266	1,184
Acceptances and endorsements	31,965	31,750	21,191	21,001
Share based payment liability to HSBC	2,560	2,729	2,068	2,212
Other liabilities	28,606	26,893	15,898	11,777
	94,791	108,314	58,887	71,585

34 Liabilities under insurance contracts issued

	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
2012			
Non-life insurance liabilities			
Unearned premiums	39	–	39
Notified claims	12	–	12
Claims incurred but not reported	26	–	26
Other	43	–	43
	120	–	120
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
Total liabilities under insurance contracts	244,921	(4,492)	240,429
2011			
Non-life insurance liabilities			
Unearned premiums	1,674	(157)	1,517
Notified claims	984	(203)	781
Claims incurred but not reported	256	(35)	221
Other	145	–	145
	3,059	(395)	2,664
Life insurance liabilities to policyholders			
Life (non-linked)	176,238	(228)	176,010
Life (linked)	30,055	(6,666)	23,389
Investment contracts with discretionary participation features	86	–	86
	206,379	(6,894)	199,485
Total liabilities under insurance contracts	209,438	(7,289)	202,149

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

Notes on the Financial Statements (continued)**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
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
2011			
Unearned premiums			
At 1 January	1,495	(158)	1,337
Gross written premiums	3,318	(455)	2,863
Gross earned premiums	(3,135)	456	(2,679)
Foreign exchange and other movements	(4)	–	(4)
At 31 December	1,674	(157)	1,517
Notified and incurred but not reported claims			
At 1 January	1,303	(262)	1,041
– Notified claims	1,008	(219)	789
– Claims incurred but not reported	295	(43)	252
Claims paid in current year	(1,420)	147	(1,273)
Claims incurred	1,387	(161)	1,226
Foreign exchange and other movements	(30)	38	8
At 31 December			
– Notified claims	984	(203)	781
– Claims incurred but not reported	256	(35)	221
Total at 31 December	1,240	(238)	1,002

34 Liabilities under insurance contracts issued (continued)

(ii) Life insurance liabilities to policyholders

	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
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	<u>210,825</u>	<u>(1,389)</u>	<u>209,436</u>
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	<u>33,948</u>	<u>(3,103)</u>	<u>30,845</u>
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	<u>28</u>	<u>–</u>	<u>28</u>
Total liabilities to policyholders	<u>244,801</u>	<u>(4,492)</u>	<u>240,309</u>
2011			
Life (non-linked)			
At 1 January	145,960	(161)	145,799
Benefits paid	(6,399)	178	(6,221)
Increase in liabilities to policyholders	36,997	(183)	36,814
Foreign exchange and other movements	(320)	(62)	(382)
At 31 December	<u>176,238</u>	<u>(228)</u>	<u>176,010</u>
Life (linked)			
At 1 January	28,920	(5,567)	23,353
Benefits paid	(1,958)	385	(1,573)
Increase in liabilities to policyholders	3,150	(802)	2,348
Foreign exchange and other movements	(57)	(682)	(739)
At 31 December	<u>30,055</u>	<u>(6,666)</u>	<u>23,389</u>
Investment contracts with discretionary participation features			
At 1 January	170	–	170
Benefits paid	(85)	–	(85)
Increase in liabilities to policyholders	1	–	1
Foreign exchange and other movements	–	–	–
At 31 December	<u>86</u>	<u>–</u>	<u>86</u>
Total liabilities to policyholders	<u>206,379</u>	<u>(6,894)</u>	<u>199,485</u>

Notes on the Financial Statements (continued)**35 Provisions for liabilities and charges***Provisions for liabilities and charges*

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
At 1 January	1,686	1,359	1,184	858
Additional provisions/increase in provisions	1,835	767	1,053	707
Provisions used	(1,362)	(276)	(970)	(243)
Amounts reversed	(225)	(85)	(135)	(54)
Exchange and other movements	210	(79)	134	(84)
At 31 December	2,144	1,686	1,266	1,184

Of which: provisions for restructuring costs

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
At 1 January	476	83	439	77
Additional provisions/increase in provisions	619	631	483	580
Provisions used	(683)	(233)	(556)	(211)
Amounts reversed	(92)	(8)	(78)	(2)
Exchange and other movements	(33)	3	(32)	(5)
At 31 December	287	476	256	439

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.

		2012 HK\$m	2011 HK\$m
<i>The Bank</i>			
US\$1,200m	Undated floating rate primary capital notes	9,355	9,386
		9,355	9,386
<i>The group</i>			
A\$42m	Floating rate subordinated notes due 2018, callable from 2013 ¹	338	332
A\$200m	Floating rate subordinated notes due 2020, callable from 2015	1,608	1,580
US\$300m	Floating rate subordinated notes due 2017, callable from 2012 ²	–	2,328
RM500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017 ³	1,267	1,227
RM500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022 ⁴	1,299	1,261
		13,867	16,114

1 The interest rate on the A\$42m callable subordinated floating rate notes due 2018 will increase by 0.5% from March 2013.

2 The US\$300m callable subordinated floating rate notes due 2017 were redeemed in July 2012.

3 The interest rate on the RM500m 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.

4 The interest rate on the RM500m 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.

37 Preference shares

Authorised

At both 31 December 2012 and 31 December 2011, 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 INR1,320m (2011: INR900m) of authorised preference share capital comprising 13.2m compulsorily convertible preference shares of INR100 each in the share capital of a subsidiary.

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Issued and fully paid				
Redeemable preference shares	11,243	24,862	11,243	24,862
Irredeemable preference shares	68,231	68,354	68,080	68,227
Share premium	3,872	3,880	3,872	3,880
	83,346	97,096	83,195	96,969

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. 1,750m cumulative redeemable preference shares were issued in 2007, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1 per share. 250m cumulative redeemable preference shares were redeemed on 29 March 2012 at US\$1 per share and 1,500m cumulative redeemable preference shares were redeemed on 26 November 2012 at US\$1 per share.

400m cumulative redeemable preferences shares were issued in 2008, which have a mandatory redemption date of 29 March 2023 but may be redeemed at the Bank's option on or after 29 March 2018, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1 per share. 1,050m cumulative redeemable preferences shares were issued in 2009, which have a mandatory redemption date of 2 January 2024 but may be redeemed at the Bank's option on or after 2 January 2019, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1 per share. 550m cumulative redeemable preference shares, issued in 2006, were redeemed at the issue price of US\$1 per share on 21 December 2011. The total number of issued cumulative redeemable preference shares at 31 December 2012 was 1,450.5m (2011: 3,200.5m). No cumulative redeemable preference shares were issued during the year (2011: 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. The number of issued non-cumulative irredeemable preference shares at 31 December 2012 was 6,653m (2011: 6,653m). No non-cumulative irredeemable preference shares were issued during the year (2011: nil).

Notes on the Financial Statements (continued)**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. The number of issued cumulative irredeemable preference shares at 31 December 2012 was 2,130m (2011: 2,130m). No cumulative irredeemable preference shares were issued during the year (2011: 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.

During the year HSBC InvestDirect issued an additional INR450m of CCPS (2011: Nil) comprising 4.5m CCPS of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after three months 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 six months 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 2.5m CCPS in to 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 2012 was HK\$80,000m (2011: HK\$50,000m) divided into 32,000m (2011: 20,000m) ordinary shares of HK\$2.50 each subsequent to the increase in authorised ordinary share capital by the creation of HK\$30,000m divided into 12,000m new ordinary shares of HK\$2.50 each on 26 November 2012. 11,511,335,607 new ordinary shares were issued during 2012 (2011: 3,078,560,000).

Issued and fully paid

	The group and the Bank	
	2012 HK\$m	2011 HK\$m
Ordinary share capital	58,969	30,190

	The group and the Bank	
	2012 Number	2012 HK\$m
Ordinary shares of HK\$2.50 each		
At 1 January	12,076,147,294	30,190
Issued during the year	11,511,335,607	28,779
At 31 December	23,587,482,901	58,969

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.

39 Reserves

Regulatory reserve

The Bank and its banking subsidiaries maintain a regulatory reserve to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2012, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK\$19,426m (31 December 2011: HK\$17,108m).

Retained profits

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

Property revaluation reserve

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

Available-for-sale investment reserve

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

Cash flow hedge reserve

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

Foreign exchange reserve

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

Other reserve

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

Notes on the Financial Statements (continued)

40 Maturity analysis of assets and liabilities

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

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
Placements 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	52,058	—	—	17,001
Equity shares	—	—	—	—	—	—	—	—	—	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

40 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)

40 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										
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
Placements 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

40 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 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
2011										
Assets										
Cash and short-term funds	311,907	311,104	189,622	107,273	—	—	—	—	—	919,906
Items in the course of collection	—	—	—	—	—	—	—	—	—	—
from other banks	—	34,546	—	—	—	—	—	—	—	34,546
Placings with banks maturing	—	—	143,663	29,835	17,917	6,872	—	—	—	198,287
after one month	—	—	18,542	47,138	5,559	4,399	45	—	—	88,691
Certificates of deposit	—	13,008	—	—	—	—	—	—	—	—
Hong Kong Government certificates	—	—	—	—	—	—	—	—	—	—
of indebtedness	162,524	—	—	—	—	—	—	—	—	162,524
Trading assets	—	—	—	—	—	—	—	447,968	—	447,968
Financial assets designated at										
fair value	—	332	1,145	1,684	10,389	3,822	40,298	—	—	57,670
Debt securities	—	332	1,145	1,684	9,749	3,822	30	—	—	16,762
Equity shares	—	—	—	—	—	—	40,268	—	—	40,268
Other	—	—	—	—	640	—	—	—	—	640
Derivatives	—	—	—	—	—	—	—	376,636	660	377,296
Loans and advances to customers	124,518	233,188	239,508	358,702	644,001	542,255	(11,301)	—	—	2,130,871
Financial investments	—	43,713	73,793	197,476	254,224	106,331	46,896	—	—	722,433
Debt securities held to maturity	—	873	2,223	5,452	53,873	72,299	—	—	—	134,720
Debt securities available for sale	—	42,840	71,570	192,024	200,351	34,032	1,719	—	—	542,536
Equity shares available for sale	—	—	—	—	—	—	45,177	—	—	45,177
Amounts due from Group										
companies	47,688	71,033	5,138	7,621	6,722	3,407	—	11,121	—	152,730
interests in associates and	—	—	—	—	—	—	—	—	—	—
joint ventures	—	—	—	—	—	—	91,785	—	—	91,785
Goodwill and intangible assets	—	—	—	—	—	—	34,839	—	—	34,839
Property, plant and equipment	—	—	—	—	—	—	85,294	—	—	85,294
Deferred tax assets	—	—	—	—	—	—	2,325	—	—	2,325
Other assets	12,288	20,434	15,898	22,152	4,034	8,817	16,692	—	—	100,315
Total assets	658,925	727,358	687,309	771,881	942,846	675,903	306,873	835,725	660	5,607,480

40 Maturity analysis of assets and liabilities (continued)

The group

2011	On demand HK\$	Due within 1 month HK\$	Due between 1 and 3 months HK\$	Due between 3 and 12 months HK\$	Due between 1 and 5 years HK\$	Due after 5 years HK\$	No contractual maturity HK\$	Trading instruments HK\$	Non-trading derivatives HK\$	Total HK\$
Liabilities										
Hong Kong currency notes in circulation	162,524	—	—	—	—	—	—	—	—	162,524
Items in the course of transmission to other banks	—	47,163	—	—	—	—	—	—	—	47,163
Deposits by banks	107,668	92,898	18,399	2,565	821	231	—	—	—	222,582
Customer accounts	2,626,096	453,716	307,705	162,600	14,761	123	—	—	—	3,565,001
Trading liabilities	—	—	—	—	—	—	—	171,431	—	171,431
Financial liabilities designated at fair value	237	—	—	—	5,796	360	33,999	—	—	40,392
Derivatives	—	—	—	—	—	—	—	379,989	3,263	383,252
Debt securities in issue	1,433	6,161	15,207	8,444	42,221	4,006	—	—	—	77,472
Retirement benefit liabilities	—	—	—	—	—	—	8,097	—	—	8,097
Amounts due to Group companies	18,783	26,259	6,737	9,154	140	9,675	—	37,675	—	108,423
Other liabilities and provisions	8,259	25,653	28,003	38,293	3,257	176	4,673	—	—	108,314
Liabilities under insurance contracts issued	953	—	—	—	—	—	208,485	—	—	209,438
Current tax liabilities	314	450	352	3,000	10	—	—	—	—	4,126
Deferred tax liabilities	—	—	—	—	—	—	14,712	—	—	14,712
Subordinated liabilities	—	—	—	2,328	1,912	2,488	9,386	—	—	16,114
Preference shares	—	—	—	—	—	28,742	68,354	—	—	97,096
Total liabilities	2,926,267	652,300	376,403	226,384	68,918	45,801	347,706	589,095	3,263	5,236,137

Notes on the Financial Statements (continued)

40 Maturity analysis of assets and liabilities (continued)

The Bank

	On demand HK\$	Due within 1 month HK\$	Due between 1 and 3 months HK\$	Due between 3 and 12 months HK\$	Due between 1 and 5 years HK\$	Due after 5 years HK\$	No contractual maturity HK\$	Trading instruments HK\$	Non-trading derivatives HK\$	Total HK\$
Assets										
Cash and short-term funds	214,248	151,511	176,113	70,393	-	-	-	-	-	612,265
Items in the course of collection	-	29,821	-	-	-	-	-	-	-	29,821
Placements with banks maturing after one month	-	-	84,073	9,024	15,283	493	-	-	-	108,873
Certificates of deposit	-	5,987	6,467	9,943	1,584	-	6	-	-	23,987
Hong Kong Government certificates of indebtedness	162,524	-	-	-	-	-	-	-	-	162,524
Trading assets	-	-	-	-	-	-	-	317,321	-	317,321
Financial assets designated at fair value	-	-	728	172	1,383	-	-	-	-	2,283
Debt securities	-	-	728	172	1,383	-	-	-	-	2,283
Equity shares	-	-	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-	-	-
Derivatives	-	-	-	-	-	-	-	370,361	317	370,678
Loans and advances to customers	77,229	120,632	122,399	182,890	375,521	305,645	(7,714)	-	-	1,176,602
Financial investments	-	27,138	45,761	118,641	115,164	17,719	37,884	-	-	362,307
Debt securities held to maturity	-	-	-	-	-	-	-	-	-	-
Debt securities available for sale	-	27,138	45,761	118,641	115,164	17,719	713	-	-	325,136
Equity shares available for sale	-	-	-	-	-	-	37,171	-	-	37,171
Amounts due from Group companies	63,048	96,765	20,340	19,943	13,375	20,075	-	14,455	-	248,001
Investments in subsidiaries	-	-	-	-	-	-	57,724	-	-	57,724
Interests in associates and joint ventures	-	-	-	-	-	-	28,139	-	-	28,139
Goodwill and intangible assets	-	-	-	-	-	-	4,831	-	-	4,831
Property, plant and equipment	-	-	-	-	-	-	51,876	-	-	51,876
Deferred tax assets	-	-	-	-	-	-	1,098	-	-	1,098
Other assets	2,822	11,478	9,417	14,752	3,162	428	14,952	-	-	57,011
Total assets	519,871	443,332	465,298	425,758	525,472	344,360	188,796	702,137	317	3,615,341

40 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
2011										
Liabilities										
Hong Kong currency notes in circulation	162,524	—	—	—	—	—	—	—	—	162,524
Items in the course of transmission to other banks	—	38,577	—	—	—	—	—	—	—	38,577
Deposits by banks	67,552	72,539	15,677	1,926	821	231	—	—	—	158,746
Customer accounts	1,733,694	280,554	128,032	66,418	11,311	63	—	—	—	2,220,072
Trading liabilities	—	—	—	—	—	—	—	78,959	—	78,959
Financial liabilities designated at fair value	—	—	—	—	5,796	101	13	—	—	5,910
Derivatives	—	—	—	—	—	—	—	375,712	1,453	377,165
Debt securities in issue	1,433	4,378	14,169	3,293	21,294	1,793	—	—	—	46,360
Retirement benefit liabilities	—	—	—	—	—	—	4,150	—	—	4,150
Amounts due to Group companies	32,892	53,074	13,494	9,661	422	10,105	—	33,258	—	152,906
Other liabilities and provisions	4,121	12,954	18,936	30,372	2,479	103	2,620	—	—	71,585
Current tax liabilities	307	7	275	2,155	4	—	—	—	—	2,748
Deferred tax liabilities	—	—	—	—	—	—	5,884	—	—	5,884
Subordinated liabilities	—	—	—	—	—	—	9,386	—	—	9,386
Preference shares	—	—	—	—	—	28,742	68,227	—	—	96,969
Total liabilities	2,002,523	462,083	190,583	113,825	42,127	41,138	90,280	487,929	1,453	3,431,941

Notes on the Financial Statements (continued)

41 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 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
At 31 December 2011						
Hong Kong currency notes						
in circulation	162,524	–	–	–	–	162,524
Items in the course of transmission						
to other banks	–	47,163	–	–	–	47,163
Deposits by banks	107,693	111,446	2,595	882	265	222,881
Customer accounts	2,626,340	766,222	167,859	16,729	211	3,577,361
Trading liabilities	171,431	–	–	–	–	171,431
Financial liabilities designated at						
fair value	244	114	138	6,006	34,362	40,864
Derivatives	380,205	205	765	2,065	94	383,334
Debt securities in issue	1,433	21,703	9,260	44,378	5,197	81,971
Amounts due to Group companies ..	56,459	33,025	9,195	165	9,706	108,550
Other financial liabilities	7,641	48,661	37,000	2,791	118	96,211
Subordinated liabilities	–	189	2,724	3,996	16,089	22,998
Preference shares	–	874	1,413	9,148	117,189	128,624
	3,513,970	1,029,602	230,949	86,160	183,231	5,043,912
Loan commitments	1,101,283	327,017	31,249	13,080	9	1,472,638
Financial guarantee and credit risk						
related guarantee contracts	48,432	–	–	–	–	48,432
	4,663,685	1,356,619	262,198	99,240	183,240	6,564,982

41 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 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
At 31 December 2011						
Hong Kong currency notes						
in circulation	162,524	–	–	–	–	162,524
Items in the course of transmission						
to other banks	–	38,577	–	–	–	38,577
Deposits by banks	67,552	88,366	1,955	882	265	159,020
Customer accounts	1,733,781	409,918	68,089	12,387	126	2,224,301
Trading liabilities	78,959	–	–	–	–	78,959
Financial liabilities designated at						
fair value	–	114	138	6,006	117	6,375
Derivatives	375,832	67	428	843	38	377,208
Debt securities in issue	1,433	18,661	3,559	21,706	1,974	47,333
Amounts due to Group companies ..	66,152	66,577	9,690	447	10,161	153,027
Other financial liabilities	3,840	28,844	29,789	2,206	74	64,753
Subordinated liabilities	–	121	207	1,313	12,604	14,245
Preference shares	–	874	1,413	9,148	117,062	128,497
	2,490,073	652,119	115,268	54,938	142,421	3,454,819
Loan commitments	675,165	234,915	11,650	8,713	6	930,449
Financial guarantee and credit risk						
related guarantee contracts	25,448	–	–	–	–	25,448
	3,190,686	887,034	126,918	63,651	142,427	4,410,716

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 note 52.

Notes on the Financial Statements (continued)**42 Reconciliation of operating profit to cash generated from/(used in) operations**

	2012 HK\$m	2011 HK\$m
Operating profit	89,919	76,287
Net interest income	(82,419)	(75,672)
Dividend income	(522)	(729)
Depreciation and amortisation	5,738	5,638
Amortisation of prepaid operating lease payments	18	18
Loan impairment charges and other credit risk provisions	3,578	3,059
Loans and advances written off net of recoveries	(4,924)	(4,138)
Other provisions for liabilities and charges	1,358	723
Provisions used	(1,362)	(276)
Surplus arising on property revaluation	(2)	(8)
Gains on investment properties	(834)	(1,033)
(Profit)/loss on disposal of property, plant and equipment and assets held for sale	(30)	3
(Profit)/loss on disposal of subsidiaries, associates and business portfolios	(5,247)	9
Impairment on interests in associates and joint ventures	395	–
Gains less losses from financial investments	(2,634)	(128)
Share-based payments granted cost free	1,751	2,274
Movement in present value of in-force business	(4,432)	(5,524)
Interest received	101,158	90,790
Interest paid	(29,909)	(27,458)
Operating profit before changes in working capital	71,600	63,835
Change in treasury bills with original term to maturity of more than three months	(107,676)	(56,042)
Change in placings with banks maturing after one month	13,576	(48,730)
Change in certificates of deposit with original term to maturity of more than three months	(11,498)	(15,773)
Change in trading assets	(29,901)	(39,833)
Change in trading liabilities	13,212	19,897
Change in financial assets designated as fair value	(12,101)	(3,066)
Change in financial liabilities designated as fair value	3,878	65
Change in derivative assets	(21,677)	(74,674)
Change in derivative liabilities	13,958	73,414
Change in financial investments held for backing liabilities to long-term policyholders	(27,345)	(19,813)
Change in loans and advances to customers	(224,461)	(243,760)
Change in amounts due from Group companies	(23,275)	(15,097)
Change in other assets	(57,677)	(49,408)
Change in deposits by banks	21,553	54,755
Change in customer accounts	328,713	251,757
Change in amounts due to Group companies	(12,944)	22,043
Change in debt securities in issue	(2,503)	18,189
Change in liabilities under insurance contracts issued	38,390	31,468
Change in other liabilities	3,723	47,405
Exchange adjustments	1,804	(49)
Cash generated from/(used in) operations	(20,651)	16,583

43 Analysis of cash and cash equivalents

a Change in cash and cash equivalents during the year

	2012 HK\$m	2011 HK\$m
Balance at 1 January	688,673	618,199
Net cash inflow before the effect of foreign exchange movements	19,859	70,898
Effect of foreign exchange movements	(1,346)	(424)
Balance at 31 December	<u>707,186</u>	<u>688,673</u>

b Analysis of balances of cash and cash equivalents in the consolidated balance sheet

	2012 HK\$m	2011 HK\$m
Cash in hand and sight balances with central banks	214,104	110,107
Items in the course of collection from other banks	23,079	34,546
Placings with banks	384,385	481,842
Treasury bills	114,937	96,443
Certificates of deposit	4,141	11,421
Other eligible bills	2,065	1,477
Less: items in the course of transmission to other banks	(35,525)	(47,163)
	<u>707,186</u>	<u>688,673</u>

c Disposal of subsidiaries and businesses

	2012			Total HK\$m
	Banking businesses HK\$m	Insurance businesses HK\$m	Other 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	<u>7,716</u>	<u>3,158</u>	<u>1,384</u>	<u>12,258</u>
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	<u>20,617</u>	<u>3,819</u>	<u>41</u>	<u>24,477</u>
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	<u>(11,514)</u>	<u>655</u>	<u>4,051</u>	<u>(6,808)</u>
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	<u>(11,514)</u>	<u>655</u>	<u>4,051</u>	<u>(6,808)</u>

Notes on the Financial Statements (continued)**44 Contingent liabilities and commitments****a Off-balance sheet contingent liabilities and commitments**

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	225,483	192,428	153,546	128,827
Other contingent liabilities	345	359	295	454
	225,828	192,787	153,841	129,281
Commitments				
Documentary credits and short-term trade-related transactions	39,902	44,524	32,707	33,233
Forward asset purchases and forward forward deposits placed	3,000	2,524	8	255
Undrawn formal standby facilities, credit lines and other commitments to lend	1,561,277	1,425,590	1,001,322	896,961
	1,604,179	1,472,638	1,034,037	930,449

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

44 Contingent liabilities and commitments (continued)

b Guarantees (including financial guarantee contracts)

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

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Guarantees in favour of third parties				
Financial guarantee contracts ¹	34,735	26,694	18,896	12,904
Standby letters of credit which are financial guarantee contracts ²	20,620	19,684	9,527	10,294
Other direct credit substitutes ³	42,551	38,211	33,719	32,311
Performance bonds ⁴	64,220	54,429	46,674	39,289
Bid bonds ⁴	2,752	2,169	1,615	1,602
Standby letters of credit related to particular transactions ⁴	20,608	12,169	16,007	7,630
Other transaction-related guarantees ⁴	29,773	31,892	15,438	17,678
	215,259	185,248	141,876	121,708
Guarantees in favour of other HSBC Group entities	10,224	7,180	11,670	7,119
	225,483	192,428	153,546	128,827

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.

Notes on the Financial Statements (continued)**45 Assets pledged as security for liabilities and collateral accepted as security for assets**

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Assets pledged to secure liabilities				
Financial assets ¹ pledged to secure liabilities.....	91,466	117,963	78,813	74,594
Liabilities secured by financial assets	85,789	112,721	73,309	70,013
Collateral accepted as security for assets				
Fair value of the collateral permitted to sell or repledge in the absence of default ²	202,321	120,319	179,350	88,197
Fair value of collateral actually sold or repledged	27,245	14,504	11,838	5,980

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.

46 Capital commitments

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Expenditure contracted for	4,231	3,511	2,446	3,355
Expenditure authorised by the Directors but not contracted for	8	6	3	2
	4,239	3,517	2,449	3,357

Capital commitments mainly relate to the commitment to purchase premises and equipment.

47 Lease commitments

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

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Premises				
Amounts payable within				
– one year or less	2,841	3,734	1,325	1,414
– five years or less but over one year	4,597	4,603	2,213	2,385
– over five years	821	1,103	510	761
	8,259	9,440	4,048	4,560
Equipment				
Amounts payable within				
– one year or less	92	71	6	6
– five years or less but over one year	78	100	10	9
	170	171	16	15

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 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 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.

Notes on the Financial Statements (continued)**48 Segmental analysis** (continued)*Total assets*

	2012		2011	
	HK\$m	%	HK\$m	%
Hong Kong	3,944,090	65.0	3,594,991	64.1
Rest of Asia-Pacific	2,639,425	43.5	2,429,228	43.3
Intra region	(518,188)	(8.5)	(416,739)	(7.4)
	6,065,327	100.0	5,607,480	100.0

Total liabilities

	2012		2011	
	HK\$m	%	HK\$m	%
Hong Kong	3,736,637	66.8	3,436,629	65.6
Rest of Asia-Pacific	2,373,800	42.4	2,216,247	42.3
Intra region	(518,188)	(9.2)	(416,739)	(7.9)
	5,592,249	100.0	5,236,137	100.0

Interests in associates and joint ventures

	2012		2011	
	HK\$m	%	HK\$m	%
Hong Kong	1,739	1.5	1,525	1.7
Rest of Asia-Pacific	117,534	98.5	90,260	98.3
	119,273	100.0	91,785	100.0

Credit commitments and contingencies (contract amounts)

	2012		2011	
	HK\$m	%	HK\$m	%
Hong Kong	868,161	47.4	769,088	46.2
Rest of Asia-Pacific	961,846	52.6	896,337	53.8
	1,830,007	100.0	1,665,425	100.0

Property, plant and equipment, goodwill and intangible assets acquired in the year

	2012		2011	
	HK\$m	%	HK\$m	%
Hong Kong	1,018	51.2	1,740	59.9
Rest of Asia-Pacific	972	48.8	1,167	40.1
	1,990	100.0	2,907	100.0

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
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)

Notes on the Financial Statements (continued)**48 Segmental analysis** (continued)

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Intra-segment elimination HK\$m	Total HK\$m
2011				
Interest income	42,309	68,706	(3,557)	107,458
Interest expense	(7,035)	(28,310)	3,559	(31,786)
Net interest income	35,274	40,396	2	75,672
Fee income	27,022	19,315	(1,171)	45,166
Fee expense	(4,162)	(3,880)	1,171	(6,871)
Net trading income	7,691	12,510	(2)	20,199
Net expense from financial instruments				
designated at fair value	(4,230)	(293)	–	(4,523)
Gains less losses from financial investments	310	(182)	–	128
Dividend income	723	6	–	729
Net earned insurance premiums	39,738	5,932	–	45,670
Other operating income	13,229	2,674	(4,514)	11,389
Total operating income	115,595	76,478	(4,514)	187,559
Net insurance claims incurred and movement				
in liabilities to policyholders	(35,778)	(4,611)	–	(40,389)
Net operating income before loan impairment charges				
and other credit risk provisions	79,817	71,867	(4,514)	147,170
Loan impairment charges and other credit risk provisions	(938)	(2,121)	–	(3,059)
Net operating income	78,879	69,746	(4,514)	144,111
Operating expenses	(36,106)	(36,232)	4,514	(67,824)
Operating profit	42,773	33,514	–	76,287
Share of profit in associates and joint ventures	424	14,659	–	15,083
Profit before tax	43,197	48,173	–	91,370
Tax expense	(7,703)	(9,763)	–	(17,466)
Profit for the year	35,494	38,410	–	73,904
Profit attributable to shareholders	31,165	36,426	–	67,591
Profit attributable to non-controlling interests	4,329	1,984	–	6,313
Net operating income				
– external	70,903	71,088	–	141,991
– inter-company/inter-segment	7,976	(1,342)	(4,514)	2,120
Depreciation and amortisation included in operating				
expenses	(4,047)	(1,591)	–	(5,638)
Restructuring costs	(520)	(344)	–	(864)

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 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
Year ended 31 December 2011							
External	48,615	31,821	61,508	(196)	243	–	141,991
Intercompany/intersegment	10,904	1,984	(10,824)	597	6,334	(6,875)	2,120

Information by country

	Net external operating income ¹		Non-current assets ²	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Hong Kong	84,627	70,903	82,780	91,177
Mainland China	10,941	11,952	121,854	91,687
Australia	6,952	7,115	1,544	1,629
India	8,771	9,684	2,362	2,342
Indonesia	5,069	4,715	5,001	5,349
Malaysia	7,547	7,232	1,109	1,033
Singapore	8,876	8,028	1,589	1,256
Taiwan	3,795	3,717	2,487	2,564
Vietnam	1,424	1,606	1,401	2,742
Other	18,843	17,039	3,534	5,151
Total	156,845	141,991	223,661	204,930

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.

Notes on the Financial Statements (continued)**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 2012, the Bank has issued HK\$83,195m of preference shares to its immediate holding company (2011: HK\$96,969m). 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 2012, the Bank has issued HK\$11,905m of subordinated liabilities to its ultimate holding company (2011: HK\$9,599m). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Interest expense ¹	2,386	2,337	277	172
Other operating income	–	–	243	150
Other operating expenses	19	30	1,394	1,584

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Amounts due from ¹	–	–	191	167
Amounts due to ²	84,555	98,243	12,285	9,990

The Bank

	Immediate holding company		Ultimate holding company	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Amounts due from ¹	–	–	151	167
Amounts due to ²	84,555	98,243	12,122	9,916

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\$83,195m (2011: HK\$96,969m). Amounts due to the ultimate holding company included subordinated liabilities of HK\$11,905m (2011: HK\$9,599m).

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK\$326m (2011: HK\$283m).

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 2012 amounted to HK\$2,638m and HK\$2,561m respectively (2011: HK\$2,915m and HK\$2,729m respectively).

c Pension funds

At 31 December 2012, HK\$12.6bn (2011: HK\$12.5bn) 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\$47m for the year (2011: HK\$53m).

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	
	2012 HK\$m	2011 HK\$m
Interest income	429	445
Interest expense	872	797
Fee income	2,582	2,470
Fee expense	734	935
Other operating income	3,022	3,227
Other operating expenses ¹	5,843	5,169

¹ In 2012 payments were made of HK\$920m (2011: HK\$1,271m) for software costs which were capitalised as intangible assets in the balance sheet of the group.

Notes on the Financial Statements (continued)**49 Related party transactions** (continued)*Balances at 31 December**The group*

	Fellow subsidiaries	
	2012 HK\$m	2011 HK\$m
Assets		
Trading assets	6,710	11,120
Financial assets designated at fair value	4,966	5,390
Other assets	164,136	136,051
	175,812	152,561
Liabilities		
Trading liabilities	27,112	37,675
Financial liabilities designated at fair value	2	5
Other liabilities	57,010	59,605
	84,124	97,285
Guarantees	10,224	7,180
Commitments	5,051	6,689

The Bank

	Subsidiaries		Fellow subsidiaries	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Assets				
Trading assets	6,537	3,486	6,589	10,970
Financial assets designated at fair value	–	–	–	–
Other assets	157,159	113,761	151,163	119,616
	163,696	117,247	157,752	130,586
Liabilities				
Trading liabilities	7,764	7,421	11,205	25,837
Financial liabilities designated at fair value	–	–	–	–
Other liabilities	64,856	54,655	51,930	53,803
	72,620	62,076	63,135	79,640
Guarantees	2,441	1,039	9,229	6,080
Commitments	36,460	38,484	3,885	3,639

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Derivative assets	83,270	85,977	87,291	89,781
Derivative liabilities	96,442	90,663	99,688	93,677

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

	2012		2011	
	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				
– subordinated	–	–	34	33
– unsubordinated	27,056	20,784	23,418	19,183
Amounts due from joint ventures				
– subordinated	39	6	13	6
– unsubordinated	787	1	1,107	966
	27,882	20,791	24,572	20,188
Amounts due to associates	6,589	2,020	4,536	3,672
Amounts due to joint ventures	1,034	–	1,488	1,013
	7,623	2,020	6,024	4,685
Commitments	2,529	349	1,431	711

The Bank

	2012		2011	
	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	5,448	1,297	7,509	3,825
Amounts due from joint ventures				
– unsubordinated	787	1	881	876
	6,235	1,298	8,390	4,701
Amounts due to associates	1,190	697	1,065	1,065
Amounts due to joint ventures	1,032	–	1,486	1,011
	2,222	697	2,551	2,076
Commitments	2,164	225	1,012	351

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.

Notes on the Financial Statements (continued)**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:

	2012	2011
	HK\$m	HK\$m
Salaries and other short term benefits	235	220
Retirement benefits		
– Defined contribution plans	11	8
– Defined benefit plans	1	2
Termination benefits	14	–
Share-based payments	83	110
	344	340

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:

	2012	2011
	HK\$m	HK\$m
During the year		
Highest average assets ¹	32,044	43,416
Highest average liabilities ¹	36,208	39,548
Contribution to the group's profit before tax	775	818
At the year end		
Guarantees	4,034	3,874
Commitments	7,698	6,417

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	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
By the Bank	80	73	101	83
By subsidiaries	10	13	13	15
	90	86	114	98

50 Share-based payments

a Income statement charge

	2012 HK\$m	2011 HK\$m
Restricted share awards	1,497	1,907
Performance share awards	–	17
Savings-related share option plans	256	350
	1,753	2,274
Equity-settled share-based payments	1,751	2,274
Cash-settled share-based payments	2	–

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.

b HSBC Share Awards

Award	Policy	Purpose
Restricted share awards (including GPSP awards)	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Rewards employee performance, potential and retention of key employees To defer variable pay
Performance share awards	<ul style="list-style-type: none"> Vesting of awards based on three independent performance measures (relative TSR (40%), economic profit (40%) and growth in earnings per share ('EPS') (20%)) and an over-riding 'sustained improvement' judgment by the HSBC Group Remuneration Committee Performance conditions are measured over a three year period and reviewed annually Awards are forfeited to the extent the performance conditions have not been met 	<ul style="list-style-type: none"> Align interests of executives with the creation of shareholder value and recognise individual performance and potential To reflect HSBC's relative and absolute performance over the long-term, taking account of an external measure of value creation, a measure of the extent to which the return on capital invested in HSBC is in excess of a benchmark return and a direct measure of the profits generated for shareholders
Achievement share awards	<ul style="list-style-type: none"> Additional awards made throughout the three-year vesting period Original award together with the additional share awards are released after three years of continued employment within HSBC Group Shares awarded without corporate performance conditions 	<ul style="list-style-type: none"> To promote widespread interest in HSBC shares amongst employees Rewards eligible employees for their prior year performance High performing and/or senior and middle managers are normally eligible to receive achievement shares during their annual pay review

Notes on the Financial Statements (continued)**50 Share-based payments** (continued)*Movement on HSBC share awards*

<i>The group</i>	Restricted share awards		Performance share awards¹		Achievement share awards¹	
	2012	2011	2012	2011	2012	2011
	Number	Number	Number	Number	Number	Number
	(000s)	(000s)	(000s)	(000s)	(000s)	(000s)
Outstanding at 1 January	50,225	38,476	–	283	–	2,911
Additions during the year	17,450	17,380	–	10	–	33
Released in the year	(30,929)	(4,674)	–	(61)	–	(2,886)
Transferred in the year	690	744	–	–	–	(12)
Lapsed in the year	(1,396)	(1,701)	–	(232)	–	(46)
Outstanding at 31 December	36,040	50,225	–	–	–	–
Weighted average remaining vesting period (years)	0.75	0.68	–	–	–	–

1 Additions during the year comprised reinvested dividend equivalents.

c HSBC Share Option Plans

Award	Policy	Purpose
Savings-related share option plans	<ul style="list-style-type: none"> 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% (2011: 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) 	<ul style="list-style-type: none"> 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 To align the interests of all employees with the creation of shareholder value
Executive Share Option Scheme ('ESOS') and Group Share Option Plan ('GSOP')	<ul style="list-style-type: none"> Vesting of awards based on achievement of certain TSR targets Exercisable between third and tenth anniversaries of the date of grant Plan ceased in May 2005 	<ul style="list-style-type: none"> 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

The table on page 150 shows the movement on HSBC share option plans during the year.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a Black-Scholes model. 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.

50 Share-based payments (continued)

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
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
2011			
Risk-free interest rate ¹ (%)	0.8	1.7	2.5
Expected life ² (years)	1	3	5
Expected volatility ³ (%)	25	25	25
Share price at grant date (£)	6.37	6.37	6.37

- 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 5% per annum in line with consensus analyst forecasts (2011: 4.5%) which vested in subsequent years.

Notes on the Financial Statements (continued)**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\$
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
2011						
Outstanding at 1 January	19,895	7.07	15,404	3.99	45,306	40.72
Granted during the year	–	–	3,551	5.10	4,857	64.99
Forfeited/expired in the year	(4,171)	7.54	(2,757)	4.88	(4,039)	53.06
Exercised during the year	(107)	6.03	(1,719)	5.47	(2,355)	60.99
Transferred in the year	(63)	7.74	108	3.71	(36)	35.98
Outstanding at 31 December	15,554	6.95	14,587	3.93	43,733	53.06
Exercisable at 31 December	15,554	6.95	317	6.01	50	91.61
At 31 December 2011						
Weighted average fair value of options granted during the year...		–		1.25		15.68
Weighted average share price at the date the options were exercised .		6.45		5.40		69.24
Weighted average remaining contractual life (years)		1.57		1.75		2.02
Exercise price range		6.02 - 7.96		3.31 - 6.69		37.88 - 94.51

1 *Weighted Average Exercise Price.*

During the year, options granted for schemes with option prices set in euros and US dollars were insignificant.

51 Fair value of financial instruments

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

Financial instruments measured at fair value on an ongoing basis include trading assets and liabilities, instruments designated at fair value through profit or loss, derivatives, and financial instruments classified as available-for-sale (including treasury and other eligible bills, debt securities and equity securities). Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage, fee expense, and post-trade costs are included in operating expenses. The future cost of administering the over-the-counter derivative portfolio is also not included in fair value, but is expensed as incurred.

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, independent development or validation 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 ongoing 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.

(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 models where one or more significant inputs are unobservable.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments (continued)

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.

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations, including interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. For collateralised counterparties and in significant major currencies, the group has adopted a discounting curve that reflects the overnight interest rate ('OIS discounting'). Prior to 2010, in line with market practice, discount curves did not reflect this overnight interest rate component but were based on a term LIBOR rate. During the period, the group applied an OIS discounting curve to an expanded range of significant currencies in line with evolving market practice. The financial effect of this change was not significant at the time of adoption.

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 derivation 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 carrying amount and/or inception profit ('day 1 gain or loss') 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 level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (consensus pricing data may, for example, be used).

In certain circumstances, primarily where debt is hedged with interest rate derivatives, the group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available. Where quoted prices are not available, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liabilities. The change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived by incorporating our own credit spreads in the valuation. Then, using discounted cash flow, each security is valued using a LIBOR-based discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and 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.

51 Fair value of financial instruments *(continued)*

Fair value adjustments

Fair value adjustments are adopted when the group considers that there are additional factors that would be considered by a market participant that are not incorporated within the valuation model. The magnitude of fair value adjustments depends upon many entity-specific factors, and therefore fair value adjustments may not be comparable across the banking industry.

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

HKAS 39 requires that portfolios are marked at bid or offer, as appropriate. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the cost that would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the actual 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 rather more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

(iii) Credit risk adjustment methodology

The credit risk adjustment is an adjustment to the valuation of OTC 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.

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 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 probability of default 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.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments (continued)

From 31 December 2012, the group revised its methodologies for determining the CVA and DVA for derivatives. Historically, the probability of default used in the CVA calculation has been based on the group's internal credit rating for the counterparty, taking into account how credit ratings may deteriorate over the duration of the exposure based on historical rating transition matrices, and the probability of default used in the DVA calculation has been zero. As a result of evolving market practice, the group has decided to revise the methodology for determining the probability of default to one that uses credit default swap ('CDS') spreads where these are available and reliable for a specific counterparty, including for the group with respect to the DVA, or relevant proxies where relevant CDS spreads are not available. The derivation of a proxy has regard to the range of market practice, and considers relevant data in this context, including CDS index and rating transition data. For most products, to calculate the expected positive exposure to a counterparty, the group uses a simulation methodology to incorporate the range of potential exposures across the portfolio of transactions with the counterparty over the life of an instrument. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default 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. The net impact of these changes was insignificant on the consolidated income statement of the Bank and the group.

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 such a mapping approach is not appropriate, a simplified methodology is used, generally following 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 used in the simulation methodology described previously.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises where the underlying value of the derivative prior to any credit risk adjustment is positively correlated to the probability of default of the counterparty. Where 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, all third party counterparties are included in the credit risk adjustment calculation and credit risk adjustments are not netted across group entities.

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(h). 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 (continued)

Fair value valuation bases

The approach used to calculate the fair value of each type of financial instrument is as follows:

Loans, including leveraged finance and loans held for securitisation

Loans held at fair value are valued from broker quotes and/or market data consensus providers where available. Where unavailable, fair value will be determined using valuation techniques. These techniques include discounted cash flow models, which incorporate assumptions regarding an appropriate credit spread for the loan, derived from other market instruments issued by the same or comparable entities.

Debt securities, treasury and eligible bills, and equities

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

Derivatives

Over-the-counter (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures or estimated from historical data or other sources. Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors, such as foreign exchange rates, interest rates and equity prices.

Structured notes

The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph above on derivatives.

Trading liabilities valued using a valuation technique with significant unobservable inputs principally comprised equity-linked structured notes, which are issued by the group and provide the counterparty with a return that is linked to the performance of certain equity securities, and other portfolios. The notes are classified as level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices, between equity prices and interest rates and between interest rates and foreign exchange rates.

Asset-backed securities

While quoted market prices are generally used to determine the fair value of these securities, valuation models are used to substantiate the reliability of the limited market data available and to identify whether any adjustments to quoted market prices are required. For asset-backed securities, including residential mortgage-backed securities, the valuation uses an industry standard model and the assumptions relating to prepayment speeds, default rates and loss severity based on collateral type, and performance, as appropriate. The valuation's output is benchmarked for consistency against observable data for securities of a similar nature.

Private equity and strategic investments

The group's private equity and strategic investments are generally classified as available-for-sale and are not all 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.

Notes on the Financial Statements (continued)**51 Fair value of financial instruments** (continued)*Analysis of fair value determination*

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

The group

	Valuation techniques			Third party total HK\$m	Amounts with HSBC entities HK\$m	Total HK\$m
	Quoted market price Level 1 HK\$m	using observable inputs Level 2 HK\$m	with significant unobservable inputs Level 3 HK\$m			
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
At 31 December 2011						
Assets						
Trading assets	306,444	140,294	1,230	447,968	–	447,968
Financial assets designated at fair value	33,552	20,637	3,481	57,670	–	57,670
Derivatives	3,146	286,765	1,408	291,319	85,977	377,296
Available-for-sale investments ¹	544,954	459,528	17,085	1,021,567	–	1,021,567
Liabilities						
Trading liabilities	53,214	103,703	14,514	171,431	–	171,431
Financial liabilities designated at fair value	–	40,392	–	40,392	–	40,392
Derivatives	6,117	285,427	1,045	292,589	90,663	383,252

¹ An analysis of available-for-sale investments across balance sheet lines can be found in note 10.

There were no material movements between Level 1 and Level 2 during the year.

51 Fair value of financial instruments (continued)

The Bank

	Valuation techniques			Third party total HK\$M	Amounts with HSBC entities HK\$M	Total HK\$M
	Quoted market price Level 1 HK\$M	using observable inputs Level 2 HK\$M	with significant unobservable inputs Level 3 HK\$M			
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
At 31 December 2011						
Assets						
Trading assets	234,611	81,546	1,164	317,321	–	317,321
Financial assets designated at fair value	–	2,283	–	2,283	–	2,283
Derivatives	2,539	277,227	1,131	280,897	89,781	370,678
Available-for-sale investments ¹	453,706	219,516	12,773	685,995	–	685,995
Liabilities						
Trading liabilities	25,746	46,973	6,240	78,959	–	78,959
Financial liabilities designated at fair value	–	5,910	–	5,910	–	5,910
Derivatives	5,856	276,699	933	283,488	93,677	377,165

¹ An analysis of available-for-sale investments across balance sheet lines can be found in note 10.

There were no material movements between Level 1 and Level 2 during the year.

Notes on the Financial Statements (continued)**51 Fair value of financial instruments** (continued)*Reconciliation of fair value measurements in Level 3 of the fair value hierarchy*

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

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)
At 1 January 2011	22,155	2,035	2,437	1,372	–	14,514	1,612
Total gains or losses recognised in profit or loss	(324)	(60)	52	782	–	(433)	282
Total gains or losses recognised in other comprehensive income	(1,460)	(30)	(4)	(14)	–	(71)	3
Purchases	3,544	1,070	1,459	–	–	–	–
Issues	–	–	–	–	–	2,368	–
Sales	(85)	(737)	(157)	–	–	–	–
Deposits / settlements	(4,597)	(625)	(44)	87	–	3,886	(106)
Transfers out	(2,273)	(916)	(1,276)	(930)	–	(8,009)	(768)
Transfers in	125	493	1,014	111	–	2,259	22
At 31 December 2011	17,085	1,230	3,481	1,408	–	14,514	1,045
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period ¹	(8)	5	60	58	–	(167)	(265)

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 (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 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)
At 1 January 2011	17,708	1,968	112	1,075	–	7,791	1,495
Total gains or losses recognised in profit or loss	(5)	(60)	(34)	871	–	(480)	192
Total gains or losses recognised in other comprehensive income	(1,896)	(30)	–	(15)	–	(49)	(1)
Purchases	3,001	1,070	–	–	–	–	–
Issues	–	–	–	–	–	1,952	–
Sales	–	(737)	(78)	–	–	–	–
Deposits / settlements	(3,877)	(625)	–	(25)	–	(59)	(73)
Transfers out	(2,158)	(915)	–	(884)	–	(3,169)	(702)
Transfers in	–	493	–	109	–	254	22
At 31 December 2011	12,773	1,164	–	1,131	–	6,240	933
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period ¹	214	2	–	183	–	(155)	(203)

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** (continued)

Some investments in unlisted equity shares were transferred to assets held for sale and the observability of valuations of certain debt securities resulted in these assets being transferred out of level 3 during the year. Transfers into level 3 resulted from the valuations of certain debt securities becoming unobservable during the year.

For assets designated at fair value through profit or loss, the observability of valuations of certain debt securities resulted in these assets being transferred out of level 3 during the year. Transfers into level 3 resulted from the valuations of certain debt securities becoming unobservable during the year.

For derivative assets and liabilities, an increase in the observability of equity volatilities and interest rate basis spreads during the year resulted in transfers out of level 3.

For held-for-trading liabilities, transfers into level 3 were due to a reduction in the observability of volatilities and correlations. Transfers out of level 3 resulted from an increase in the observability of volatilities and correlations.

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.

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.

51 Fair value of financial instruments (continued)

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 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)
At 31 December 2011				
Derivatives/trading assets/trading liabilities	353	(281)	–	–
Financial assets/liabilities designated at fair value	348	(348)	–	–
Financial investments: available-for-sale	–	–	1,663	(1,663)

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 2012				
Derivatives/trading assets/trading liabilities	587	(563)	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Financial investments: available-for-sale	–	–	761	(761)
At 31 December 2011				
Derivatives/trading assets/trading liabilities	223	(153)	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Financial investments: available-for-sale	–	–	1,232	(1,232)

Changes in fair value recorded in the income statement

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

- the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component; and
- instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges.

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
At 31 December				
Derivatives/trading assets/trading liabilities	(2,690)	(369)	(2,844)	(173)
Financial assets/liabilities designated at fair value	71	60	–	–

Notes on the Financial Statements (continued)**51 Fair value of financial instruments** (continued)*Fair value of financial instruments not carried at fair value*

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

The group

	31 December 2012		31 December 2011	
	Carrying value HK\$m	Fair value HK\$m	Carrying value HK\$m	Fair value HK\$m
Assets				
Placings with banks	546,908	548,115	654,581	654,756
Loans and advances to customers	2,349,043	2,335,254	2,130,871	2,101,243
Debt securities	163,819	176,172	143,062	151,363
Liabilities				
Deposits by banks	244,135	244,136	222,582	222,697
Customer accounts	3,874,884	3,875,259	3,565,001	3,565,036
Debt securities in issue	74,647	74,854	77,472	77,330
Subordinated liabilities	13,867	12,497	16,114	14,157
Preference shares	83,346	73,762	97,096	86,932

The Bank

	31 December 2012		31 December 2011	
	Carrying value HK\$m	Fair value HK\$m	Carrying value HK\$m	Fair value HK\$m
Assets				
Placings with banks	246,104	246,718	341,527	341,970
Loans and advances to customers	1,282,720	1,274,154	1,176,602	1,159,635
Liabilities				
Deposits by banks	204,520	204,520	158,746	158,743
Customer accounts	2,417,400	2,417,576	2,220,072	2,220,031
Debt securities in issue	40,406	40,552	46,360	46,245
Subordinated liabilities	9,355	7,894	9,386	7,354
Preference shares	83,195	73,611	96,969	86,805

The following table lists those financial instruments for which their carrying amounts are a reasonable approximation of fair values because, for example, they are short term in nature or reprice to current market rates frequently:

Assets	Liabilities
Cash and balances at central banks	Items in the course of transmission to other banks
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'

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

51 Fair value of financial instruments (continued)

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

Loans and advances to customers

The fair value of loans and advances to customers is based on observable market transactions where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models.

Performing loans are grouped, as far as possible, in to homogenous pools segregated by maturity and interest rates and the contractual cash flows are generally discounted using the group's estimate of the discount rate that market participants would use in valuing instruments with similar maturity, re-pricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans. 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 earning streams of equivalent quoted securities.

Deposits and customer accounts

For the purpose of estimating fair value, deposits 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 deposits repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

Debt securities in issue and subordinated liabilities

The fair value of debt securities in issue and subordinated liabilities is based on quoted market prices for the same or similar instruments at the balance sheet date.

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

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

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

Notes on the Financial Statements (continued)

52 Risk management

The group's activities involve the analysis, evaluation, acceptance and management of financial risks. The principal financial risks are:

- credit risk;
- liquidity and funding risk;
- market risk (including foreign exchange, interest rate and equity price risks);
- operational risk;
- insurance risk; and
- capital management

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

a *Credit risk*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from derivatives and off-balance sheet products such as guarantees and from the group's holding of debt and other securities. 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.

52 Risk management *(continued)*

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

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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)

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

The group

	2012 HK\$m	2011 HK\$m
Cash and short-term funds	1,111,199	919,906
Items in the course of collection from other banks	23,079	34,546
Placings with banks maturing after one month	184,711	198,287
Certificates of deposit	93,085	88,691
Hong Kong Government certificates of indebtedness	176,264	162,524
Trading assets	389,296	432,908
Debt securities	176,757	168,849
Treasury bills and other eligible bills	155,464	230,959
Other	57,075	33,100
Financial assets designated at fair value	17,421	17,402
Debt securities	17,001	16,762
Other	420	640
Derivatives	398,956	377,296
Loans and advances to customers	2,349,043	2,130,871
Financial investments: Debt securities	618,671	677,256
Amounts due from Group companies	176,004	152,730
Other assets	80,105	77,521
Acceptances and endorsements	31,965	31,750
Other	48,140	45,771
Financial guarantees and other credit-related contingent liabilities	59,065	48,432
Loan commitments and other credit-related commitments	1,820,719	1,683,589
At 31 December	7,497,618	7,001,959

The Bank

	2012 HK\$m	2011 HK\$m
Cash and short-term funds	761,187	612,265
Items in the course of collection from other banks	17,355	29,821
Placings with banks maturing after one month	80,200	108,873
Certificates of deposit	20,150	23,987
Hong Kong Government certificates of indebtedness	176,264	162,524
Trading assets	254,323	302,343
Debt securities	125,372	120,575
Treasury bills and other eligible bills	116,214	160,911
Other	12,737	20,857
Financial assets designated at fair value: debt securities	1,432	2,283
Derivatives	391,839	370,678
Loans and advances to customers	1,282,720	1,176,602
Financial investments: Debt securities	257,804	325,136
Amounts due from group companies	321,600	248,001
Other assets	45,231	43,059
Acceptances and endorsements	21,191	21,001
Other	24,040	22,058
Financial guarantees and other credit-related contingent liabilities	32,317	25,448
Loan commitments and other credit-related commitments	1,167,024	1,067,049
At 31 December	4,809,446	4,498,069

52 Risk management (continued)

(ii) Credit quality of financial instruments

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

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

Credit quality classification

Quality Classification	Debt securities/ other bills	Wholesale lending and derivatives		Retail lending	
		External rating	Internal credit rating	Probability of default	Internal credit rating ¹
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 ²

1 We observe the convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired. (See note 52(v))

2 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

- 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(d) and 3(g) on the Financial Statements. Analysis of impairment allowances as at 31 December 2012 and the movement of such allowances during the year are disclosed in note 19.

Notes on the Financial Statements (continued)

52 Risk management (continued)

Granular risk rating scales

The CRR ('Customer Risk Rating') 10-grade scale maps to a more granular underlying 23-grade scale of obligor probability of default. These scales are used Group-wide for all individually significant customers, depending on which Basel II approach is adopted for the assets in question. The EL 10-grade scale for retail business summarises a more granular 29-grade scale combining obligor and facility/product risk factors in a composite measure, used Group-wide. The external ratings cited above have for clarity of reporting been assigned to the quality classifications defined for internally-rated exposures.

The basis of reporting reflects risk rating systems under the HSBC Group's Basel II programme and to extend the range of financial instruments covered in the presentation of portfolio quality.

Impairment is not measured for financial instruments held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the income statement.

(iii) Collateral and other credit enhancements

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the group's 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 exclude 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.

52 Risk management (continued)

Personal lending

Residential mortgages including loan commitments by level of collateral

	2012 HK\$m	2011 HK\$m
Not collateralised	79	1,290
Fully collateralised	747,689	659,976
– Less than 25% LTV	96,626	60,167
– 25% to 50% LTV	329,650	230,027
– 51% to 75% LTV	249,448	278,216
– 76% to 90% LTV	62,920	81,597
– 91% to 100% LTV	9,045	9,969
Partially collateralised		
– Greater than 100% LTV	2,929	4,156
– Collateral value	2,513	3,912
Total residential mortgages	750,697	665,422

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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)**Corporate, commercial and financial (non-bank) lending**

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

	2012	2011
	HK\$m	HK\$m
Rated CRR/EL 1 to 7	314,079	280,706
Not collateralised	111,895	120,602
Fully collateralised	181,832	144,975
Partially collateralised (A)	20,352	15,129
– collateral value on A	12,735	6,770
Rated CRR/EL 8 to 10	878	616
Not collateralised	–	95
Fully collateralised	486	193
– Less than 25% LTV	12	–
– 25% to 50% LTV	437	14
– 51% to 75% LTV	17	9
– 76% to 90% LTV	9	14
– 91% to 100% LTV	11	156
Partially collateralised (B)	392	328
– collateral value on B	115	203
Total commercial real estate loans and advances	314,957	281,322

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).

52 Risk management (continued)

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

	2012 HK\$m	2011 HK\$m
Not collateralised	6,447	8,882
Fully collateralised	1,784	1,634
– Less than 25% LTV	113	107
– 25% to 50% LTV	515	588
– 51% to 75% LTV	547	334
– 76% to 90% LTV	278	251
– 91% to 100% LTV	331	354
Partially collateralised (A)	2,591	1,985
– collateral value on A	1,011	1,015
Total	10,822	12,501

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

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

	2012 HK\$m	2011 HK\$m
Not collateralised	492,106	615,783
Fully collateralised	61,702	64,411
Partially collateralised (A)	20,661	3,847
– collateral value on A	20,054	1,996
Total loans and advances to banks	574,469	684,041

The collateral used in the assessment of the above 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.

Notes on the Financial Statements (continued)**52 Risk management (continued)****Derivatives**

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

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 45 '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 44 '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:

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Residential properties	115	103	21	35
Commercial and industrial properties	26	6	23	–
Other assets	3	3	–	–
	144	112	44	35

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.

52 Risk management (continued)

(iv) Distribution of financial instruments by credit quality

The group

	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium ¹ HK\$m	Sub-standard HK\$m				
31 December 2012							
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 held at amortised cost	1,792,378	1,040,803	26,324	33,203	13,014	(9,771)	2,895,951
– loans and advances to banks	472,123	72,026	2,682	77	–	–	546,908
– loans and advances to customers	1,320,255	968,777	23,642	33,126	13,014	(9,771)	2,349,043
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	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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)

	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium ¹ HK\$m	Sub-standard HK\$m				
31 December 2011							
Items in the course of collection from other banks	32,852	1,690	4	–	–	–	34,546
Trading assets	371,013	61,562	333	–	–	–	432,908
– treasury and other eligible bills	224,302	6,657	–	–	–	–	230,959
– debt securities	123,177	45,596	76	–	–	–	168,849
– loans and advances to banks	22,413	3,491	257	–	–	–	26,161
– loans and advances to customers	1,121	5,818	–	–	–	–	6,939
Financial assets designated at fair value	14,701	2,701	–	–	–	–	17,402
– debt securities	14,061	2,701	–	–	–	–	16,762
– loans and advances to customers	640	–	–	–	–	–	640
Derivatives	320,122	56,721	453	–	–	–	377,296
Loans and advances held at amortised cost	1,778,778	954,195	23,329	26,600	13,851	(11,301)	2,785,452
– loans and advances to banks	581,800	71,227	1,252	302	–	–	654,581
– loans and advances to customers	1,196,978	882,968	22,077	26,298	13,851	(11,301)	2,130,871
Financial investments	1,018,523	99,824	1,048	–	57	–	1,119,452
– treasury and other eligible bills	329,458	24,047	–	–	–	–	353,505
– debt securities ²	689,065	75,777	1,048	–	57	–	765,947
Other assets	28,910	46,338	1,635	545	93	–	77,521
– endorsements and acceptances	6,549	24,320	876	–	5	–	31,750
– other	22,361	22,018	759	545	88	–	45,771
Total	3,564,899	1,223,031	26,802	27,145	14,001	(11,301)	4,844,577

1 Includes HK\$91,657m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.

2 Includes HK\$16m of impaired debt securities overdue more than 1 year.

52 Risk management (continued)

The Bank

	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium ¹ HK\$m	Sub-standard HK\$m				
31 December 2012							
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 held at amortised cost	931,321	565,029	15,224	16,251	6,548	(5,549)	1,528,824
– loans and advances to banks	208,565	37,414	49	76	–	–	246,104
– loans and advances to customers	722,756	527,615	15,175	16,175	6,548	(5,549)	1,282,720
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.

Notes on the Financial Statements (continued)

52 Risk management (continued)

	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium ¹ HK\$m	Sub-standard HK\$m				
31 December 2011							
Items in the course of collection from other banks	28,334	1,483	4	–	–	–	29,821
Trading assets	254,395	47,615	333	–	–	–	302,343
– treasury and other eligible bills	154,316	6,595	–	–	–	–	160,911
– debt securities	84,222	36,277	76	–	–	–	120,575
– loans and advances to banks	14,742	1,531	257	–	–	–	16,530
– loans and advances to customers	1,115	3,212	–	–	–	–	4,327
Financial assets designated at fair value:							
debt securities	587	1,696	–	–	–	–	2,283
Derivatives	317,049	53,294	335	–	–	–	370,678
Loans and advances held at amortised cost	972,734	519,868	12,504	11,786	8,951	(7,714)	1,518,129
– loans and advances to banks	303,108	37,739	386	294	–	–	341,527
– loans and advances to customers	669,626	482,129	12,118	11,492	8,951	(7,714)	1,176,602
Financial investments	571,375	76,344	1,048	–	57	–	648,824
– treasury and other eligible bills	278,105	21,596	–	–	–	–	299,701
– debt securities	293,270	54,748	1,048	–	57	–	349,123
Other assets	11,255	30,556	1,080	82	86	–	43,059
– endorsements and acceptances	3,949	16,665	382	–	5	–	21,001
– other	7,306	13,891	698	82	81	–	22,058
Total	2,155,729	730,856	15,304	11,868	9,094	(7,714)	2,915,137

1 Includes HK\$81,436m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.

52 Risk management (continued)

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

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.

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 2012						
Loans and advances held at amortised cost ...	26,876	4,874	1,353	81	19	33,203
– loans and advances to banks	77	–	–	–	–	77
– loans and advances to customers ¹	26,799	4,874	1,353	81	19	33,126
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	96	37	38	31	26	228
	26,972	4,911	1,391	112	45	33,431
31 December 2011						
Loans and advances held at amortised cost ...	21,616	3,685	1,113	143	43	26,600
– loans and advances to banks	302	–	–	–	–	302
– loans and advances to customers ¹	21,314	3,685	1,113	143	43	26,298
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	138	143	71	66	127	545
	21,754	3,828	1,184	209	170	27,145

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 2012						
Loans and advances held at amortised cost ...	13,187	2,518	509	21	16	16,251
– loans and advances to banks	76	–	–	–	–	76
– loans and advances to customers ¹	13,111	2,518	509	21	16	16,175
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	23	9	3	10	17	62
	13,210	2,527	512	31	33	16,313
31 December 2011						
Loans and advances held at amortised cost ...	9,628	1,700	410	31	17	11,786
– loans and advances to banks	294	–	–	–	–	294
– loans and advances to customers ¹	9,334	1,700	410	31	17	11,492
Financial investments	–	–	–	–	–	–
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	–	–	–	–	–
Other assets	28	16	13	14	11	82
	9,656	1,716	423	45	28	11,868

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

Notes on the Financial Statements (continued)

52 Risk management (continued)

(vi) Impaired loans and advances

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(d).

Analyses of impairment allowances at 31 December 2012, and the movement of such allowances during the year, are disclosed in note 19.

b Liquidity and funding risk

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 (the 'framework') 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 our Asset, Liability and Capital Management ('ALCM') structure, we have established Asset and Liability Management Committees ('ALCOs') at Group level, in the regions and in operating entities. 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. Our most significant operating entities are overseen by regional ALCOs, Group ALCO and the Risk Management Meeting. The remaining smaller operating entities are overseen by regional ALCOs, with appropriate escalation of significant issues to 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 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.

Compliance with liquidity and funding requirements is monitored by local ALCO which report to the group ALCM 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.

52 Risk management (continued)

Primary sources of funding

Customer deposits in the form of current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and we place considerable importance on maintaining their stability. For deposits, stability depends upon preserving depositor confidence in our capital strength and liquidity, and on competitive and transparent pricing. Professional markets are accessed for the purposes of providing additional funding, maintaining a presence in local money markets and optimising asset and liability maturities.

The management of funding and liquidity risk

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 categorisation of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during a 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

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and mitigate against reliance on short-term professional 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 regional ALCOs 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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)*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.

Compliance with liquidity and funding requirements is monitored by local ALCOs which report to the group ALCM on a regular basis.

Advances to core funding ratios and the stressed one-month and three-month coverage ratios for the Bank 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	
	2012 %	2011 %	2012 %	2011 %	2012 %	2011 %
Year-end	73.1	75.0	129.5	122.9	126.1	118.5
Maximum	75.0	78.9	133.6	144.6	126.2	125.9
Minimum	71.4	70.3	122.9	116.4	118.5	109.5
Average	73.1	75.9	129.0	124.0	123.4	116.2

Liquidity behaviouralisation

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. Our approach to liquidity risk management will often mean a different approach is applied to assets and liabilities. For example, management may assume a shorter life for liabilities and a longer-term funding requirement for assets.

Contingent liquidity risk

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.

Liquidity ratio under the Hong Kong Banking Ordinance

The Hong Kong Banking Ordinance also requires banks operating in Hong Kong to maintain a minimum liquidity ratio. The requirement applies separately to the Hong Kong branches of the Bank and to those subsidiaries which are Authorised Institutions under the Banking Ordinance in Hong Kong.

52 Risk management (continued)

c Market risk

Market risk is the risk that movements in foreign exchange rates, interest rates, credit spreads, or equity and commodity prices will result in profits or losses to the group. Market risk arises on financial instruments which are measured at fair value and those which are measured at amortised cost. The objective of market risk management is to control market risk exposures to achieve an optimal return while maintaining risk at acceptable levels.

The group monitors market risk separately for trading portfolios and non-trading portfolios. Trading portfolios include positions arising from market-making in exchange rate, interest rate, credit and equity derivative instruments, as well as in debt and equity securities. Trading risks arise either from customer-related business or from proprietary position-taking.

The management of market risk is principally undertaken in Global Markets through risk limits approved by the group's Executive Committee. Wholesale 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.

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (99% for the group). VAR is calculated daily. The group uses a historical simulation model which derives plausible future scenarios from historical market data. Potential movements in market prices are calculated with reference to market data from the last two years. The model used assumes a 1-day holding period, as this reflects the way the risk positions are managed.

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

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

Trading

The group's control of market risk is based on restricting individual operations to trading within a list of permissible instruments authorised for each site by 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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)

The total VAR for Global Markets were as follows:

	The group		The Bank	
	2012 HK\$m	2011 HK\$m	2012 HK\$m	2011 HK\$m
Total VAR				
Year end	199	393	173	279
Average	260	306	211	235
Maximum	473	463	357	326
Minimum	167	190	159	156
Total interest rate VAR				
Year end	169	151	149	105
Average	209	141	168	121
Maximum	261	187	212	161
Minimum	169	108	137	92
Total foreign exchange VAR				
Year end	43	49	43	51
Average	38	50	39	52
Maximum	85	116	93	111
Minimum	23	28	22	29
Total credit spread VAR				
Year end	121	343	69	196
Average	177	246	110	166
Maximum	325	380	212	247
Minimum	118	136	67	96
Total trading VAR				
Year end	134	184	119	156
Average	136	131	128	118
Maximum	232	208	227	184
Minimum	89	73	84	69
Interest rate trading VAR				
Year end	95	98	90	101
Average	110	91	101	87
Maximum	159	150	142	120
Minimum	68	62	70	59
Foreign exchange trading VAR				
Year end	43	46	43	48
Average	38	47	39	47
Maximum	85	99	93	95
Minimum	23	24	22	27
Credit spread trading VAR				
Year end	39	109	25	82
Average	47	67	39	57
Maximum	98	115	82	96
Minimum	29	36	23	32
Equity trading VAR ¹				
Year end	26	15	26	15
Average	27	18	27	18
Maximum	54	37	54	37
Minimum	14	5	14	5

1 In addition to equity trading positions managed by Global Markets, the group also has exposure to changes in equity prices and interest rates relating to guarantees given to customers who purchase certain HSBC investment contracts. As at 31 December 2012, a 10% decrease in equity prices would reduce profit before tax and net assets by HK\$182m (2011: HK\$186m) and a 100 basis points decrease in interest rates would reduce profit before tax and net assets by HK\$23m (2011: HK\$156m).

52 Risk management *(continued)*

Non-trading portfolios

Market risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on optionality in certain product areas, for example mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example current accounts. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of the local Asset and Liability Management Committee ('ALCO').

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

As noted above, in certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to alternative investment products and the precise prepayment speeds of mortgages will vary at different interest rate levels. In such circumstances, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

Within the group, banking entities also monitor the sensitivity of projected net interest income under varying interest rate scenarios. The group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

A large part of the group's exposure to changes in net interest income arising from movements in interest rates relates to its core deposit franchise. The group's core deposit franchise is exposed to changes in the value of the deposits raised and spreads against wholesale funds. The value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is, however, asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.

Notes on the Financial Statements (continued)**52 Risk management** (continued)**Structural foreign exchange exposure**

The group's gross structural foreign exchange exposure is represented by the net asset value of the group's foreign currency investments in subsidiaries, branches and associates, and the fair value of the group's long-term foreign currency equity investments.

The group's structural foreign currency exposures are managed by the group's ALCO with the primary objective of ensuring, where practical, that the group's and the Bank's capital ratios are protected from the effect of changes in exchange rates. The group considers hedging structural foreign currency exposures only in limited circumstances to protect the capital ratios or the value of capital invested. Such hedging would be undertaken using foreign exchange contracts or by financing with borrowings in the same currencies as the functional currencies involved.

Foreign currency investments amounted to the foreign currency equivalent of HK\$324,804m (74% of shareholders' funds) at 31 December 2012, an increase of HK\$57,422m from HK\$267,382m (78% of shareholders' funds) at 31 December 2011. 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		The Bank	
	LCYm	HK\$m	LCYm	HK\$m
At 31 December 2012				
Chinese renminbi	153,638	189,446	39,447	48,641
At 31 December 2011				
Chinese renminbi	117,895	145,347	32,290	39,809

52 Risk management (continued)

d Operational risk

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

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

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

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

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

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

e Insurance risk

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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)

The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. Insurance events are, by their nature, 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.

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 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

52 Risk management (continued)

	Life linked contracts ¹ HK\$m	Life non-linked contracts ² HK\$m	Non-life insurance HK\$m	Other assets ³ HK\$m	Total HK\$m
At 31 December 2011					
Financial assets:					
– financial assets designated at fair value	28,067	26,016	404	120	54,607
– derivatives	10	873	–	–	883
– financial investments	4	147,049	1,151	10,843	159,047
– other financial assets	2,086	31,022	1,355	1,271	35,734
Total financial assets	30,167	204,960	2,910	12,234	250,271
Reinsurance assets	6,666	228	395	96	7,385
PVIF ⁴	–	–	–	20,232	20,232
Other assets	7	3,419	190	3,879	7,495
Total assets	36,840	208,607	3,495	36,441	285,383
Liabilities under investment contracts designated at fair value					
	6,633	27,849	–	–	34,482
Liabilities under insurance contracts					
	30,055	176,324	3,059	–	209,438
Deferred tax	(6)	161	1	3,479	3,635
Other liabilities	–	–	–	2,625	2,625
Total liabilities	36,682	204,334	3,060	6,104	250,180
Total equity	–	–	–	35,203	35,203
Total equity and liabilities	36,682	204,334	3,060	41,307	285,383

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 buys a combination of proportionate and non-proportionate reinsurance to reduce the exposures and uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes. The group also 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.

Notes on the Financial Statements (continued)

52 Risk management (continued)

Nature of risks covered

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

(i) *Insurance contracts – non-linked products*

The basic feature of non-linked insurance business is to provide guaranteed death 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 after deduction of premium fees. Other 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 non-life businesses during 2012, this risk is minimal.

52 Risk management (continued)

Concentrations of insurance risks

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

The group is subject to concentration risk arising from accidents relating to common carriers, conflagration, epidemics, earthquakes and other natural disasters that affect the lives, properties and physical conditions 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, its associates and joint ventures, are mainly residents of Hong Kong, Macau, mainland China, Taiwan, Singapore, Malaysia, Vietnam, India and South Korea, 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 187.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore 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. An additional provision is established where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries at 31 December 2012 by type of liability, and provides a view of the exposure to financial risk:

Notes on the Financial Statements (continued)

52 Risk management (continued)

Financial assets held by insurance manufacturing subsidiaries

	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
	At 31 December 2011				
	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	–	13,815	404	120	14,339
– Equity securities	28,067	12,201	–	–	40,268
	28,067	26,016	404	120	54,607
Financial investments					
Held-to-maturity:					
– Debt securities	–	131,932	1,033	10,097	143,062
Available-for-sale:					
– Treasury bills	–	–	–	–	–
– Debt securities	–	15,115	118	728	15,961
– Equity securities	4	2	–	18	24
	4	15,117	118	746	15,985
Derivatives	10	873	–	–	883
Other financial assets	2,086	31,022	1,355	1,271	35,734
	30,167	204,960	2,910	12,234	250,271

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 12.8% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2012 (2011: 12.1%). The table also shows that approximately 68.7% of financial assets were invested in debt securities at 31 December 2012 (2011: 69.3%) with 17.6% (2011: 16.1%) 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.

52 Risk management (continued)

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 2012 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 2012		31 December 2011	
	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	1,096	(1,238)	1,065	(390)
- 100 basis points shift in yield curves	(1,424)	1,032	(977)	547

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 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 2012		31 December 2011	
	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	515	515	629	629
10% decrease in equity prices	(518)	(518)	(1,075)	(1,076)

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 policyholder for participating products but do not allow for the effect of other management actions which may mitigate 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 assets with liabilities in the same currency, effectively reducing the foreign currency exchange rate exposure. Limits are set to ensure that the net foreign currency exposure is kept to an acceptable level. The group uses forward exchange contracts and swaps to manage its foreign currency risk.

Notes on the Financial Statements (continued)**52 Risk management** (continued)**Credit risk**

The group's 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 167. 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% (2011: 91.1%) of the assets included in the table are invested in investments rated as 'Strong'.

	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium HK\$m	Sub-standard HK\$m				
31 December 2012							
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 funds¹							
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

52 Risk management (continued)

31 December 2011	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium HK\$m	Sub- standard HK\$m				
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	13,238	981	–	–	–	–	14,219
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,238	981	–	–	–	–	14,219
Financial investments	134,738	13,460	–	–	–	–	148,198
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	134,738	13,460	–	–	–	–	148,198
Supporting shareholders funds ¹							
Financial assets designated at fair value	96	24	–	–	–	–	120
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	96	24	–	–	–	–	120
Financial investments	9,837	988	–	–	–	–	10,825
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	9,837	988	–	–	–	–	10,825
Total							
Financial assets designated at fair value	13,334	1,005	–	–	–	–	14,339
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,334	1,005	–	–	–	–	14,339
Financial investments	144,575	14,448	–	–	–	–	159,023
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	144,575	14,448	–	–	–	–	159,023

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:

Notes on the Financial Statements (continued)**52 Risk management** (continued)**Reinsurers' share of liabilities under insurance contracts**

	Neither past due nor impaired			Past due not impaired HK\$m	Impaired HK\$m	Impairment allowances HK\$m	Total HK\$m
	Strong HK\$m	Medium HK\$m	Sub-standard HK\$m				
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
31 December 2011							
Linked insurance contracts	3	6,663	–	–	–	–	6,666
Non-linked insurance contracts	428	194	–	1	–	–	623
Total	431	6,857	–	1	–	–	7,289
Reinsurance debtors	27	18	–	51	–	–	96

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 2012, the exposure to the third party was HK\$3,101m (2011: HK\$6,663m).

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 costs of unexpected cash requirements.

52 Risk management (continued)

The following table shows the expected maturity of insurance contract liabilities at 31 December 2012:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				Total HK\$m
	Within 1 year HK\$m	1-5 years HK\$m	5-15 years HK\$m	Over 15 years HK\$m	
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
At 31 December 2011					
Non-life insurance	1,782	834	388	56	3,060
Life insurance (non-linked)	10,490	85,770	148,983	178,200	423,443
Life insurance (linked)	3,538	10,824	39,266	98,261	151,889
	15,810	97,428	188,637	276,517	578,392

Remaining contractual maturity of investment contract liabilities

	Linked investment contracts HK\$m	Non-linked investment contracts HK\$m	Investment contracts with DPF HK\$m	Total HK\$m
	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
At 31 December 2011				
Remaining contractual maturity				
– due within 1 year	216	21	60	297
– due between 1 and 5 years	–	–	26	26
– due between 5 and 10 years	259	–	–	259
– undated ¹	6,157	27,828	–	33,985
	6,632	27,849	86	34,567

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.

Notes on the Financial Statements (continued)**52 Risk management** (continued)*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 2012 was HK\$24,425m (2011: HK\$20,232m), representing the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

The calculation of the PVIF asset was refined in 2011 by incorporating explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the discount rate. The valuation now 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 an active basis with reference to market risk free yields and have been reduced as a result of removing the implicit adjustments. It should be noted that these refinements introduced greater volatility within the insurance results in response to changes in market conditions.

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 2012 of changes in the main economic assumption:

	Impact on results	
	2012 HK\$m	2011 HK\$m
+ 100 basis points shift in risk-free rate	1,111	1,101
- 100 basis points shift in risk-free rate	(1,153)	(687)

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, for non-life business, claims costs and expense rates and, for life business, 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 2012 across all insurance manufacturing subsidiaries is as follows:

	Impact on 2012 results		Impact on 2011 results	
	Profit after tax HK\$m	Net assets HK\$m	Profit after tax HK\$m	Net assets HK\$m
20% increase in claims costs	(3)	(3)	(194)	(194)
20% decrease in claims costs	3	3	194	194
10% increase in mortality and/or morbidity rates	(362)	(362)	(406)	(406)
10% decrease in mortality and/or morbidity rates	374	374	407	407
50% increase in lapse rates	(1,048)	(1,048)	(605)	(605)
50% decrease in lapse rates	2,328	2,328	1,524	1,524
10% increase in expense rates	(275)	(275)	(286)	(286)
10% decrease in expense rates	281	281	285	285

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 risk sharing mechanism with policyholder 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.

52 Risk management (continued)

f Capital management

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.

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. Capital also includes the collective impairment allowances held in respect of loans and advances.

Externally imposed capital requirements

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

Basel II enhancements (commonly known as Basel 2.5) took effect from 1 January 2012. The main changes include raising banks' capital requirements for trading and securitisation exposures, providing supplemental guidance on risk management principles and strengthening disclosure in corresponding areas. The resulting effect was an increase in risk weighted assets for market risk.

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 and foreign exchange (including gold) exposures. As opposed to the standardised (market risk) approach that was used at 31 December 2011, the group has adopted an internal models approach to calculate the general market risk and specific risk for the risk category of equity exposures. The group also uses an internal models approach to calculate its market risk in respect of specific risk for interest rate 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 Hong Kong Monetary Authority.

Notes on the Financial Statements (continued)

52 Risk management (continued)

Basel III

In December 2010, the Basel Committee issued two documents: 'A global regulatory framework for more resilient banks and banking systems' and 'International framework for liquidity risk measurement, standards and monitoring', which together are commonly referred to as 'Basel III'. In June 2011, the Basel Committee issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.

The Basel III rules set out the minimum common equity tier 1 (CET1) requirement of 4.5% and 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 ('BCAR 2012') came into effect on 1 January 2013 to implement the first phase of 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.

53 Special purpose entities

The group enters into certain transactions with customers in the ordinary course of business which involve the use of special purpose entities ('SPEs') to facilitate or secure customer transactions. The group structures that use SPEs are authorised centrally prior to being established to ensure appropriate purpose and governance. The activities of SPEs administered by the group are closely monitored by senior management. The most significant categories of complex or non-transparent structures using SPEs are discussed in more detail 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 SPEs. The group enters into contracts with the SPEs, generally in the form of derivatives, in order to pass the required risks and rewards of the reference portfolios to the SPEs.

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 SPE by the group pursuant to one or more derivatives could be greater than the value of the collateral held by the SPE 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

The group also uses SPEs to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and/or for capital efficiency purposes. In such cases, the loans and advances are transferred by the group to the SPEs for cash, and the SPEs 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 SPEs. These SPEs are consolidated when the group is exposed to the majority of risks and rewards of ownership.

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 guarantee provided. Off balance sheet financial guarantees are disclosed in note 44 (b).

53 Special purpose entities *(continued)*

Third-party financing SPEs

The group also transacts with third party SPEs 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 SPE and, in most cases, the customer, a sponsor or third party provides some credit enhancement or guarantee in the structure. The group generally provides financing in the form of senior lending or debt instruments but may also enter into derivative contracts with these SPEs. These SPEs are consolidated when the group is exposed to the majority of risks and rewards of ownership.

The derivative and lending exposures are generally secured by the SPE'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 SPEs is managed within the group's market risk framework (see 'Market risk' in note 52c). Credit risk is managed within the group's credit risk framework (see 'Credit risk' in note 52a).

54 Legal proceedings

US regulatory and law enforcement investigations

In December 2012, HSBC Holdings plc, the Bank's ultimate parent company, entered into agreements to achieve a resolution with US and UK government agencies that have investigated HSBC's conduct related to inadequate compliance with anti-money laundering ('AML'), US Bank Secrecy Act ('BSA') and sanctions laws. This was as a result of investigations by the US Department of Justice ('DoJ'), the Federal Reserve, the Office of the Comptroller of the Currency and the US Department of Treasury's Financial Crimes Enforcement Network in connection with AML/BSA compliance in various parts of the HSBC Group. As part of the resolution, HSBC and HSBC Bank USA, N.A. entered into a deferred prosecution agreement (the 'US DPA') with the DoJ, the United States Attorney's Office for the Eastern District of New York, and the United States Attorney's Office for the Northern District of West Virginia, and a deferred prosecution agreement with the New York County District Attorney, and consented to a cease and desist order with the Federal Reserve.

HSBC also entered into an undertaking with the UK Financial Services Authority ('FSA') to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. Under these agreements, HSBC will continue to cooperate fully with US and UK regulatory and law enforcement authorities and take further action to strengthen their compliance policies and procedures. Over the five-year term of the agreements with the DoJ and FSA, an independent monitor will evaluate HSBC's progress in fully implementing these and other measures it recommends, and will produce regular assessments of the effectiveness of HSBC's compliance function. If HSBC fulfils all of the requirements imposed by the US DPA and other agreements, the DoJ's charges against it will be dismissed at the end of the five-year period.

The above agreements cover the activities of all entities in the HSBC Group, including the Bank and its subsidiaries. As at 31 December 2012, there has been no specific action taken against the Bank or any of its subsidiaries in relation to the above investigations, and no financial penalties have been incurred and none are anticipated.

Other matters

The group is named in and defending legal actions in a number of jurisdictions including Hong Kong, arising out of its normal business operations. None of the actions is regarded as material litigation, and none is expected to result in a significant adverse effect on the financial position of the group, either collectively or individually. Management believes that adequate provisions have been made in respect of such litigation.

Notes on the Financial Statements (continued)

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

On 5 December 2012, we announced an agreement to sell our shares in Ping An. This transaction completed on 6 February 2013. See note 28 for further details on the transaction.

On 7 January 2013, Industrial Bank Co., Ltd. ('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 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 approximately HK\$9.5bn. Thereafter, the holding is recognised as an available-for-sale financial investment.

58 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 4 March 2013.

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