

The Hongkong and Shanghai Banking
Corporation Limited
Annual Report and Accounts 2011



Annual Report and Accounts 2011

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Certain defined terms

This document comprises the *Annual Report and Accounts 2011* 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，如欲查閱可向下列地址索取：香港皇后大道中 1 號滙豐總行大廈 32 樓集團企業傳訊部（亞太區）。本年報之中英文本亦載於本行之網址 www.hsbc.com.hk。

Financial Highlights

	2011 HK\$m	2010 HK\$m
For the year		
Net operating income before loan impairment charges	147,170	131,566
Profit before tax	91,370	77,885
Profit attributable to shareholders	67,591	57,597
At the year-end		
Shareholders' equity	340,824	320,130
Total equity	371,343	347,435
Total capital base	246,206	236,720
Customer accounts	3,565,001	3,313,244
Total assets	5,607,480	5,039,918
Ratios		
	%	%
Return on average shareholders' equity	21.6	21.1
Post-tax return on average total assets	1.34	1.33
Cost efficiency ratio	46.1	45.8
Net interest margin	1.91	1.83
Capital adequacy ratios		
– core capital	12.4	11.7
– total capital	14.6	14.7

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 seven other countries around the world. Employing some 71,400 people, of whom 37,400 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2011 of HK\$5,607bn.

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 85 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America.

The Hongkong and Shanghai Banking Corporation Limited

Incorporated in the Hong Kong SAR with limited liability

Registered Office and Head Office: HSBC Main Building, 1 Queen's Road Central, Hong Kong

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Report of the Directors

Board of Directors

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 Sohmen-Pao
Dr Raymond Ch'ien Kuo Fung, GBS, CBE	T Brian Stevenson, SBS
Naina L Kidwai	Paul A Thurston
Margaret Leung Ko May Yee	Dr Patrick Wang Shui Chung
Victor Li Tzar Kuoi	Dr Rosanna Wong Yick-ming, DBE
Dr Lo Ka Shui, GBS	Marjorie Yang Mun Tak

Principal Activities

The Hongkong and Shanghai Banking Corporation Limited and its subsidiaries and associates provide a comprehensive range of domestic and international banking and related financial services, principally in the Asia-Pacific region.

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 27 to 192.

Share Capital

To fund strategic investments and a capital injection into HSBC Bank (China) Limited, a wholly-owned subsidiary, the Bank issued 1,366.56m ordinary shares at par value of HK\$2.5 each to the existing shareholder, HSBC Asia Holdings BV ("HAHBV"), on 24 August 2011. The Bank also issued 1,712m ordinary shares at par value to HAHBV on 21 December 2011 to fund the redemption of preference shares.

Reserves and dividends

Profits attributable to shareholders, before dividends, of HK\$67,591m have been transferred to reserves. During the year, a surplus of HK\$10,872m, 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 2011 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 above. All the Directors served throughout the year save for Paul A Thurston and James Riley, who were appointed on 20 April 2011 and 1 January 2012 respectively. David Wei Zhe resigned as a Director on 22 February 2011.

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 Plan, 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. Under the HSBC Holdings Savings-Related Share Option Plan, 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 in service for a period and, for Performance Share awards, the attainment of corporate performance conditions.

Report of the Directors (continued)

During the year, Stuart T Gulliver, Naina L Kidwai, Margaret Leung Ko May Yee, 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 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.

Executive Committee

An Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board. Peter Wong Tung Shun is Chairman of the Committee and the current members of the Committee are:

Louisa Cheang Wai Wan (*Regional Head of Retail Banking and Wealth Management, Asia-Pacific*), Raymond Cheng Siu Hong (*Chief Operating Officer, Asia-Pacific*), R H Cox (*Chief Risk Officer, Asia-Pacific*), S A Davis (*Chief Executive Officer, India*), Anita Fung Yuen Mei (*Chief Executive Officer, Hong Kong*), G D Harvey-Samuel (*Head of International*), A C Hungate (*Chief Executive Officer, Singapore*), M M Hussain (*Deputy Chairman, HSBC Bank Malaysia Berhad*), S C Legg (*Chief Financial Officer, Asia-Pacific*), R C Phillips (*Head of Global Banking and Markets, Asia-Pacific*), N P Quinn (*Regional Head of Commercial Banking, Asia-Pacific*), Cindy Tang Hsin (*Head of Communications, 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*).

The Board has also established an Asset and Liability Management Committee and a Risk Management Committee.

Audit and Risk Committee

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

Nomination Committee

A Nomination Committee was established in 2011 to lead the process for Board appointments. The Committee is responsible for the identification and nomination for the approval of the Board, candidates for appointment to the Board. The members of the Nomination Committee are Stuart T Gulliver (*Chairman of the Committee*), Laura Cha May Lung, Dr William Fung Kwok Lun and Peter Wong Tung Shun.

Remuneration Committee

The Board of the Bank's ultimate parent company, HSBC Holdings plc, has established a Remuneration Committee comprising independent non-executive directors. Details of remuneration policy and principles are contained within the *Annual Report and Accounts 2011* and *Capital and Risk Management Pillar 3 Disclosures as at 31 December 2011* of HSBC Holdings plc.

Donations

Donations made by the Bank and its subsidiaries during the year amounted to HK\$107m.

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

The Directors are of the view that the Accounts and Supplementary Notes for the year ended 31 December 2011, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance and that the Bank complies with the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'.

Auditor

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

On behalf of the Board
Stuart T Gulliver, *Chairman*
27 February 2012

Financial Review

Summary of Financial Performance

Results for 2011

Profit attributable to shareholders for 2011 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') increased by HK\$9,994m, or 17.4%, to HK\$67,591m in 2011. Profit before taxation increased by HK\$13,485m, or 17.3%, to HK\$91,370m.

Profit before tax

	2011 HK\$m	2010 HK\$m
Hong Kong	43,197	42,190
Rest of Asia-Pacific	48,173	35,695
Total	91,370	77,885

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

From 1 January 2011 the Asset Management Group, previously reported within GB&M, was combined with the global business previously reported as Personal Financial Services (PFS) to form Retail Banking and Wealth Management ('RBWM'). Global business comparative information has been restated accordingly.

Financial Review (continued)**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
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 policyholders' liabilities	(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
2010				
Net interest income	31,736	30,123	17	61,876
Net fee income	21,080	14,203	–	35,283
Net trading income	8,699	12,034	(17)	20,716
Net income from financial instruments designated at fair value ..	3,454	303	–	3,757
Gains less losses from financial investments	937	1,079	–	2,016
Dividend income	545	19	–	564
Net earned insurance premiums	33,713	3,480	–	37,193
Other operating income	12,714	2,282	(4,992)	10,004
Total operating income	112,878	63,523	(4,992)	171,409
Net insurance claims incurred and movement in policyholders' liabilities	(37,022)	(2,821)	–	(39,843)
Net operating income before loan impairment charges and other credit risk provisions	75,856	60,702	(4,992)	131,566
Loan impairment charges and other credit risk provisions	(883)	(3,736)	–	(4,619)
Net operating income	74,973	56,966	(4,992)	126,947
Operating expenses	(33,053)	(32,183)	4,992	(60,244)
Operating profit	41,920	24,783	–	66,703
Share of profit in associates and joint ventures	270	10,912	–	11,182
Profit before tax	42,190	35,695	–	77,885

Geographical Regions *(continued)*

Hong Kong

Hong Kong reported pre-tax profits of HK\$43,197m compared with HK\$42,190m in 2010, an increase of 2%. The increase in profitability was driven by higher revenues from increased customer lending which reflected growth in trade flows, coupled with strong demand for wealth management products. This was partly offset by a rise in staff and support costs, notably in GB&M and RBWM, reflecting wage inflation and higher business volumes in 2011. Following significant loan growth in 2010 and the first half of 2011, we experienced slower growth in our businesses during the second half of 2011.

We retained market leadership across our key products. In residential mortgages we retained the number one market position as we continued to provide competitive products for our customers. Our leading market share in life insurance reflected our strong customer focus and diverse product offerings. We maintained our number one position in cards reflecting the success of various marketing campaigns and our customer focus.

We maintained our number one market position in Hong Kong dollar bond issuance and acted as a joint lead manager on the government's first inflation-linked bond issue, the largest ever retail bond issue in Hong Kong. We also continued to enhance our equity capital markets capabilities, expanded our equity research team and were bookrunner in six of the ten largest initial public offerings ('IPOs') in Hong Kong this year. We continued to reinforce our position as a leading international renminbi bank and became the market leader in offshore renminbi bond issuance and won awards from both *Finance Asia* and *IFR Asia* for Best Offshore Renminbi Bond House. We arranged the first ever renminbi subordinated bank bond and participated in the largest ever offshore renminbi bond deal by a sovereign issuer, demonstrating the depth and diversity of our involvement in this market.

Net interest income was 11% higher than in 2010, driven by the income from strong lending growth during 2010 and the first half of 2011 which reflected increased trade flows and demand for credit. We saw more moderate loan growth in GB&M and RBWM in the second half of 2011, which was more than offset by a reduction in certain trade finance loans in CMB. The Hong Kong property market slowed in the second half of 2011 and we continued to lend conservatively, with average loan to value ratios of 49% on new residential mortgage draw-downs and an estimated 37% on the portfolio as a whole.

Spreads narrowed in RBWM due to a shift in the product mix to lower yielding HIBOR-linked mortgages and in CMB as growth was concentrated in lower margin trade financing and HIBOR-linked loans. HIBOR-linked spreads began to improve marginally in the second half of the year due to product repricing.

Average customer deposit balances rose despite a highly competitive environment, supported by the opening of new business centres, growth in the offshore renminbi market and our comprehensive suite of renminbi solutions across the Trade and Supply Chain and Payments and Cash Management businesses.

Net fee income increased by 8% as a result of higher sales of wealth management products, particularly unit trusts, reflecting increased product offerings, competitive pricing and ongoing marketing campaigns. This was achieved in the low interest rate environment in which clients sought products which could increase their returns. Card transactions grew, reflecting higher retail spending in 2011, supported by marketing campaigns. Underwriting fees rose due to our participation in many of the largest equity capital market transactions in 2011, supported by the continued enhancement of our equity market capabilities. Remittances and trade-related fees also increased reflecting higher cross-border trade volumes. This was partly offset by lower broking income, notably towards the end of the year due to increased competition.

Financial Review (continued)

Geographical Regions (continued)

Net trading income reduced by 12%. We recorded adverse fair value movements on derivatives relating to certain provident funds as long-term investment returns fell. We also incurred losses on equity options backing an endowment product in RBWM due to unfavourable movements in the underlying equity indices, which resulted in a corresponding decrease in 'Net insurance claims incurred and movement in liabilities to policyholders'. These losses were partly offset by higher trading income in GB&M due to a rise in net interest income from trading Asian government debt securities and corporate bonds. Net trading income was also impacted by lower revenues in credit trading as credit spreads widened in some markets. This was partly offset by higher revenues in foreign exchange following greater market volatility in the region along supported by the collaboration between CMB and GB&M. In addition, revenues in Equities increased in line with improved volumes in the business.

Net expense from financial instruments designated at fair value was HK\$4,230m compared with gains in 2010, due to investment losses on assets held by the insurance business as a result of negative movements in the equity market during the second half of 2011. To the extent that these investment losses were attributed to policyholders, there was a corresponding decrease in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Net earned insurance premiums increased by 18% as a result of successful sales initiatives for deferred annuities, unit-linked products and a universal life insurance product aimed at high net worth individuals. This reflected our strategic focus on wealth management, of which insurance is a key part. 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\$515m largely due to an increase in the present value of in force insurance business ('PVIF') and higher revaluation gains on investment properties. PVIF rose as a result of higher life insurance sales and the refinement to the PVIF calculation during the year, to bring greater comparability and consistency across our insurance operations, offset by the impact of revised assumptions reflecting the low interest rate environment.

Loan impairment charges and other credit risk provisions increased by HK\$55m from a low base due to a specific impairment charge against one customer and higher collective impairment charges in CMB resulting from lending growth. These were partly offset by releases in GB&M relating to specific impairment charges raised in 2010.

Operating expenses rose by HK\$3,053m due to higher staff costs across the business reflecting wage inflation in a competitive labour market and a rise in average staff numbers to support increased business activity. Performance costs increased in GB&M due to higher amortisation charges for previous years' performance shares and an acceleration in the expense recognition of current year deferred bonus awards.

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
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 policyholders' liabilities	(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
2010							
Net interest income/(expense)	20,332	8,595	7,101	–	(3,597)	(695)	31,736
Net fee income	12,408	4,922	3,639	–	111	–	21,080
Net trading income/(expense)	1,089	941	5,977	–	(1)	693	8,699
Net income/(expense) from financial instruments designated at fair value	3,113	(74)	470	–	(57)	2	3,454
Gains less losses from financial investments	(5)	–	454	–	488	–	937
Dividend income	1	10	79	–	455	–	545
Net earned insurance premiums ...	28,409	5,171	133	–	–	–	33,713
Other operating income	3,978	525	1,210	–	8,938	(1,937)	12,714
Total operating income	69,325	20,090	19,063	–	6,337	(1,937)	112,878
Net insurance claims incurred and movement in policyholders' liabilities	(32,576)	(4,346)	(100)	–	–	–	(37,022)
Net operating income before loan impairment charges and other credit risk provisions	36,749	15,744	18,963	–	6,337	(1,937)	75,856
Loan impairment (charges)/releases and other credit risk provisions	(585)	(219)	(80)	–	1	–	(883)
Net operating income	36,164	15,525	18,883	–	6,338	(1,937)	74,973
Operating expenses	(13,008)	(5,077)	(8,571)	–	(8,334)	1,937	(33,053)
Operating profit/(loss)	23,156	10,448	10,312	–	(1,996)	–	41,920
Share of profit in associates and joint ventures	43	56	26	–	145	–	270
Profit/(loss) before tax	23,199	10,504	10,338	–	(1,851)	–	42,190

Financial Review (continued)

Geographical Regions (continued)

Rest of Asia-Pacific

Rest of Asia-Pacific reported pre-tax profits of HK\$48,173m compared with HK\$35,695m in 2010, an increase of 35%. The growth in profitability in the region reflected strong lending and deposit growth during 2010 and 2011, coupled with widening deposit spreads due to higher interest rates in certain countries, notably India and mainland China. Loan impairment charges improved as a result of the non-recurrence of a number of individual impairments and the reduction of certain unsecured lending portfolios. Costs increased, though to a lesser extent than revenues, to support business expansion, notably in mainland China, and maintain our competitive position in our other strategic markets. The contribution from our associates in mainland China also grew, benefiting from continued loan growth and increased income from fee-based revenue streams.

Trade revenues grew in most of our sites and we were awarded the 'Best Trade Finance Bank in Asia Pacific' by *FinanceAsia* for the fourteenth consecutive year. We continued to invest in building our franchise in mainland China where we remained the leading foreign bank by network size. Trade-related lending grew strongly in Singapore as we continued to enhance our trade finance capabilities. In Malaysia we expanded our branch network through the launch of new Amanah branches and experienced strong commercial lending growth. In India, we were ranked the number one foreign bank by *Bloomberg* for domestic bonds in 2011 and issued the first and only offshore renminbi bond in the country.

As part of our strategic review process, in December 2011 we announced the sale of our private banking operations in Japan and, in January 2012, we announced the sale of the RBWM operations in Thailand. We expect to complete these transactions during 2012. In February 2012, we announced the discontinuation of Premier in Japan.

Net interest income increased by 34%. Average lending balances grew, most notably in CMB and GB&M, particularly in mainland China and Singapore, as we captured inbound and outbound trade flows and as demand for credit in the region increased. In RBWM mortgage lending balances rose, notably in Singapore and Australia, driven by competitive product offerings and strong property markets. This was partly offset by continued pressure on asset spreads, most notably in RBWM due to competitive pressures and growth in residential mortgage lending at lower spreads.

Customer deposit balances rose across most of the region, notably in Payments and Cash Management reflecting our investment in infrastructure as part of a targeted strategy to support growth in customer lending. Deposit spreads increased as interest rates rose in a number of countries, particularly in mainland China and India.

Net interest income from Balance Sheet Management was higher than in 2010 reflecting increased interest rates and the widening of onshore US dollar lending spreads in mainland China, and a higher return from short-term lending and growth in the balance sheet in Singapore.

Net fee income increased by 9% primarily from trade-related fees as we targeted asset growth and trade activity largely in mainland China, Bangladesh and Singapore, supported by marketing activities, customer acquisition and a rise in transactions from existing customers. Card fees rose, notably in Australia, from the increased issuance of our co-branded credit cards, higher retail spending, and more customers converting to a higher card status.

Net trading income of HK\$12,510m was broadly unchanged compared with 2010. Net interest income on trading activities was lower as we progressively reduced our positions in government debt securities following increased market volatility in bond markets and from growth in structured deposits where the related income is recorded under 'Net interest income'. This was offset by higher Foreign Exchange trading income due to increased customer transaction volumes resulting from the collaboration between GB&M and CMB and as more clients sought protection from volatility in the markets.

Geographical Regions *(continued)*

Net expense from financial instruments designated at fair value was HK\$293m compared with income of HK\$303m in 2010. This was due to investment losses on assets held by the insurance business, primarily in Singapore, as a result of negative equity market movements during the second half of 2011. To the extent that these investment losses were attributed to policyholders, there was a corresponding decrease in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Losses from financial investments were HK\$182m compared with gains of HK\$1,079m in 2010, due to an impairment loss on an equity investment in 2011 in GB&M, lower gains on the disposal of government debt securities across the region and the non-recurrence of a gain on disposal of an equity investment in a Singaporean property company in 2010.

Net earned insurance premiums increased by 70% to HK\$5,932m as a result of successful sales initiatives, most notably resulting in improved sales in Singapore of a universal life insurance product aimed at high net worth individuals. 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\$392m largely due to a rise in the PVIF asset in Singapore as a result of higher life insurance sales and a one-off gain recognised upon the refinement of the calculation of the PVIF asset. This was offset by lower recoveries against initial fair value on loan portfolios acquired from The Chinese Bank Co., Ltd in Taiwan.

Loan impairment charges and other credit risk provisions decreased by 43% to HK\$2,121m as a result of the non-recurrence of a number of individual loan impairment charges in GB&M on a small number of accounts, coupled with the ongoing reduction of unsecured lending portfolios in India. We remain cautious on the outlook for credit quality and sustained our focus on maintaining high levels of underwriting and asset quality.

Operating expenses increased by 13% due to wage inflation which reflected the competitive labour market, along with an increase in average staff numbers, notably in mainland China. Increased business volumes across the region led to higher support costs. Premises and equipment costs also rose in certain countries, reflecting increased rental expenses resulting from lease renewals and new branch openings.

Share of profit from associates and joint ventures increased by 34%. The contribution from Bank of Communications rose, driven by strong loan growth, wider deposit spreads following interest rate increases in mainland China and higher fee income, notably from investment banking and cards. Income from Industrial Bank also increased as a result of strong growth in customer lending, a rise in fee-based revenue and a fall in loan impairment charges.

Financial Review (continued)**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
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 policyholders' liabilities	(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
2010							
Net interest income	12,283	7,281	12,163	127	390	(2,121)	30,123
Net fee income/(expense)	6,159	3,432	4,567	144	(99)	–	14,203
Net trading income/(expense)	626	1,003	8,576	48	(340)	2,121	12,034
Net income/(expense) from financial instruments designated at fair value	319	14	(7)	–	(23)	–	303
Gains less losses from financial investments	1	21	395	–	662	–	1,079
Dividend income	2	–	1	–	16	–	19
Net earned insurance premiums ...	2,994	486	–	–	–	–	3,480
Other operating income	844	676	376	9	820	(443)	2,282
Total operating income	23,228	12,913	26,071	328	1,426	(443)	63,523
Net insurance claims incurred and movement in policyholders' liabilities	(2,514)	(307)	–	–	–	–	(2,821)
Net operating income before loan impairment charges and other credit risk provisions	20,714	12,606	26,071	328	1,426	(443)	60,702
Loan impairment (charges)/releases and other credit risk provisions	(2,315)	(209)	(1,209)	(5)	2	–	(3,736)
Net operating income	18,399	12,397	24,862	323	1,428	(443)	56,966
Operating expenses	(17,105)	(6,207)	(8,252)	(348)	(714)	443	(32,183)
Operating profit/(loss)	1,294	6,190	16,610	(25)	714	–	24,783
Share of profit in associates and joint ventures	1,471	5,833	3,077	–	531	–	10,912
Profit/(loss) before tax	2,765	12,023	19,687	(25)	1,245	–	35,695

Net interest income

Net interest income increased as a result of loan volume growth in all key locations and increasing interest rates in certain countries, notably mainland China, Australia, India, Thailand and Malaysia.

Average interest-earning assets increased by HK\$563,136m or 16.6% compared to the year ended 31 December 2010. Average customer lending increased 31.5% with notable growth in mortgages and term lending. Financial investments decreased as maturities and disposals were redeployed to fund customer lending.

	2011 HK\$m	2010 HK\$m
Average interest-earning assets	3,951,997	3,388,861

Net interest margin increased by eight basis points to 1.91% compared to 2010 as interest rate increases in some countries led to improved liability spreads, offset by asset spread compression. Net interest spread increased by six basis points to 1.81%, whilst the contribution from net free funds increased by two basis points to 10 basis points.

Net interest margin (%)

	2011 %	2010 %
Spread	1.81	1.75
Contribution from net free funds	0.10	0.08
Total	1.91	1.83

Net interest margin (%)

	2011 %	2010 %
Hong Kong:		
The Bank	1.35	1.38
Hang Seng Bank	1.97	1.91
Rest of Asia-Pacific	2.10	2.04

In **Hong Kong**, the bank recorded a small decrease in net interest margin of three basis points to 1.35%. Net interest spread also decreased by three basis points to 1.35% as the cost of funds increased more than asset yield. Average interest-earning assets increased by 14.1% compared to 2010. Net interest income recorded a small increase despite strong loan growth, due to lower asset spreads on customer loans and advances, in particular on mortgages and term lending, as growth was concentrated in lower yielding HIBOR based loans and secured lending.

At **Hang Seng Bank**, the net interest margin increased by six basis points to 1.97% and the net interest spread increased by three basis points to 1.89%. The net interest margin increased due to strong growth in average interest-earning assets in mainland China which earned a relatively higher yield. The benefit of net free funds increased by three basis points to eight basis points.

In the **Rest of Asia-Pacific**, the net interest margin was 2.10%, 10 basis points higher than 2010 with interest rate rises in a number of countries across the region since the second half of 2010. Notable growth in the loan book was recorded in Singapore, mainland China, Australia and Malaysia. The net interest margin increased in particular in mainland China through a shortage of liquidity in the local market as a result of monetary policy measures to control inflation.

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

Net fee income increased by HK\$3,012m, or 8.5% compared to 2010.

Fees from import/export and remittances increased by 14.9% and 15.5% respectively, on the back of growing trade activities, notably in Hong Kong, mainland China and Singapore.

Fee income from cards and account services was up by 12.5% and 16.1% respectively. Card fee income was driven by higher transaction fees in Hong Kong from increased retail spending and, in Australia through continued growth in co-branded credit cards. Account services fees benefited from growth in deposits and loans. Fees from unit trusts rose by 19.1%, with notable increases in Hong Kong driven by increased product offerings and ongoing marketing campaigns.

Securities and broking fees fell by 5.8%, largely in Hong Kong as competition increased, particularly towards year end.

	2011	2010
	HK\$m	HK\$m
Account services	2,686	2,314
Credit facilities	2,812	2,642
Import/export	4,793	4,171
Remittances	2,839	2,457
Securities/stockbroking	8,234	8,744
Cards	6,709	5,963
Insurance	712	626
Unit trusts	3,832	3,218
Funds under management	4,442	4,658
Underwriting	1,219	899
Other	6,888	5,965
Fee income	45,166	41,657
Fee expense	(6,871)	(6,374)
Net fee income	38,295	35,283

Net trading income

Net trading income decreased by HK\$517m, or 2.5%.

Dealing profits were broadly flat compared to 2010. Foreign exchange income was higher, benefiting from increased client activity and favourable positioning to capture market volatility. This was offset by lower income from equities and other trading due to adverse fair value movements on derivatives relating to certain provident funds as long term investment returns fell. There were losses on equity options backing an endowment product in RBWM due to unfavourable movements in the underlying equity indices which resulted in a corresponding decrease in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Net interest income on trading activities was lower by 17%, as we progressively reduced our positions in government debt securities following increased market volatility in bond markets, and growth in structured deposits where the related income is recorded under 'Net interest income'.

	2011	2010
	HK\$m	HK\$m
Dealing profits	15,590	15,484
Loss from hedging activities ..	(71)	(11)
Net interest income	3,958	4,767
Dividend income from trading securities	722	476
Net trading income	20,199	20,716

Gains less losses from financial investments

Gains on disposal of available-for-sale securities decreased by HK\$1,895m as lower gains were recognised on disposals of debt securities in Hong Kong, along with the non-recurrence of the gain on reclassification of Bao Viet Holdings to an associate following the purchase of additional shares in 2010.

	2011	2010
	HK\$m	HK\$m
Gains on disposal of available-for-sale securities	470	2,365
Impairment of available-for-sale equity investments	(342)	(349)
Gains less losses from financial investments	128	2,016

Other operating income

The movement in present value of in-force insurance business rose by HK\$1,418m or 34.5%, due to a refinement of the calculation of the PVIF asset, described more fully in note 52e, along with strong sales of life insurance products in Hong Kong, particularly during the first half of 2011.

Gains on investment properties increased in comparison to 2010 reflecting the favourable property market conditions in Hong Kong.

This was offset by the non-recurrence of the gain recognised following the sale of the private equity business in 2010.

'Other' largely comprises recoveries of IT and other operating costs from shared services activities incurred on behalf of fellow Group companies.

	2011	2010
	HK\$m	HK\$m
Rental income from investment properties	191	170
Movement in PVIF	5,524	4,106
Gains on investment properties	1,033	483
(Loss)/gain on disposal of property, plant and equipment, and assets held for sale	(3)	13
(Loss)/gain on disposal of subsidiaries, associates and business portfolios	(9)	603
Surplus arising on property revaluation	8	102
Other	4,645	4,527
Other operating income	11,389	10,004

Financial Review (continued)**Insurance income**

Net interest income increased by 16.2% as funds under management grew, reflecting net inflows from new and renewal insurance business.

Net expense from financial instruments designated at fair value was HK\$4,460m in 2011 compared to net income of HK\$3,371m in 2010, due to investment losses on assets held by the insurance business as a result of negative movements in the equity market, principally during the second half of 2011. To the extent that gains and losses on revaluation are attributed to policyholders, there is an offsetting movement reported under 'Net insurance claims incurred and movement in policyholders' liabilities'.

Gains less losses from financial investments included the accounting gain of HK\$386m in 2010 arising from the reclassification of Bao Viet Holdings to an associate following the purchase of additional shares.

Net insurance premiums rose by 22.8%, mainly as a result of successful sales initiatives for deferred annuities, unit-linked products and a universal life insurance product aimed at high net worth individuals. This reflected our strategic focus on wealth management, of which insurance is a key part. The growth in premiums resulted in a corresponding increase in 'Net insurance claims incurred and movement in liabilities to policy holders'.

The movement in present value of in-force business increased by 34.5%, driven by higher sales in 2011 compared with 2010 and a refinement of the calculation of the PVIF asset during the period. The revised PVIF approach explicitly rather than implicitly allows for non-economic risks and the cost of options and guarantees. This refinement led to an increase of HK\$1,133m. This was offset by a reduction as assumptions were revised to reflect the low interest rate environment.

Insurance income

	2011	2010
	HK\$m	HK\$m
Net interest income	6,779	5,832
Net fee income	692	1,070
Net trading loss	(386)	(5)
Net income from financial instruments designated at fair value	(4,460)	3,371
Gains less losses from financial investments	(1)	386
Dividend income	1	–
Net earned insurance premiums	45,670	37,193
Movement in PVIF	5,524	4,106
Other operating income	237	70
	54,056	52,023
Net insurance claims incurred and movement in policyholders' liabilities	(40,389)	(39,843)
Net operating income	13,667	12,180

Loan impairment charges and other credit risk provisions

The net charge for loan impairment and other credit risk provisions decreased by HK\$1,560m or 33.8% compared to 2010.

The net charge for individually assessed allowances decreased by HK\$1,520m as a number of large specific impairment charges recorded in 2010 did not recur, principally for customers in Singapore, India, Australia and Hong Kong.

The net charge for collectively assessed impairment allowances fell by HK\$73m, mainly driven by a managed reduction of unsecured portfolios and falling delinquent balances in India and Indonesia. This decrease was partly offset by a higher charge due to loan growth in both CMB and RBWM.

Net charge for loan impairment by region

	2011	2010
	HK\$m	HK\$m
Hong Kong	922	919
Rest of Asia-Pacific	2,173	3,769
Total	3,095	4,688

Net charge for loan impairment and other credit risk provisions

	2011	2010
	HK\$m	HK\$m
Net charge for impairment of customer loans and advances		
– Individually assessed impairment allowances:		
New allowances	2,254	3,605
Releases	(1,204)	(1,069)
Recoveries	(356)	(322)
	694	2,214
– Net charge for collectively assessed impairment allowances	2,401	2,474
	3,095	4,688
Net charge for other credit risk provisions	(36)	(69)
Net charge for loan impairment and other credit risk provisions	3,059	4,619

Financial Review (continued)**Operating Expenses**

Total employee compensation and benefits increased HK\$5,068m, or 15.5%, due to wage inflation reflecting the competitive labour market, along with an increase in average headcount notably in Hong Kong, mainland China, Singapore, Vietnam and Taiwan. The increased headcount reflected increasing business volumes and operational demands across the region.

Wages and salaries also increased due to an acceleration in the expense recognition of deferred bonus awards and included HK\$326m of restructuring costs in Hong Kong related to the organisational efficiency programme in the second half of 2011. The reduction in year end staff numbers in Rest of Asia-Pacific was largely in India, in line with the reduction in our unsecured lending portfolios.

Staff numbers by region (full time equivalent)

	At 31 December	
	2011	2010
Hong Kong:		
The bank and wholly owned subsidiaries	19,770	19,932
Hang Seng Bank		
Hong Kong	8,003	7,960
Total Hong Kong	27,773	27,892
Rest of Asia-Pacific:		
Australia	1,839	1,843
Mainland China	8,235	7,705
Malaysia	4,839	4,948
India	6,560	8,040
Indonesia	5,609	5,304
Singapore	3,064	3,045
Taiwan	3,230	3,511
Sri Lanka	1,777	1,735
Others	8,494	8,544
Total Rest of Asia-Pacific	43,647	44,675
Total	71,420	72,567

General and administrative expenses rose by HK\$1,963m, or 8.8%, compared to 2010.

Charges in respect of premises and equipment were HK\$667m, or 10.6%, higher than 2010, predominantly in Hong Kong. The increase reflects both higher IT maintenance costs and higher property costs. Property costs were higher resulting mainly from business expansion throughout the region, notably in mainland China. Included in other premises and equipment costs in 2011 is HK\$171m of restructuring expenses incurred in Japan.

Other administrative expenses increased by HK\$1,218m, or 10.0%, with costs rising from higher transaction volumes and systems development.

	2011	2010
	%	%
Cost efficiency ratio	46.1	45.8

Operating expenses

	2011	2010
	HK\$m	HK\$m
Employee compensation and benefits	37,834	32,766
General and administrative expenses	24,352	22,389
Depreciation of property plant and equipment	3,878	3,425
Amortisation of intangible assets	1,760	1,664
Total	67,824	60,244
Of which: restructuring costs..	864	357

Share of profit in associates and joint ventures

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

	2011	2010
	HK\$m	HK\$m
Share of profit in associates and joint ventures	15,083	11,182

Tax expense

The effective tax rate for 2011 was 19.1% compared with 18.8% in 2010.

	2011	2010
	%	%
Effective tax rate	19.1	18.8

Assets

Total assets increased by HK\$568bn, or 11.3%, since 31 December 2010.

Loans and advances to customers increased by HK\$238bn, or 12.5%, since the end of 2010.

Loans and advances to customers in Hong Kong increased by HK\$125bn, or 11.8%, during 2011 largely attributable to growth in corporate and commercial lending (up HK\$83bn). Consistent with our focus on international trade the growth was strongest in trade related finance. Growth was also noted in commercial real estate and other property-related sectors, supported by a buoyant property market particularly in the first half of the year. Personal lending increased by HK\$41bn, driven by mortgage lending which increased by HK\$34bn as the property market remained active.

In the Rest of Asia-Pacific, loans and advances to customers increased by HK\$113bn, or 13.4%, net of foreign exchange translation effects of HK\$11bn. The underlying increase of HK\$124bn was mainly from corporate and commercial lending (up HK\$87bn), resulting from business growth in mainland China, Singapore, Taiwan, Malaysia, Indonesia and Australia. Residential mortgages increased by HK\$29bn, most notably in Singapore, Australia, mainland China and Malaysia.

Assets 2011¹

	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	5,444,956	100.0

Assets 2010¹

	HK\$m	%
Cash and short term funds	807,985	16.5
Placings with banks maturing after one month and certificates of deposit	222,804	4.5
Trading assets	390,208	8.0
Loans and advances to customers	1,891,060	38.7
Financial investments	826,662	16.9
Other	753,065	15.4
Total	4,891,784	100.0

¹ Excluding Hong Kong Government certificates of indebtedness.

Financial Review (continued)**Customer accounts**

Customer accounts increased by HK\$252bn, or 7.6%, during 2011.

Customer accounts by region

	2011	2010
	HK\$m	HK\$m
Hong Kong excluding Hang Seng Bank	1,640,369	1,518,947
Hang Seng Bank Hong Kong	656,843	643,849
Rest of Asia-Pacific	1,267,789	1,150,448
Total	3,565,001	3,313,244

In Hong Kong, customer accounts increased by HK\$134bn or 6.2% and in the Rest of Asia-Pacific customer accounts increased by HK\$117bn or 10.2% compared to 31 December 2010.

The group's advances-to-deposits ratio increased to 59.8% at 31 December 2011, from 57.1% at 31 December 2010 as more of the commercial surplus was deployed to customer lending.

	2011	2010
	%	%
Advances to deposits ratio	59.8	57.1

Customer accounts by type

	2011	2010
	HK\$m	HK\$m
Current accounts	696,435	643,850
Savings accounts	1,826,893	1,765,835
Other deposit accounts	1,041,673	903,559
Total	3,565,001	3,313,244

Equity

Equity increased by HK\$24bn, or 6.9%, to HK\$371bn. The increase came from retained profits, an increase in property revaluation reserves and the issue of shares. This was offset by decreases in the value of available-for-sale securities, largely from the group's investment in Ping An Insurance, as well as actuarial losses on defined benefit plans.

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 191.

There are no relevant capital shortfalls in any of the group's subsidiaries as at 31 December 2011 which are not included in its consolidation group for regulatory purposes.

Capital structure at 31 December

	2011 HK\$m	2010 HK\$m
Core capital:		
Share capital per balance sheet	30,190	22,494
Revaluation reserve capitalisation issue	(1,454)	(1,454)
Paid-up ordinary share capital	28,736	21,040
Paid-up irredeemable non-cumulative preference shares	51,681	51,714
Reserves per balance sheet	310,634	297,636
Proposed dividend	(10,000)	(12,000)
Unconsolidated subsidiaries	(32,672)	(26,320)
Cash flow hedging reserve	(51)	(106)
Regulatory reserve	(17,108)	(7,702)
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities	(73,570)	(92,065)
Unrealised gains on equities and debt securities designated at fair value	(77)	(191)
Own credit spread	(429)	(231)
Total reserves included in core capital	176,727	159,021
Non-controlling interests per balance sheet	30,519	27,305
Non-controlling interests in unconsolidated subsidiaries	(2,838)	(2,574)
Regulatory adjustments to non-controlling interests	(2,976)	(2,002)
Non-controlling interests	24,705	22,729
Goodwill and intangible assets	(19,663)	(19,977)
50% of unconsolidated investments	(53,749)	(44,946)
50% of securitisation positions and other deductions	(140)	(192)
Deductions	(73,552)	(65,115)
Total core capital	208,297	189,389
Supplementary capital:		
Paid-up irredeemable cumulative preference shares	16,546	16,557
Perpetual subordinated debt	9,386	9,404
Paid-up term preference shares	28,742	33,035
Term subordinated debt	16,327	17,957
Property revaluation reserves ¹	7,977	7,977
Unrealised gains on available-for-sale equities and debt securities ²	2,318	3,194
Unrealised gains on equities and debt securities designated at fair value	35	86
Regulatory reserve ³	2,267	1,100
Collective impairment allowances ³	545	625
Excess impairment allowances over expected losses ⁴	7,655	2,534
Supplementary capital before deductions	91,798	92,469
50% of unconsolidated investments	(53,749)	(44,946)
50% of securitisation positions and other deductions	(140)	(192)
Deductions	(53,889)	(45,138)
Total supplementary capital	37,909	47,331
Capital base	246,206	236,720

Financial Review (continued)**Capital Adequacy** (continued)*Risk weighted assets at 31 December*

	2011 HK\$m	2010 HK\$m
Risk weighted assets		
Credit risk	1,350,467	1,303,535
Counterparty risk	71,270	56,451
Market risk	38,585	35,251
Operational risk	221,429	216,866
Total	1,681,751	1,612,103

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

	2011	2010
Core capital ratio	12.4%	11.7%
Capital adequacy ratio	14.6%	14.7%

Reserves and deductible items

	2011 HK\$m	2010 HK\$m
Published reserves	146,357	138,680
Profit and loss account	30,370	20,341
Total reserves included in core capital	176,727	159,021

	2011 HK\$m	2010 HK\$m
Total of items deductible 50% from core capital and 50% from supplementary capital	107,778	90,276

- 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 158 to 191.

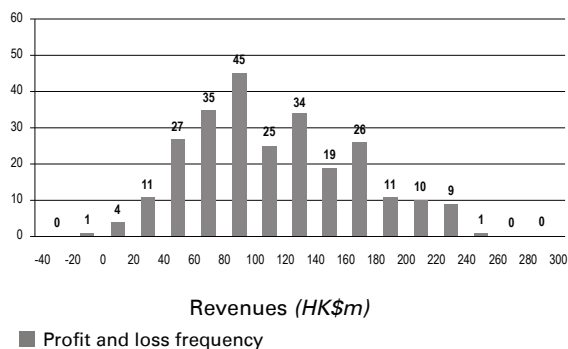
Market Risk Management

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 174 to 178.

The average daily revenue earned from market risk-related treasury activities in 2011, including accrual book net interest income and funding related to dealing positions, was HK\$113m compared with HK\$100m in 2010. The standard deviation of these daily revenues was HK\$53m (HK\$49m for 2010).

Daily distribution of market risk revenues 2011

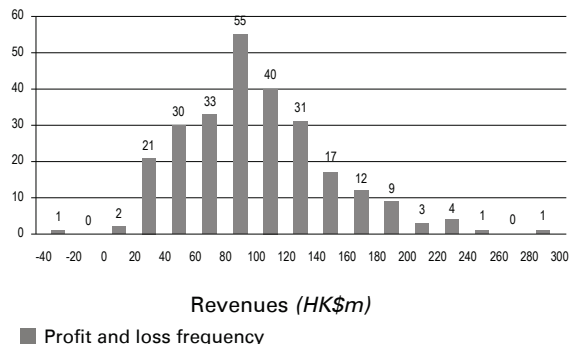
Number of days



An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 1 day in 2011. The most frequent result was a daily revenue of between HK\$80m and HK\$100m with 45 occurrences. The highest daily revenue was HK\$241m. The most frequent result in 2010 was a daily revenue of between HK\$80m and HK\$120m with 95 occurrences. The highest daily revenue in 2010 was HK\$299m.

Daily distribution of market risk revenues 2010

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 and Risk 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 25, 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 ('HKCO') 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 causing adequate accounting records to be 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

S T Gulliver
Chairman

27 February 2012

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 set out on pages 27 to 192, which comprise the consolidated and the Bank's balance sheets as at 31 December 2011, 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 2011 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

27 February 2012

Financial Statements

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Consolidated income statement for the year ended 31 December 2011

	Note	2011 HK\$m	2010 HK\$m
Interest income	4(a)	107,458	85,523
Interest expense	4(b)	(31,786)	(23,647)
Net interest income		75,672	61,876
Fee income		45,166	41,657
Fee expense		(6,871)	(6,374)
Net fee income	4(c)	38,295	35,283
Net trading income	4(d)	20,199	20,716
Net (expense) / income from financial instruments designated at fair value	4(e)	(4,523)	3,757
Gains less losses from financial investments	4(f)	128	2,016
Dividend income	4(g)	729	564
Net earned insurance premiums	5(b)	45,670	37,193
Other operating income	4(h)	11,389	10,004
Total operating income		187,559	171,409
Net insurance claims incurred and movement in policyholders' liabilities	5(c)	(40,389)	(39,843)
Net operating income before loan impairment charges and other credit risk provisions		147,170	131,566
Loan impairment charges and other credit risk provisions	4(i)	(3,059)	(4,619)
Net operating income		144,111	126,947
Employee compensation and benefits	6(a)	(37,834)	(32,766)
General and administrative expenses	4(j)	(24,352)	(22,389)
Depreciation of property, plant and equipment	26	(3,878)	(3,425)
Amortisation and impairment of intangible assets	25(c)	(1,760)	(1,664)
Total operating expenses		(67,824)	(60,244)
Operating profit		76,287	66,703
Share of profit in associates and joint ventures		15,083	11,182
Profit before tax		91,370	77,885
Tax expense	7	(17,466)	(14,608)
Profit for the year		73,904	63,277
Profit attributable to shareholders		67,591	57,597
Profit attributable to non-controlling interests		6,313	5,680

Financial Statements (continued)**Consolidated statement of comprehensive income for the year ended 31 December 2011**

	2011	2010
	HK\$m	HK\$m
Profit for the year	73,904	63,277
Other comprehensive income		
Available-for-sale investments:		
– fair value changes taken to equity	(25,410)	18,252
– fair value changes transferred to the income statement on disposal	(231)	(2,076)
– amounts derecognised on deconsolidation	–	(1,849)
– amounts transferred to the income statement on impairment	(208)	(24)
– fair value changes transferred to the income statement on hedged items due to hedged risk	(1,124)	(500)
– income taxes	119	330
Cash flow hedges:		
– fair value changes taken to equity	303	654
– fair value changes transferred to the income statement	(399)	(1,591)
– income taxes	15	155
Property revaluation:		
– fair value changes taken to equity	12,940	9,936
– income taxes	(2,068)	(1,766)
Share of other comprehensive income of associates and joint ventures	(1,259)	(66)
Exchange differences	(1,235)	8,881
Actuarial losses on post-employment benefits:		
– before income taxes	(3,518)	(807)
– income taxes	575	149
Other comprehensive (expense) / income for the year, net of tax	(21,500)	29,678
Total comprehensive income for the year, net of tax	52,404	92,955
Total comprehensive income for the year attributable to:		
– shareholders	45,428	86,473
– non-controlling interests	6,976	6,482
	52,404	92,955

Consolidated balance sheet at 31 December 2011

	Note	2011 HK\$m	2010 HK\$m
ASSETS			
Cash and short-term funds	11	919,906	807,985
Items in the course of collection from other banks		34,546	16,878
Placings with banks maturing after one month	12	198,287	149,557
Certificates of deposit	13	88,691	73,247
Hong Kong Government certificates of indebtedness	14	162,524	148,134
Trading assets	15	447,968	390,208
Financial assets designated at fair value	16	57,670	54,604
Derivatives	17	377,296	302,622
Loans and advances to customers	18	2,130,871	1,891,060
Financial investments	21	722,433	826,662
Amounts due from Group companies		152,730	137,633
Interests in associates and joint ventures	24	91,785	75,568
Goodwill and intangible assets	25	34,839	29,690
Property, plant and equipment	26	85,294	72,347
Deferred tax assets	7	2,325	2,515
Retirement benefit assets	6	111	301
Other assets	28	100,204	60,907
Total assets		5,607,480	5,039,918
LIABILITIES			
Hong Kong currency notes in circulation	14	162,524	148,134
Items in the course of transmission to other banks		47,163	26,495
Deposits by banks		222,582	167,827
Customer accounts	29	3,565,001	3,313,244
Trading liabilities	30	171,431	151,534
Financial liabilities designated at fair value	31	40,392	40,327
Derivatives	17	383,252	309,838
Debt securities in issue	32	77,472	59,283
Retirement benefit liabilities	6	8,097	4,713
Amounts due to Group companies		108,423	83,128
Other liabilities and provisions	33	108,314	70,946
Liabilities under insurance contracts issued	34	209,438	177,970
Current tax liabilities	7	4,126	4,419
Deferred tax liabilities	7	14,712	11,913
Subordinated liabilities	36	16,114	21,254
Preference shares	37	97,096	101,458
Total liabilities		5,236,137	4,692,483
EQUITY			
Share capital	38	30,190	22,494
Other reserves		112,218	124,382
Retained profits		188,416	161,254
Proposed fourth interim dividend	9	10,000	12,000
Total shareholders' equity		340,824	320,130
Non-controlling interests		30,519	27,305
Total equity		371,343	347,435
Total equity and liabilities		5,607,480	5,039,918

Directors

Stuart T Gulliver
Paul A Thurston
Peter T S Wong

Secretary

Paul A Stafford

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2011

	2011									
	Share capital HK\$m	Retained profits and proposed dividend HK\$m	Other reserves					Total share- holders' 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			
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)	—	—	(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 changes in equity for the year ended 31 December 2010

2010

	Other reserves									
	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	Total shareholders' equity HK\$m	Non-controlling interests HK\$m	Total equity HK\$m
At 1 January	22,494	148,105	22,983	43,385	848	6,998	15,389	260,202	26,425	286,627
Profit for the year	—	57,597	—	—	—	—	—	57,597	5,680	63,277
Other comprehensive income (net of tax)	—	(766)	7,605	14,168	(742)	8,791	(180)	28,876	802	29,678
Available-for-sale investments	—	—	—	14,095	—	—	—	14,095	38	14,133
Cash flow hedges	—	—	—	(743)	(743)	—	—	(743)	(39)	(782)
Property revaluation	—	(100)	7,604	—	—	—	—	7,504	666	8,170
Actuarial losses on defined benefit plans	—	(660)	—	—	—	—	—	(660)	2	(658)
Share of other comprehensive income of associates and joint ventures	—	(2)	1	113	—	—	(178)	(66)	—	(66)
Exchange differences	—	(4)	—	(40)	1	8,791	(2)	8,746	135	8,881
Total comprehensive income for the year	—	56,831	7,605	14,168	(742)	8,791	(180)	86,473	6,482	92,955
Dividends paid	—	(26,850)	—	—	—	—	—	(26,850)	(3,899)	(30,749)
Movement in respect of share-based payment arrangements	—	159	—	—	—	—	219	378	36	414
Changes in ownership interest in subsidiaries	—	(88)	—	—	—	—	—	(88)	—	(88)
Changes in non-controlling interests on deconsolidation	—	—	—	—	—	—	—	—	(1,708)	(1,708)
Other movements	—	10	1	4	—	—	—	15	(31)	(16)
Transfers	—	(4,913)	(609)	(4)	—	—	5,526	—	—	—
At 31 December	22,494	173,254	29,980	57,553	106	15,789	20,954	320,130	27,305	347,435

Financial Statements (continued)**Consolidated statement of cash flows for the year ended 31 December 2011**

	<i>Note</i>	2011 HK\$m	2010 HK\$m
Operating activities			
Cash generated from/(used in) operations	42	16,583	(107,924)
Interest received on financial investments		13,269	12,711
Dividends received on financial investments		723	560
Dividends received from associates		935	2,768
Taxation paid		(15,790)	(13,269)
Net cash inflow/(outflow) from operating activities		15,720	(105,154)
Investing activities			
Purchase of financial investments		(495,823)	(475,669)
Proceeds from sale or redemption of financial investments		588,409	548,115
Purchase of property, plant and equipment		(2,870)	(6,165)
Proceeds from sale of property, plant and equipment and assets held for sale		215	63
Purchase of other intangible assets		(1,804)	(1,373)
Net cash outflow in respect of the acquisition of and increased shareholding in subsidiaries	43	(143)	(127)
Net cash inflow/(outflow) in respect of the sale of subsidiaries	43	1	(13)
Net cash outflow in respect of the purchase of interests in associates and joint ventures		(263)	(10,676)
Net cash inflow from the sale of interests in business portfolios	43	5,649	–
Proceeds from the sale of interests in associates		19	136
Net cash inflow from investing activities		93,390	54,291
Net cash inflow/(outflow) before financing		109,110	(50,863)
Financing			
Issue of ordinary share capital		7,696	–
Redemption of preference shares		(4,280)	–
Change in non-controlling interests		–	(24)
Repayment of subordinated liabilities		(5,152)	(2,055)
Issue of subordinated liabilities		3,502	1,533
Ordinary dividends paid	9	(33,000)	(26,850)
Dividends paid to non-controlling interests		(3,764)	(3,899)
Interest paid on preference shares		(2,421)	(3,118)
Interest paid on subordinated liabilities		(793)	(582)
Net cash outflow from financing		(38,212)	(34,995)
Increase/(decrease) in cash and cash equivalents	43	70,898	(85,858)

Bank balance sheet at 31 December 2011

	<i>Note</i>	2011 HK\$m	2010 HK\$m
ASSETS			
Cash and short-term funds	11	612,265	551,003
Items in the course of collection from other banks		29,821	12,143
Placings with banks maturing after one month	12	108,873	74,791
Certificates of deposit	13	23,987	27,888
Hong Kong Government certificates of indebtedness	14	162,524	148,134
Trading assets	15	317,321	297,929
Financial assets designated at fair value	16	2,283	2,086
Derivatives	17	370,678	295,479
Advances to customers	18	1,176,602	1,016,312
Financial investments	21	362,307	503,752
Amounts due from group companies		248,001	198,322
Investments in subsidiaries	23	57,724	52,924
Interests in associates and joint ventures	24	28,139	28,139
Goodwill and intangible assets	25	4,831	4,713
Property, plant and equipment	26	51,876	45,061
Deferred tax assets	7	1,098	1,104
Retirement benefit assets	6	73	179
Other assets	28	56,938	31,873
Total assets		3,615,341	3,291,832
LIABILITIES			
Hong Kong currency notes in circulation	14	162,524	148,134
Items in the course of transmission to other banks		38,577	17,951
Deposits by banks		158,746	130,476
Customer accounts	29	2,220,072	2,044,664
Trading liabilities	30	78,959	91,184
Financial liabilities designated at fair value	31	5,910	6,581
Derivatives	17	377,165	303,882
Debt securities in issue	32	46,360	43,139
Retirement benefit liabilities	6	4,150	2,465
Amounts due to group companies		152,906	145,894
Other liabilities and provisions	33	71,585	44,032
Current tax liabilities	7	2,748	2,686
Deferred tax liabilities	7	5,884	5,525
Subordinated liabilities	36	9,386	9,404
Preference shares	37	96,969	101,306
Total liabilities		3,431,941	3,097,323
EQUITY			
Share capital	38	30,190	22,494
Other reserves		49,278	71,929
Retained profits		93,932	88,086
Proposed fourth interim dividend	9	10,000	12,000
Total equity		183,400	194,509
Total equity and liabilities		3,615,341	3,291,832

Directors

Stuart T Gulliver
Paul A Thurston
Peter T S Wong

Secretary

Paul A Stafford

Financial Statements (continued)

Bank statement of changes in equity for the year ended 31 December 2011

	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 2011	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	—	(33,000)	—	—	—	—	—	(33,000)
Movement in respect of share-based payment	—	52	—	—	—	—	551	603
Other movements	—	(4)	—	—	—	—	(60)	(64)
Transfers	—	519	(519)	—	—	—	—	—
At 31 December 2011	30,190	103,932	24,296	26,013	63	(3,152)	2,058	183,400

Bank statement of changes in equity for the year ended 31 December 2010

	2010						
	Other reserves						
	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	Total equity HK\$m
At 1 January 2010	22,494	88,837	13,595	39,050	763	(1,313)	164,911
Profit for the year	—	38,227	—	—	—	—	38,227
Other comprehensive income (net of tax)	—	(671)	5,191	11,499	(693)	2,617	17,943
Available-for-sale investments	—	—	—	11,539	—	—	11,539
Cash flow hedges	—	—	—	—	(694)	—	(694)
Property revaluation	—	(53)	5,191	—	—	—	5,138
Actuarial losses on defined benefit plans	—	(624)	—	—	—	—	(624)
Exchange differences	—	6	—	(40)	1	2,617	2,584
Total comprehensive income	—	37,556	5,191	11,499	(693)	2,617	56,170
Dividends	—	(26,850)	—	—	—	—	(26,850)
Movement in respect of share-based payment	—	112	—	—	—	—	194
Other movements	—	82	—	2	—	—	84
Transfers	—	349	(349)	—	—	—	—
At 31 December 2010	22,494	100,086	18,437	50,551	70	1,304	194,509

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 2011.

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 and premises.

During 2011 the group adopted a number of interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of the Bank.

- b** 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 2011.

c Future Accounting Developments

At 31 December 2011, 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 2011.

Standards applicable in 2012

In December 2010, the HKICPA issued an amendment to HKAS 'Income Taxes', whereby deferred taxes on investment property, carried under the fair value model in HKAS 40, will be measured on the presumption that an investment property is recovered entirely through sale. The presumption is rebutted if the investment property is held within a business whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The amendment will be effective for annual periods beginning on or after 1 January 2012. The group does not expect adoption of the amendment to HKAS 12 to have a significant effect on the group's consolidated financial statements.

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'). The standards are effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. 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 initial assessment, we do not expect HKFRS 11 to have a material effect on the group's financial statements. The group is currently assessing the impact of HKFRS 10 and it is not practical to quantify the effect as at the date of publication of these financial statements.

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.

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.

The group is currently assessing HKFRS 13 and it is not practical to quantify the effect as at the date of publication of these financial statements.

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 must 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 2011 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 expected to be material. The effect at the date of adoption will depend on market interest rates, rates of return and the actual mix of scheme assets at that time.

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.

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 additions to HKFRS 9 relating to financial liabilities. Together, these changes represent the first phase in the planned replacement of HKAS 39 'Financial Instruments: Recognition and Measurement' ('HKAS 39') with a new standard for financial instruments.

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 with early adoption permitted. HKFRS 9 is required to be applied retrospectively but prior periods need not be restated.

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. The HKAS 39 replacement project has not yet been completed. The group remains unable to provide a date by which it plans to apply HKFRS 9 and it remains impracticable to quantify the impact of HKFRS 9 as at the date of publication of these consolidated financial statements.

Notes on the Financial Statements (continued)

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 first, whether there are indications that an impairment loss may have already been incurred, and then estimating the amount and timing of expected cash flows, which form the basis of the impairment loss that is recorded.

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

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.

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.

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

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

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

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 available-for-sale financial investments

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

Liabilities under investment contracts

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

Insurance contracts

Classification

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

Present value of in-force long-term 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.

Notes on the Financial Statements (continued)

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.

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 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 impairment losses. 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.

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.

d *Loan impairment*

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 and are for larger amounts, which 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.

Notes on the Financial Statements (continued)

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;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

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.

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.

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 utilises 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. 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.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

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.

Incurring 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 loss. 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.

Notes on the Financial Statements (continued)

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.

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 provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included within 'Other operating income' in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised as a gain in 'Other operating income' in the income statement, 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. These renegotiated loans 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.

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). Such financial assets or financial liabilities are recognised initially at fair value, with transaction costs taken to the income statement, and are subsequently remeasured at fair value. All subsequent gains and losses from changes in the fair value of these assets and liabilities, together with related interest income and expense and dividends, are recognised in the income statement within 'Net trading income' as they arise.

f *Financial instruments designated at fair value*

A financial instrument, other than one held for trading, is classified in this category if it meets the criteria set out below, and is so designated by management. 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 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). Financial assets and financial liabilities so designated are recognised initially at fair value., with transaction costs taken directly to the income statement, and are subsequently re-measured at fair value. Subsequently, the fair values are re-measured, and gains and losses from changes in the fair value 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.

Notes on the Financial Statements (continued)

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, 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.

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 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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

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'.

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'.

3 Summary of significant accounting policies (continued)

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

If the hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

Cash flow hedge

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

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

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

Net investment hedge

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

Hedge effectiveness testing

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

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

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

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

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.

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.

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.

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 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.

- (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).

Notes on the Financial Statements (continued)

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

(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.

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 '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. 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 utilised.

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

Notes on the Financial Statements (continued)

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.

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 and presentation 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 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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies (continued)

w Insurance contracts

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

Insurance contracts are accounted for as follows:

Premiums

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 on a payable basis.

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 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 discretionary participating features, 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.

3 Summary of significant accounting policies *(continued)*

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.

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.

Notes on the Financial Statements (continued)**4 Operating profit**

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

a Interest income

	2011 HK\$m	2010 HK\$m
Interest income on listed securities	8,004	8,012
Interest income on unlisted securities	17,989	15,878
Other interest income	89,699	69,053
	115,692	92,943
Less: interest income classified as 'Net trading income' (note 4(d))	(8,183)	(7,366)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 4(e))	(51)	(54)
	107,458	85,523

Included in the above is interest income accrued on impaired financial assets of HK\$308m (2010: HK\$465m), including unwinding of discounts on loan impairment losses of HK\$294m (2010: HK\$324m).

b Interest expense

	2011 HK\$m	2010 HK\$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	831	704
Interest expense on preference shares	2,337	2,659
Other interest expense	32,867	22,908
	36,035	26,271
Less: interest expense classified as 'Net trading income' (note 4(d))	(4,225)	(2,599)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	(24)	(25)
	31,786	23,647

c Net fee income

	2011 HK\$m	2010 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	15,081	13,172
– fee expense	(1,415)	(1,404)
	13,666	11,768
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	8,862	8,717
– fee expense	(1,213)	(1,005)
	7,649	7,712

4 Operating profit (continued)

d Net trading income

	2011 HK\$m	2010 HK\$m
Dealing profits	15,590	15,484
– Foreign exchange	15,313	13,036
– Interest rate derivatives	400	978
– Debt securities	1,300	672
– Equities and other trading	(1,423)	798
Loss from hedging activities	(71)	(11)
Fair value hedges		
– Net gain on hedged items attributable to the hedged risk	1,050	563
– Net loss on hedging instruments	(1,147)	(579)
– Other	26	–
Cash flow hedges		
– Net hedging gain	–	5
Interest on trading assets and liabilities	3,958	4,767
– Interest income (note 4(a))	8,183	7,366
– Interest expense (note 4(b))	(4,225)	(2,599)
Dividend income from trading securities	722	476
– Listed investments	608	391
– Unlisted investments	114	85
	20,199	20,716

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

	2011 HK\$m	2010 HK\$m
(Expense)/income on assets designated at fair value which back insurance and investment contracts	(4,542)	4,509
Change in fair value of liabilities to customers under investment contracts	30	(1,217)
	(4,512)	3,292
Net change in fair value of other financial assets/liabilities designated at fair value ¹	(38)	436
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	51	54
– Interest expense (note 4(b))	(24)	(25)
	(4,523)	3,757

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 2011 the group recognised a HK\$15m gain on changes in the fair value of these instruments arising from changes in own credit risk (2010: HK\$51m loss).

f Gains less losses from financial investments

	2011 HK\$m	2010 HK\$m
Gains on disposal of available-for-sale securities	470	2,365
Impairment of available-for-sale equity investments	(342)	(349)
	128	2,016

There are no gains or losses on the disposal of held-to-maturity investments in the year (2010: nil).

Notes on the Financial Statements (continued)**4 Operating profit** (continued)**g Dividend income**

	2011 HK\$m	2010 HK\$m
Listed investments	431	418
Unlisted investments	298	146
	729	564

h Other operating income

	2011 HK\$m	2010 HK\$m
Rental income from investment properties	191	170
Movement in present value of in-force insurance business	5,524	4,106
Gains on investment properties	1,033	483
(Loss)/gain on disposal of property, plant and equipment, and assets held for sale	(3)	13
(Loss)/gain on disposal of subsidiaries, associates and business portfolios	(9)	603
Surplus arising on property revaluation	8	102
Other	4,645	4,527
	11,389	10,004

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\$558m (2010: HK\$1,049m). There are no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2010: nil).

i Loan impairment charges and other credit risk provisions

	2011 HK\$m	2010 HK\$m
Net charge for impairment of loans and advances to customers		
– Individually assessed impairment allowances:		
New allowances	2,254	3,605
Releases	(1,204)	(1,069)
Recoveries	(356)	(322)
	694	2,214
– Net charge for collectively assessed impairment allowances	2,401	2,474
Net charge for other credit risk provisions	(36)	(69)
Net charge for loan impairment and other credit risk provisions	3,059	4,619

Included in the net charge for other credit risk provisions is an impairment release of HK\$4m against available-for-sale debt securities (2010: impairment release of HK\$38m). There are no impairment losses or provisions relating to held-to-maturity investments (2010: nil).

4 Operating profit (continued)

j General and administrative expenses

	2011 HK\$m	2010 HK\$m
Premises and equipment		
– Rental expenses	3,102	2,749
– Amortisation of prepaid operating lease payments	18	18
– Other premises and equipment	3,810	3,496
	6,930	6,263
Marketing and advertising expenses	3,969	3,891
Other administrative expenses	13,453	12,235
	24,352	22,389

Included in operating expenses are direct operating expenses of HK\$19m (2010: HK\$20m) 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\$2m (2010: HK\$2m).

Included in operating expenses are minimum lease payments under operating leases of HK\$3,170m (2010: HK\$2,934m).

k Auditors' remuneration

Auditors' remuneration amounted to HK\$77m (2010: HK\$76m), of which HK\$29m (2010: HK\$29m) related to the Bank.

Notes on the Financial Statements (continued)

5 Insurance income

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

a Insurance income

	2011 HK\$m	2010 HK\$m
Net interest income	6,779	5,832
Net fee income	692	1,070
Net trading loss	(386)	(5)
Net income from financial instruments designated at fair value	(4,460)	3,371
Gains less losses from financial investments	(1)	386
Dividend income	1	–
Net earned insurance premiums (note 5(b))	45,670	37,193
Movement in present value of in-force business	5,524	4,106
Other operating income	237	70
	54,056	52,023
Net insurance claims incurred and movement in policyholders' liabilities (note 5(c))	(40,389)	(39,843)
Net operating income	13,667	12,180

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
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
2010					
Gross written premiums	3,166	30,729	4,224	–	38,119
Movement in unearned premiums	(235)	–	–	–	(235)
Gross earned premiums	2,931	30,729	4,224	–	37,884
Gross written premiums ceded to reinsurers	(457)	(267)	(8)	–	(732)
Reinsurers' share of movement in unearned premiums	41	–	–	–	41
Reinsurers' share of gross earned premiums	(416)	(267)	(8)	–	(691)
Net earned premiums	2,515	30,462	4,216	–	37,193

5 Insurance income (continued)

c Net insurance claims incurred and movement in policyholders' liabilities

	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
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 policyholders' liabilities	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 policyholders' liabilities	(161)	(183)	(802)	–	(1,146)
Net insurance claims incurred and movement in policyholders' liabilities	1,226	36,814	2,348	1	40,389
2010					
Claims, benefits and surrenders paid ..	1,290	4,030	2,330	122	7,772
Movement in provision	(14)	28,866	2,672	(119)	31,405
Gross claims incurred and movement in policyholders' liabilities	1,276	32,896	5,002	3	39,177
Reinsurers' share of claims, benefits and surrenders paid	(160)	(157)	(298)	–	(615)
Reinsurers' share of movement in provision	20	3	1,258	–	1,281
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(140)	(154)	960	–	666
Net insurance claims incurred and movement in policyholders' liabilities	1,136	32,742	5,962	3	39,843

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

	2011	2010
	HK\$m	HK\$m
Wages and salaries	35,020	30,412
Social security costs	912	736
Retirement benefit costs		
– Defined contribution plans	1,043	920
– Defined benefit plans (note 6(v))	859	698
	37,834	32,766

b Directors' emoluments

The aggregate emoluments of the Directors of the Bank, calculated in accordance with section 161 of the Hong Kong Companies Ordinance, were HK\$71m (2010: HK\$117m). This comprises fees of HK\$6m (2010: HK\$7m) and other emoluments of HK\$66m (2010: HK\$110m) which includes pension benefits of HK\$1m (2010: HK\$6m).

c Retirement benefit pension plans

The group operates 80 (2010: 77) retirement benefit plans, with a total cost of HK\$1,902m (2010: HK\$1,618m), of which HK\$587m (2010: HK\$649m) relates to overseas plans and HK\$30m (2010: HK\$28m) are 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 35% (2010: 37%) 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\$804m (2010: HK\$628m) 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:

	2011	2010
	% p.a.	% p.a.
Discount rate	1.47	2.85
Expected rates of return on plan assets ¹		
– equities	7.5	8.8
– bonds	3.9	3.8
– other	3.9	5.1
Rate of pay increase		
– long term	5.0	5.0
Mortality table	HKLT2001²	HKLT2001 ²

1 The expected rates of return are weighted on the basis of the fair value of the plan assets.

2 HKLT2001 – Hong Kong Life Tables 2001.

The overall expected long-term rate of return on assets as at 31 December 2011 was 4.7% (2010: 4.9%). 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.

6 Employee compensation and benefits (continued)

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 103% 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 108% 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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Equities	3,162	3,144	1,483	1,416
Bonds	9,357	9,626	6,600	6,625
Other	1,594	2,117	1,269	1,818
Fair value of plan assets	14,113	14,887	9,352	9,859
Present value of funded obligations	21,699	19,021	13,186	11,958
Present value of unfunded obligations	402	287	247	198
Defined benefit obligations	22,101	19,308	13,433	12,156
Past service cost not recognised	3	10	5	12
Effect of limit on plan surpluses	1	1	1	1
Net defined benefit liability	(7,986)	(4,412)	(4,077)	(2,286)
Reported as 'Assets'	111	301	73	179
Reported as 'Liabilities'	(8,097)	(4,713)	(4,150)	(2,465)
Net defined benefit liability	(7,986)	(4,412)	(4,077)	(2,286)

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

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
At 1 January	19,308	17,948	12,156	11,437
Current service cost	1,024	979	658	626
Interest cost	591	508	390	334
Contributions by employees	2	2	–	–
Actuarial losses	2,641	808	1,263	712
Benefits paid	(1,203)	(1,104)	(848)	(704)
Past service cost – vested immediately	28	56	27	47
Past service cost – unvested benefits	–	12	–	15
Liabilities extinguished on settlements	(195)	–	(128)	–
Exchange and other movements	(95)	99	(85)	(311)
At 31 December	22,101	19,308	13,433	12,156

Notes on the Financial Statements (continued)**6 Employee compensation and benefits** (continued)*(iv) Changes in the fair value of plan assets*

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
At 1 January	14,887	14,318	9,859	9,627
Expected return	754	847	510	587
Contributions by the group/the Bank	718	705	436	479
Contributions by employees	2	2	–	–
Actuarial (losses)/gains	(880)	2	(471)	(59)
Benefits paid	(1,140)	(1,052)	(808)	(672)
Assets distributed on settlement	(153)	–	(101)	–
Exchange and other movements	(75)	65	(73)	(103)
At 31 December	14,113	14,887	9,352	9,859

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

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Equities	341	427	284	366
Others	179	92	132	50
	520	519	416	416

The group's actual loss on plan assets for the year ended 31 December 2011 was HK\$157m (2010: HK\$849m gain). The Bank's actual gain on plan assets for the year ended 31 December 2011 was HK\$8m (2010: HK\$528m gain).

The group expects to make HK\$941m of contributions to defined benefit pension plans during 2012. Contributions to be made by the Bank are expected to be HK\$480m.

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

	2011 HK\$m	2010 HK\$m
Current service cost	1,024	979
Interest cost	591	508
Expected return on plan assets	(754)	(847)
Past service costs	37	58
Gains on settlements	(39)	–
Total net expense	859	698

The total net actuarial loss recognised in total equity during 2011 in respect of defined benefit pension plans was HK\$3,518m (2010: HK\$807m). After deduction of non-controlling interests, a loss of HK\$2,912m (2010: HK\$810m) was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date are HK\$10,298m (2010: HK\$6,779m). After deduction of non-controlling interests, the total net actuarial losses recognised in total shareholders' equity to date are HK\$8,829m (2010: HK\$5,917m).

The total net actuarial loss recognised in the Bank's retained profits during 2011 in respect of defined benefit pension plans was HK\$1,727m (2010: HK\$772m). Total net actuarial losses recognised outside of the income statement to date are HK\$5,988m (2010: HK\$4,261m).

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2011 was nil (2010: HK\$1m).

6 Employee compensation and benefits (continued)

(vi) Defined benefit schemes sponsored by the Bank's immediate holding company

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

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

The scheme is denominated in Sterling with the following details:

	2011	2010
	% p.a.	% p.a.
Assumptions as at 31 December		
Inflation	3.40	3.70
Salary increases	1.75	5.45
Pension increases	3.40	3.70
Discount rate	5.10	5.40
Expected return on assets	3.93	5.51
	SIPM/FA_	
Mortality table	LYOB¹	PNA00YOB

¹ The 'SIPM/FA_ Light Year of Birth' tables are based on the series of tables for self-administered pension schemes (SAPS) prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries. The mortality rates (that is, the probability of death in a given year) in these tables have been reduced by 20% for males and 15% for females. An allowance for future improvements in mortality has been made in line with those underlying the medium cohort improvements applicable to the series, subject to a minimum improvement of 1% per annum.

Notes on the Financial Statements (continued)**6 Employee compensation and benefits** (continued)*The International Staff Scheme*

	2011 £m	2010 £m
Funded status at 31 December		
Plan assets	842	686
Defined benefit obligations	(687)	(737)
Net defined benefit asset/(liability)	155	(51)
Categories of assets at 31 December		
Bonds	420	520
Property	34	33
Other	388	133
Fair value of plan assets	842	686
Reconciliation of defined benefit obligations at 31 December		
At 1 January	737	693
Current service cost	14	14
Interest cost	39	39
Contributions by employees	1	1
Actuarial (gains) / losses	(73)	19
Benefits paid	(31)	(29)
At 31 December	687	737
Reconciliation of the fair value of plan assets at 31 December		
At 1 January	686	604
Expected return	37	33
Actuarial gains	138	66
Contributions by the group	11	11
Contributions by employees	1	1
Benefits paid	(31)	(29)
At 31 December	842	686
Estimated contributions in the following year		
Estimated company contributions in the financial year	9	11
Estimated employee contributions in the financial year	1	1
Estimated total contributions in the financial year	10	12

(vii) Amounts for the current and previous years

	The group					The Bank				
	2011 HK\$m	2010 HK\$m	2009 HK\$m	2008 HK\$m	2007 HK\$m	2011 HK\$m	2010 HK\$m	2009 HK\$m	2008 HK\$m	2007 HK\$m
Defined benefit obligations	22,101	19,308	17,948	20,954	17,966	13,433	12,156	11,437	12,841	11,310
Plan assets	14,113	14,887	14,318	13,588	16,572	9,353	9,859	9,627	9,379	10,506
Net deficit	(7,988)	(4,421)	(3,630)	(7,366)	(1,394)	(4,080)	(2,297)	(1,810)	(3,462)	(804)
Experience (losses)/gains on plan liabilities	(344)	(214)	408	(132)	(790)	(230)	(175)	60	(363)	(585)
Experience (losses)/gains on plan assets	(911)	2	368	(3,591)	948	(502)	(59)	(47)	(1,400)	487

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% (2010: 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 2011. 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:

	2011 HK\$m	2010 HK\$m
Current income tax		
– Hong Kong profits tax – on current year profit	6,395	6,378
– Hong Kong profits tax – adjustments in respect of prior years	145	93
– Overseas taxation – on current year profit	9,593	7,470
– Overseas taxation – adjustments in respect of prior years	(219)	117
	15,914	14,058
Deferred tax		
– Origination and reversal of temporary differences	1,502	710
– Adjustments in respect of prior years	50	(160)
	1,552	550
	17,466	14,608

Notes on the Financial Statements (continued)**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	Others HK\$m	Total HK\$m
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
2010						
At 1 January	1,100	–	1,460	(447)	555	2,668
Exchange and other adjustments	85	–	40	(372)	(5)	(252)
Credit/(charge) to income statement	484	–	(604)	(9)	38	(91)
(Charge)/credit to reserves	–	–	–	(24)	214	190
At 31 December	1,669	–	896	(852)	802	2,515

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	Others HK\$m	Total HK\$m
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
2010						
At 1 January	414	–	1,246	(452)	228	1,436
Exchange and other adjustments	115	–	42	(323)	47	(119)
Credit/(charge) to income statement	87	–	(442)	(9)	(36)	(400)
(Charge)/credit to reserves	–	–	–	(13)	200	187
At 31 December	616	–	846	(797)	439	1,104

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	Others HK\$m	Total HK\$m
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
2010						
At 1 January	2,059	(32)	(373)	6,085	2,764	10,503
Exchange and other adjustments	1,926	–	(12)	(315)	(1,915)	(316)
Charge/(credit) to income statement	693	1	90	(14)	(311)	459
Charge/(credit) to reserves	2	–	–	1,700	(435)	1,267
At 31 December	4,680	(31)	(295)	7,456	103	11,913

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	Others HK\$m	Total HK\$m
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
2010						
At 1 January	1,790	(32)	(232)	3,343	542	5,411
Exchange and other adjustments	(495)	–	–	(263)	641	(117)
(Credit)/charge to income statement	(171)	1	21	(39)	(323)	(511)
Charge/(credit) to reserves	–	–	–	1,189	(447)	742
At 31 December	1,124	(31)	(211)	4,230	413	5,525

Notes on the Financial Statements (continued)**7 Tax expense** (continued)(iii) *Net deferred tax liabilities*

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Deferred tax liabilities recognised on the balance sheet	14,712	11,913	5,884	5,525
Deferred tax assets recognised on the balance sheet	(2,325)	(2,515)	(1,098)	(1,104)
	12,387	9,398	4,786	4,421

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK\$3,777m (2010: HK\$3,390m). Of this amount, HK\$2,062m (2010: HK\$1,809m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK\$1,164m (2010: HK\$617m) 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 is not contemplated, 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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Hong Kong profits tax	658	981	251	366
Overseas taxation	3,468	3,438	2,497	2,320
Current tax liabilities	4,126	4,419	2,748	2,686
Deferred tax liabilities	14,712	11,913	5,884	5,525
	18,838	16,332	8,632	8,211

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

	2011 HK\$m	2010 HK\$m
Profit before tax	91,370	77,885
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	17,082	14,880
Tax effect of non-taxable revenue (net of non-deductible expenses)	(726)	(792)
Tax effect of unused tax losses not recognised	246	(94)
Under / (over) provision in prior years	(24)	50
Others	888	564
	17,466	14,608

8 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK\$37,812m (2010: HK\$38,227m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2011		2010	
	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	1.33	12,000	0.98	8,850
– first interim dividend paid	0.78	7,000	0.67	6,000
– second interim dividend paid	0.78	7,000	0.67	6,000
– third interim dividend paid	0.68	7,000	0.67	6,000
	3.57	33,000	2.99	26,850

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2011 of HK\$10,000m (HK\$0.83 per ordinary share).

Notes on the Financial Statements (continued)

10 Analysis of financial assets and liabilities by measurement basis

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
Placements 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 group

	At 31 December 2010								
	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	-	-	-	447,524	279,080	81,381	-	-	807,985
Items in the course of collection from other banks	-	-	-	-	-	16,878	-	-	16,878
Placings with banks maturing after one month ...	-	-	-	149,557	-	-	-	-	149,557
Certificates of deposit	-	-	6,290	-	66,957	-	-	-	73,247
Hong Kong Government certificates of indebtedness	-	-	-	-	-	148,134	-	-	148,134
Trading assets	390,208	-	-	-	-	-	-	-	390,208
Financial assets designated at fair value	-	54,604	-	-	-	-	-	-	54,604
Derivatives	301,304	-	-	-	-	-	422	896	302,622
Loans and advances to customers	-	-	-	1,891,060	-	-	-	-	1,891,060
Financial investments	-	-	121,743	-	704,919	-	-	-	826,662
Amounts due from Group companies	40,397	5,453	-	-	-	91,783	-	-	137,633
Other assets	-	-	-	-	-	56,452	-	-	56,452
Total financial assets	731,909	60,057	128,033	2,488,141	1,050,956	394,628	422	896	4,855,042
Liabilities									
Hong Kong currency notes in circulation	-	-	-	-	-	148,134	-	-	148,134
Items in the course of transmission to other banks	-	-	-	-	-	26,495	-	-	26,495
Deposits by banks	-	-	-	-	-	167,827	-	-	167,827
Customer accounts	-	-	-	-	-	3,313,244	-	-	3,313,244
Trading liabilities	151,534	-	-	-	-	-	-	-	151,534
Financial liabilities designated at fair value	-	40,327	-	-	-	-	-	-	40,327
Derivatives	307,225	-	-	-	-	-	2,488	125	309,838
Debt securities in issue	-	-	-	-	-	59,283	-	-	59,283
Amounts due to Group companies	25,163	3	-	-	-	57,962	-	-	83,128
Other liabilities	-	-	-	-	-	65,737	-	-	65,737
Subordinated liabilities	-	-	-	-	-	21,254	-	-	21,254
Preference shares	-	-	-	-	-	101,458	-	-	101,458
Total financial liabilities	483,922	40,330	-	-	-	3,961,394	2,488	125	4,488,259

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

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

The Bank

At 31 December 2010

	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	-	-	-	244,121	252,727	54,155	-	-	551,003
Items in the course of collection from other banks	-	-	-	-	-	12,143	-	-	12,143
Placings with banks maturing after one month	-	-	-	74,791	-	-	-	-	74,791
Certificates of deposit	-	-	-	-	27,888	-	-	-	27,888
Hong Kong Government certificates of indebtedness	-	-	-	-	-	148,134	-	-	148,134
Trading assets	297,929	-	-	-	-	-	-	-	297,929
Financial assets designated at fair value	-	2,086	-	-	-	-	-	-	2,086
Derivatives	294,739	-	-	-	-	-	122	618	295,479
Loans and advances to customers	-	-	-	1,016,312	-	-	-	-	1,016,312
Financial investments	-	-	-	-	503,752	-	-	-	503,752
Amounts due from Group companies	43,340	-	-	-	-	154,982	-	-	198,322
Other assets	-	-	-	-	-	28,980	-	-	28,980
Total financial assets	636,008	2,086	-	1,335,224	784,367	398,394	122	618	3,156,819
Liabilities									
Hong Kong currency notes in circulation	-	-	-	-	-	148,134	-	-	148,134
Items in the course of transmission to other banks	-	-	-	-	-	17,951	-	-	17,951
Deposits by banks	-	-	-	-	-	130,476	-	-	130,476
Customer accounts	-	-	-	-	-	2,044,664	-	-	2,044,664
Trading liabilities	91,184	-	-	-	-	-	-	-	91,184
Financial liabilities designated at fair value	-	6,581	-	-	-	-	-	-	6,581
Derivatives	302,365	-	-	-	-	-	1,474	43	303,882
Debt securities in issue	-	-	-	-	-	43,139	-	-	43,139
Amounts due to Group companies	15,529	-	-	-	-	130,365	-	-	145,894
Other liabilities	-	-	-	-	-	40,712	-	-	40,712
Subordinated liabilities	-	-	-	-	-	9,404	-	-	9,404
Preference shares	-	-	-	-	-	101,306	-	-	101,306
Total financial liabilities	409,078	6,581	-	-	-	2,666,151	1,474	43	3,083,327

Notes on the Financial Statements (continued)**11 Cash and short-term funds**

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Cash in hand	15,204	13,001	7,888	7,086
Sight balances with central banks	94,903	68,380	72,022	47,069
Placings with banks with remaining maturity of one month or less	456,294	447,524	232,654	244,121
Treasury bills and other eligible bills	353,505	279,080	299,701	252,727
	919,906	807,985	612,265	551,003

As at 31 December 2011, included within notes 11 and 12, the total amount placed with central banks by the group, including sight balances, amounted to HK\$350,823m (2010: HK\$232,779m). Placings with central banks made by the Bank amounted to HK\$211,307m (2010: HK\$135,453m).

Treasury bills and other eligible bills are analysed as follows:

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Treasury bills and other eligible bills – available-for-sale – subject to repledge or resale by counterparties	498	–	498	–
– not subject to repledge or resale by counterparties	353,007	279,080	299,203	252,727
	353,505	279,080	299,701	252,727

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Gross placings with banks maturing after one month but not more than one year	173,498	142,313	93,098	70,731
Gross placings with banks maturing after one year	24,789	7,244	15,775	4,060
Total placings with banks	198,287	149,557	108,873	74,791

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Held-to-maturity	8,342	6,290	–	–
Available-for-sale	80,349	66,957	23,987	27,888
	88,691	73,247	23,987	27,888

Certificates of deposit held are largely unlisted. There were no disposals of held-to-maturity certificates of deposit during the year (2010: 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.

15 Trading assets

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Debt securities	168,849	200,379	120,575	155,174
Equity shares	15,060	17,798	14,978	17,620
Treasury bills and other eligible bills	230,959	140,873	160,911	112,602
Other	33,100	31,158	20,857	12,533
	447,968	390,208	317,321	297,929
Trading assets				
– which may be repledged or resold by counterparties	281	5,619	281	5,619
– not subject to repledge or resale by counterparties	447,687	384,589	317,040	292,310
	447,968	390,208	317,321	297,929

The amount of listed treasury bills and other eligible bills amounted to HK\$4,427m at both group and Bank level as at 31 December 2011 (2010: HK\$2,624m).

a Debt securities

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	17,880	21,713	13,329	17,837
– listed outside Hong Kong	54,897	81,496	54,180	81,228
	72,777	103,209	67,509	99,065
Unlisted	96,072	97,170	53,066	56,109
	168,849	200,379	120,575	155,174
Issued by public bodies				
– central governments and central banks	114,322	143,684	77,477	103,286
– other public sector entities	6,651	9,266	6,544	9,165
	120,973	152,950	84,021	112,451
Issued by				
– banks	23,984	26,424	19,811	25,380
– corporate entities	23,892	21,005	16,743	17,343
	168,849	200,379	120,575	155,174

b Equity shares

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	4,494	3,711	4,487	3,702
– listed outside Hong Kong	7,211	10,910	7,211	10,910
	11,705	14,621	11,698	14,612
Unlisted	3,355	3,177	3,280	3,008
	15,060	17,798	14,978	17,620
Issued by				
– banks	2,192	1,287	2,192	1,287
– corporate entities	12,868	16,511	12,786	16,333
	15,060	17,798	14,978	17,620

Notes on the Financial Statements (continued)**16 Financial assets designated at fair value**

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Debt securities	16,762	17,299	2,283	2,086
Equity shares	40,268	36,674	–	–
Other	640	631	–	–
	57,670	54,604	2,283	2,086

a Debt securities

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	1,780	1,909	587	826
– listed outside Hong Kong	4,578	4,297	1,696	1,111
	6,358	6,206	2,283	1,937
Unlisted	10,404	11,093	–	149
	16,762	17,299	2,283	2,086
Issued by public bodies				
– central governments and central banks	2,298	2,266	587	593
– other public sector entities	1,992	2,402	–	270
	4,290	4,668	587	863
Issued by other bodies				
– banks	5,153	5,757	–	–
– corporate entities	7,319	6,874	1,696	1,223
	16,762	17,299	2,283	2,086

b Equity shares

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	3,354	4,299	–	–
– listed outside Hong Kong	14,732	13,907	–	–
	18,086	18,206	–	–
Unlisted	22,182	18,468	–	–
	40,268	36,674	–	–
Issued by				
– banks	1,386	1,677	–	–
– corporate entities	38,882	34,997	–	–
	40,268	36,674	–	–

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 utilised to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures as are used for traditional lending.

a *Trading and hedging derivatives*

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives and ineffective hedging derivatives 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.

Notes on the Financial Statements (continued)**17 Derivatives** (continued)(i) *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

	2011			2010		
	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	10,996,534	172,868	181,560	8,815,181	159,046	166,839
Interest rate contracts	17,283,126	166,195	161,430	15,566,345	120,045	118,337
Equity derivatives	785,433	29,729	31,066	456,339	16,424	16,275
Credit derivatives	465,174	5,000	4,784	531,899	5,233	4,968
Commodity and other	87,764	2,713	1,054	38,530	487	660
Total held for trading	29,618,031	376,505	379,894	25,408,294	301,235	307,079
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	546	3	–	19,483	37	9
Interest rate contracts	4,835	128	95	8,105	32	137
	5,381	131	95	27,588	69	146
Cash flow hedging derivatives						
Exchange rate contracts	2,679	–	79	–	–	–
Interest rate contracts	101,069	271	139	250,303	896	125
	103,748	271	218	250,303	896	125
Fair value hedging derivatives						
Interest rate contracts	109,477	389	3,045	113,458	422	2,488
Total derivatives	29,836,637	377,296	383,252	25,799,643	302,622	309,838

17 Derivatives (continued)

The Bank

	2011			2010		
	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	10,080,072	168,229	178,375	8,076,965	154,314	163,163
Interest rate contracts	16,979,848	164,555	159,977	15,323,156	118,579	116,788
Equity derivatives	791,046	30,013	30,959	459,264	16,242	16,509
Credit derivatives	465,174	5,024	4,797	531,887	5,296	5,119
Commodity and other	68,406	2,409	1,512	31,436	239	649
Total held for trading	28,384,546	370,230	375,620	24,422,708	294,670	302,228
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	546	3	–	684	37	9
Interest rate contracts	4,695	128	92	5,780	32	128
	5,241	131	92	6,464	69	137
Cash flow hedging derivatives						
Exchange rate contracts	2,679	–	79	–	–	–
Interest rate contracts	41,253	167	31	124,688	618	43
	43,932	167	110	124,688	618	43
Fair value hedging derivatives						
Interest rate contracts	53,767	150	1,343	72,976	122	1,474
Total derivatives	28,487,486	370,678	377,165	24,626,836	295,479	303,882

(ii) Risk exposure by counterparty type excluding HSBC entities

	2011		2010	
	The group %	The Bank %	The group %	The Bank %
Government	–	–	–	–
Banks	75	76	78	79
Other financial institutions	11	11	8	8
Other	14	13	14	13
Total	100	100	100	100

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the 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 2012 and beyond.

Notes on the Financial Statements (continued)**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

	2011	2010
	HK\$m	HK\$m
Gains/(losses):		
On hedging instruments	(1,147)	(579)
On the hedged items attributable to hedged risk	1,050	563
	(97)	(16)

Cash flow hedges

The group's cash flow hedges consist principally of interest rate swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their own contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2011, the amount transferred to the income statement comprised HK\$324m (2010: HK\$1,430m) 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 2011, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2010: gain of HK\$5m).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2011 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 2011			
Cash inflows from assets	80,782	68,488	22,613
Cash outflows from liabilities	(1,022)	(1,656)	(2,406)
Net cash inflows	79,760	66,832	20,207
At 31 December 2010			
Cash inflows from assets	177,416	96,529	31,841
Cash outflows from liabilities	(4,301)	(4,003)	(2,574)
Net cash inflows	173,115	92,526	29,267

17 Derivatives (continued)

b 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

	2011 HK\$m	2010 HK\$m
Balance at 1 January	101	128
Deferrals on new transactions	225	94
Reduction due to amortisation	(86)	(55)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	(101)	(69)
Exchange differences and others	(2)	3
Balance at 31 December	<u>137</u>	<u>101</u>

The Bank

	2011 HK\$m	2010 HK\$m
Balance at 1 January	91	124
Deferrals on new transactions	195	81
Reduction due to amortisation	(71)	(55)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	(89)	(62)
Exchange differences and others	(2)	3
Balance at 31 December	<u>124</u>	<u>91</u>

18 Loans and advances to customers

a Loans and advances to customers

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Gross loans and advances to customers	2,142,172	1,904,054	1,184,316	1,025,285
Impairment allowances (note 19(a))	(11,301)	(12,994)	(7,714)	(8,973)
	<u>2,130,871</u>	<u>1,891,060</u>	<u>1,176,602</u>	<u>1,016,312</u>

Notes on the Financial Statements (continued)**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 Hongkong and Shanghai Banking Corporation Limited and its subsidiaries, to manage associated risks.

The group

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
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
2010			
Residential mortgages ¹	326,767	221,558	548,325
Credit card advances	37,351	34,287	71,638
Other personal	47,874	37,779	85,653
Total personal	411,992	293,624	705,616
Commercial, industrial and international trade	260,020	325,253	585,273
Commercial real estate	150,142	67,804	217,946
Other property-related lending	118,401	42,231	160,632
Government	18,185	3,223	21,408
Other commercial	78,676	93,569	172,245
Total corporate and commercial	625,424	532,080	1,157,504
Non-bank financial institutions	21,952	16,486	38,438
Settlement accounts	2,020	476	2,496
Total financial	23,972	16,962	40,934
Gross loans and advances to customers	1,061,388	842,666	1,904,054
Individually assessed impairment allowances	(2,615)	(5,644)	(8,259)
Collectively assessed impairment allowances	(2,178)	(2,557)	(4,735)
Net loans and advances to customers	1,056,595	834,465	1,891,060

1 Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK\$25,640m (2010: HK\$27,496m).

18 Loans and advances to customers (continued)

The Bank

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
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	277,523	125,654	403,177
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	452,769	294,392	747,161
Non-bank financial institutions	21,256	12,607	33,863
Settlement accounts	–	115	115
Total financial	21,256	12,722	33,978
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	748,538	428,064	1,176,602
2010			
Residential mortgages ¹	181,599	85,761	267,360
Credit card advances	21,616	14,942	36,558
Other personal	27,833	19,451	47,284
Total personal	231,048	120,154	351,202
Commercial, industrial and international trade	162,419	157,112	319,531
Commercial real estate	112,390	36,477	148,867
Other property-related lending	26,686	19,513	46,199
Government	17,463	3,137	20,600
Other commercial	53,106	54,494	107,600
Total corporate and commercial	372,064	270,733	642,797
Non-bank financial institutions	19,931	11,240	31,171
Settlement accounts	–	115	115
Total financial	19,931	11,355	31,286
Gross loans and advances to customers	623,043	402,242	1,025,285
Individually assessed impairment allowances	(1,775)	(4,171)	(5,946)
Collectively assessed impairment allowances	(1,589)	(1,438)	(3,027)
Net loans and advances to customers	619,679	396,633	1,016,312

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\$11,235m (2010: HK\$12,663m).

Notes on the Financial Statements (continued)**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

	2011			2010		
	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	3,022	686	3,708	2,947	562	3,509
– After one year but within five years	7,241	1,701	8,942	7,104	1,441	8,545
– After five years	13,198	1,661	14,859	13,071	2,034	15,105
	23,461	4,048	27,509	23,122	4,037	27,159
Impairment allowances	(54)			(62)		
Net investment in finance leases and hire purchase contracts	23,407			23,060		

The Bank

	2011			2010		
	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	1,640	272	1,912	1,803	247	2,050
– After one year but within five years	3,938	764	4,702	4,045	644	4,689
– After five years	8,871	1,207	10,078	6,917	824	7,741
	14,449	2,243	16,692	12,765	1,715	14,480
Impairment allowances	(10)			(21)		
Net investment in finance leases and hire purchase contracts	14,439			12,744		

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
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>
2010			
At 1 January	8,088	6,192	14,280
Amounts written off	(1,995)	(5,326)	(7,321)
Recoveries of loans and advances written off in previous years	322	1,442	1,764
Net charge to income statement (note 4(i))	2,214	2,474	4,688
Unwinding of discount of loan impairment	(81)	(243)	(324)
Exchange and other adjustments	(289)	196	(93)
At 31 December (note 18(a))	<u>8,259</u>	<u>4,735</u>	<u>12,994</u>

The Bank

	Individually assessed allowances HK\$m	Collectively assessed allowances HK\$m	Total HK\$m
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>
2010			
At 1 January	5,371	4,480	9,851
Amounts written off	(1,220)	(3,835)	(5,055)
Recoveries of loans and advances written off in previous years	119	968	1,087
Net charge to income statement	1,727	1,796	3,523
Unwinding of discount of loan impairment	(47)	(190)	(237)
Exchange and other adjustments	(4)	(192)	(196)
At 31 December (note 18(a))	<u>5,946</u>	<u>3,027</u>	<u>8,973</u>

Notes on the Financial Statements (continued)

19 Impairment allowances against loans and advances to customers (continued)

b Impaired loans and advances to customers and allowances

The group

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
At 31 December 2011			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances ¹	4,538	9,313	13,851
Individually assessed allowances	(2,174)	(4,720)	(6,894)
	2,364	4,593	6,957
Individually assessed allowances as a percentage of gross impaired loans and advances	47.9%	50.7%	49.8%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	0.4%	1.0%	0.6%
At 31 December 2010			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances ¹	4,987	11,294	16,281
Individually assessed allowances	(2,615)	(5,644)	(8,259)
	2,372	5,650	8,022
Individually assessed allowances as a percentage of gross impaired loans and advances	52.4%	50.0%	50.7%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	0.5%	1.3%	0.9%

The Bank

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
At 31 December 2011			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances ¹	3,086	5,865	8,951
Individually assessed allowances	(1,377)	(3,608)	(4,985)
	1,709	2,257	3,966
Individually assessed allowances as a percentage of gross impaired loans and advances	44.6%	61.5%	55.7%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	0.4%	1.4%	0.8%
At 31 December 2010			
Loans and advances to customers which are considered to be impaired are as follows:			
Gross impaired loans and advances ¹	3,436	7,160	10,596
Individually assessed allowances	(1,775)	(4,171)	(5,946)
	1,661	2,989	4,650
Individually assessed allowances as a percentage of gross impaired loans and advances	51.7%	58.3%	56.1%
Gross impaired loans and advances as a percentage of gross loans and advances to customers	0.6%	1.8%	1.0%

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

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

19 Impairment allowances against loans and advances to customers (continued)

c Individually assessed impaired loans and advances

The group

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
At 31 December 2011			
Gross individually assessed impaired loans and advances	3,881	8,490	12,371
Individually assessed impairment allowances	<u>(2,174)</u>	<u>(4,720)</u>	<u>(6,894)</u>
	1,707	3,770	5,477
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	0.3%	0.9%	0.6%
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,403	3,252	4,655
At 31 December 2010			
Gross individually assessed impaired loans and advances	4,804	10,210	15,014
Individually assessed impairment allowances	<u>(2,615)</u>	<u>(5,644)</u>	<u>(8,259)</u>
	2,189	4,566	6,755
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	0.5%	1.2%	0.8%
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,463	2,887	4,350

The Bank

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Total HK\$m
At 31 December 2011			
Gross individually assessed impaired loans and advances	2,520	5,472	7,992
Individually assessed impairment allowances	<u>(1,377)</u>	<u>(3,608)</u>	<u>(4,985)</u>
	1,143	1,864	3,007
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	0.3%	1.3%	0.7%
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
At 31 December 2010			
Gross individually assessed impaired loans and advances	3,359	6,521	9,880
Individually assessed impairment allowances	<u>(1,775)</u>	<u>(4,171)</u>	<u>(5,946)</u>
	1,584	2,350	3,934
Gross individually assessed impaired loans and advances as a percentage of gross loans and advances to customers	0.5%	1.6%	1.0%
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	877	879	1,756

Notes on the Financial Statements (continued)**19 Impairment allowances against loans and advances to customers** (continued)

For individually assessed customer loans and advances where the industry sectors comprise more than 10% of 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 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
At 31 December 2010						
Residential mortgages	548,325	2,405	(375)	(216)	4	78
Commercial, industrial and international trade	585,273	8,445	(5,989)	(1,898)	1,096	1,049
Commercial real estate	217,946	893	(254)	(54)	76	192

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 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
At 31 December 2010						
Residential mortgages	267,360	637	(95)	(98)	(27)	43
Commercial, industrial and international trade	319,531	6,173	(4,395)	(1,198)	915	883
Commercial real estate	148,867	349	(60)	(22)	20	116

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

19 Impairment allowances against loans and advances to customers (continued)

d 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 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
At 31 December 2010						
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	341	0.0	1,906	0.2	2,247	0.1
– more than six months but less than one year	974	0.1	825	0.1	1,799	0.1
– more than one year	2,234	0.2	4,345	0.5	6,579	0.4
	3,549	0.3	7,076	0.8	10,625	0.6
Individually assessed impairment allowances made in respect of amounts overdue	(1,923)		(3,824)		(5,747)	
Fair value of collateral held in respect of amounts overdue	823		2,044		2,867	
Rescheduled loans and advances to customers	891	0.1	2,793	0.3	3,684	0.2

Notes on the Financial Statements (continued)**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 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
At 31 December 2010						
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	204	0.0	854	0.2	1,058	0.1
– more than six months but less than one year	886	0.2	391	0.1	1,277	0.1
– more than one year	1,330	0.2	2,574	0.6	3,904	0.4
	2,420	0.4	3,819	0.9	6,239	0.6
Individually assessed impairment allowances made in respect of amounts overdue	(1,115)		(2,496)		(3,611)	
Fair value of collateral held in respect of amounts overdue	529		607		1,136	
Rescheduled loans and advances to customers	772	0.1	1,251	0.3	2,023	0.2

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 loans and advances to customers'.

20 Impairments 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 2011 and 31 December 2010. Information relating to overdue balances can be found in note 52.

21 Financial investments

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Debt securities				
– held-to-maturity	134,720	121,743	–	–
– available-for-sale	542,536	632,084	325,136	442,336
Equity shares				
– available-for-sale	45,177	72,835	37,171	61,416
	722,433	826,662	362,307	503,752
Financial investments				
– which may be repledged or resold by counterparties	847	1,297	325	1,090
– not subject to repledge or resale by counterparties	721,586	825,365	361,982	502,662
	722,433	826,662	362,307	503,752

a Held-to-maturity debt securities

The group

	Book value		Fair value	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	2,932	2,496	3,209	2,733
– listed outside Hong Kong	31,017	30,013	32,847	30,941
	33,949	32,509	36,056	33,674
Unlisted	100,771	89,234	106,618	92,737
	134,720	121,743	142,674	126,411
Issued by public bodies				
– central governments and central banks	2,551	2,309	3,049	2,471
– other public sector entities	20,703	18,074	22,347	19,230
	23,254	20,383	25,396	21,701
Issued by				
– banks	72,303	72,428	75,309	74,876
– corporate entities	39,163	28,932	41,969	29,834
	134,720	121,743	142,674	126,411

Notes on the Financial Statements (continued)**21 Financial investments** (continued)**b Available-for-sale debt securities**

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	23,333	9,519	2,872	1,337
– listed outside Hong Kong	169,312	261,968	131,216	200,125
	192,645	271,487	134,088	201,462
Unlisted	349,891	360,597	191,048	240,874
	542,536	632,084	325,136	442,336
Issued by public bodies				
– central governments and central banks	295,436	263,426	182,580	199,397
– other public sector entities	78,901	63,972	51,118	46,542
	374,337	327,398	233,698	245,939
Issued by				
– banks	136,388	257,408	74,434	159,631
– corporate entities	31,811	47,278	17,004	36,766
	542,536	632,084	325,136	442,336

c Available-for-sale equity shares

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Listed				
– listed in Hong Kong	31,794	53,867	31,372	53,224
– listed outside Hong Kong	129	699	89	529
	31,923	54,566	31,461	53,753
Unlisted	13,254	18,269	5,710	7,663
	45,177	72,835	37,171	61,416
Issued by				
– banks	7,140	11,376	3,716	4,957
– corporate entities	38,037	61,459	33,455	56,459
	45,177	72,835	37,171	61,416

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. The following table analyses the carrying amount of financial assets transferred to third parties that did not qualify for derecognition during 2011 and 2010, and their associated financial liabilities:

The group

	2011		2010	
	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	21,685	21,383	14,652	14,210
Securities lending agreements	735	259	594	65
	22,420	21,642	15,246	14,275

The Bank

	2011		2010	
	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	3,829	3,888	6,692	6,485
Securities lending agreements	579	259	387	65
	4,408	4,147	7,079	6,550

The carrying amount of assets transferred by the group to other HSBC Group entities under repurchase agreements is HK\$12,276m (2010: HK\$48m) and by the Bank is HK\$15,452m (2010: HK\$11,647m). The associated liability assumed by the group is HK\$12,292m (2010: HK\$48m) and by the Bank is HK\$15,462m (2010: HK\$11,715m).

The carrying amount of assets transferred under securities lending agreements to other HSBC Group entities is HK\$3,534m (2010: HK\$2,341m) by both the group and the Bank. The associated liabilities assumed are HK\$3,534m (2010: HK\$2,458m).

Notes on the Financial Statements (continued)**23 Investments in subsidiaries**

	The Bank	
	2011 HK\$m	2010 HK\$m
Investments in subsidiaries:		
Unlisted investments	56,859	52,059
Listed investment	865	865
	57,724	52,924

The principal subsidiaries of the Bank are:

	Place of incorporation	Principal activity	Nominal value of issued share capital	Class of share	The group's interest in issued share capital
Hang Seng Bank Limited	Hong Kong	Banking	HK\$9,559m	Ordinary	62.14%
HSBC Bank (China) Company Limited ..	PRC ¹	Banking	RMB10,800m	Ordinary	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	RM\$115m	Ordinary	100%
HSBC Bank Australia Limited ²	Australia	Banking	A\$751m	Ordinary	100%
HSBC Bank (Taiwan) Limited ²	Taiwan	Banking	TWD30,000m	Ordinary	100%
HSBC Insurance (Asia) Limited ²	Hong Kong	Insurance	HK\$1,298m	Ordinary	100%
HSBC Life (International) Limited ²	Bermuda	Retirement benefits and life insurance	HK\$1,278m	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.

24 Interests in associates and joint ventures

	The Group	
	2011 HK\$m	2010 HK\$m
Share of net assets	84,493	68,046
Goodwill	5,544	5,405
Intangible assets	2,216	2,690
Deferred tax on intangible assets	(468)	(573)
	91,785	75,568

At 31 December 2011, the group's interests in associates amounted to HK\$90,130m (2010: HK\$74,099m).

	The Bank	
	2011 HK\$m	2010 HK\$m
Listed investments	26,561	26,561
Unlisted investments	1,578	1,578
	28,139	28,139

Shareholdings in associates held by the Bank include listed investments of HK\$26,561m (2010: 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\$87,107m (2010: HK\$108,458m).

a Principal associates

The principal associates of the group are:

	At 31 December 2011		At 31 December 2010	
	Carrying value HK\$m	Fair value HK\$m	Carrying value HK\$m	Fair value HK\$m
Listed				
Bank of Communications Co., Ltd	66,704	63,964	54,568	83,743
Industrial Bank Co., Ltd. ³	17,199	21,307	13,752	21,753
Bao Viet Holdings ³	1,409	1,836	1,418	2,962
	85,312	87,107	69,738	108,458

	Place of incorporation	Principal activity	Nominal value of issued share capital	Class of share	The group's interest in issued share capital
Listed					
Bank of Communications Co., Ltd ...	PRC ¹	Banking	RMB61,886m	Ordinary	19.03%
Industrial Bank Co., Ltd. ³	PRC ¹	Banking	RMB10,786m	Ordinary	12.80%
Bao Viet Holdings ³	Vietnam	Insurance	VND6,805bn	Ordinary	18.00%
Unlisted					
Barrowgate Limited ³	Hong Kong	Property investment	– ²	Ordinary	24.64%
OCLP Holdings, Inc.	Philippines	Property investment	PHP1,672m	Ordinary	34.08%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND8,788bn	Ordinary	19.61%
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.

Notes on the Financial Statements (continued)**24 Interests in associates and joint ventures** (continued)

The Bank's interests in Bank of Communications Co., Ltd ('BoCom'), Vietnam Technological and Commercial Joint Stock Bank ('TechCom Bank') and Bao Viet Holdings ('Bao Viet') are accounted for as associated companies as the group has representation on the Board of Directors of each, whilst for BoCom, the Bank has representation on the strategy committee. Hang Seng Bank Limited's ('Hang Seng') interest in Industrial Bank Co., Ltd. ('Industrial Bank') is accounted for as an associated company as Hang Seng has representation on the Board of Directors and also has representation on the executive committee.

In respect of the year ended 31 December 2011, BoCom, Industrial Bank, TechCom Bank and Bao Viet were included in these financial statements based on financial statements drawn up to 30 September 2011, but taking into account the financial effect of significant transactions or events in the subsequent period from 1 October 2011 to 31 December 2011. The group has taken advantage of the provision contained in HKAS28 '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.

In September 2011, TechCom Bank issued shares to its employees. This reduced the group's equity interest from 19.79% to 19.61%.

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.

The group has entered into Technical Support and Assistance Agreements with BoCom, Industrial Bank, TechCom Bank, Bao Viet, 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.

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
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
2010						
100%	6,754,826	6,368,911	385,915	175,768	110,321	65,447
The group's effective interest ¹	1,053,418	991,097	62,321	29,268	18,717	10,551

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

At 31 December 2011, the group's share of associates and joint ventures' contingent liabilities was HK\$266,530m (2010: HK\$199,304m).

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	INR8,000m	Ordinary	26.00%
Hana HSBC Life Insurance Co., Ltd	South Korea	Insurance manufacturing	KRW85,201m	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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Goodwill	7,629	7,891	1,177	1,167
Present value of in-force long-term insurance business	20,232	14,767	–	–
Other intangible assets	6,978	7,032	3,654	3,546
	34,839	29,690	4,831	4,713

a Goodwill

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Cost at 1 January	7,891	7,519	1,167	1,104
Exchange and other movements	(262)	372	10	63
Net book value at 31 December	7,629	7,891	1,177	1,167

Segmental analysis of goodwill

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Hong Kong – Retail Banking and Wealth Management	12	12	–	–
Hong Kong – Commercial Banking	36	36	24	24
Hong Kong – Global Banking and Markets	755	755	498	498
Rest of Asia-Pacific – Retail Banking and Wealth Management	1,430	1,598	78	78
Rest of Asia-Pacific – Commercial Banking	4,275	4,358	–	–
Rest of Asia-Pacific – Global Banking and Markets	1,121	1,132	577	567
	7,629	7,891	1,177	1,167

During 2011 there was no impairment of goodwill (2010: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2011 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 2011 were in the range of 10% to 11% (2010: 10% to 11%) across different CGUs. The nominal long-term growth rates used in the impairment test in 2011 for Hong Kong and Rest of Asia-Pacific were 7.9% and 7.8% respectively (2010: 5.3% and 6.9%).

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:

	2011	2010
Risk free rate	1.47%	3.10%
Risk discount rate	8.00%	11.00%
Expenses inflation	3.00%	3.00%
Lapse rate	0%-20% for the first policy year and 0%-15% for renewal 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	
	2011	2010
	HK\$m	HK\$m
At 1 January	14,767	10,554
Addition from current year new business	4,982	3,737
Movement from in-force business	(333)	369
Exchange and other adjustments	816	107
At 31 December	20,232	14,767

25 Goodwill and intangible assets (continued)

An impairment test was carried out in respect of the operating licenses in Taiwan as at 1 July 2011. 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 2011 was in the range of 12% to 13% (2010: 11% to 12%). The long-term growth rate used in the impairment testing during 2011 was 3% (2010: 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 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

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 2010	50,103	3,114	18,460	31,584	126	12,281
Exchange and other adjustments	429	–	497	168	–	(161)
Additions	4,026	–	2,132	4,022	–	1,356
Disposals	(43)	–	(543)	(17)	–	(316)
Elimination of accumulated depreciation on revalued land and buildings	(1,285)	–	–	(778)	–	–
Surplus on revaluation	10,038	483	–	6,444	–	–
Reclassifications	(120)	(94)	(16)	–	–	(11)
At 31 December 2010	63,148	3,503	20,530	41,423	126	13,149
Accumulated depreciation						
At 1 January 2010	11	–	12,856	–	–	8,650
Exchange and other adjustments	2	–	338	2	–	(81)
Charge for the year	1,279	–	2,146	781	–	1,376
Disposals	(5)	–	(495)	(5)	–	(298)
Elimination of accumulated depreciation on revalued land and buildings	(1,285)	–	–	(778)	–	–
Reclassifications	–	–	(13)	–	–	(10)
At 31 December 2010	2	–	14,832	–	–	9,637
Net book value at 31 December 2010	63,146	3,503	5,698	41,423	126	3,512
Total at 31 December 2010			72,347			45,061

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Cost less accumulated depreciation.....	19,575	19,475	14,541	14,507

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

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Land and buildings carried at valuation	74,901	62,956	48,318	41,423
Other land and buildings stated at cost	189	192	–	–
Land and buildings before deduction of accumulated depreciation	75,090	63,148	48,318	41,423

26 Property, plant and equipment (continued)

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

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
In Hong Kong:				
Long leaseholds (over fifty years)	34,787	28,263	29,818	24,626
Medium-term leaseholds (between ten and fifty years)	34,182	28,269	10,004	8,837
Short leaseholds (less than ten years)	90	136	90	100
	69,059	56,668	39,912	33,563
Outside Hong Kong:				
Freehold	4,444	4,287	3,489	3,361
Long leaseholds (over fifty years)	157	125	112	82
Medium-term leaseholds (between ten and fifty years)	5,978	5,527	4,905	4,501
Short leaseholds (less than ten years)	47	42	47	42
	10,626	9,981	8,553	7,986
	79,685	66,649	48,465	41,549
Analysed as follows:				
Land and buildings	75,069	63,146	48,318	41,423
Investment properties	4,616	3,503	147	126
	79,685	66,649	48,465	41,549

The group's land and buildings and investment properties were revalued at 30 November 2011 and updated for any material changes at 31 December 2011. 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\$9,384m (2010: HK\$8,931m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK\$13,981m (2010: HK\$10,521m). Amounts of HK\$9,656m (2010: HK\$7,513m) and HK\$1,041m (2010: HK\$585m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK\$9,656m (2010: HK\$7,513m) is stated after deduction of non-controlling interests of HK\$1,412m (2010: HK\$796m) and deferred tax of HK\$1,872m (2010: HK\$1,627m). The amount credited to the income statement comprises the surplus of HK\$1,033m (2010: HK\$483m) on revaluation of investment properties, and HK\$8m (2010: HK\$102m) 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, the Macau SAR and mainland China, representing 94% 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 6% 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\$191m (2010: HK\$170m) was recognised as rental income in the income statement in respect of operating leases.

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

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Within one year	163	130	9	5
After one but within five years	92	93	18	–
	255	223	27	5

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
In Hong Kong:				
Medium-term leaseholds (between ten and fifty years)	330	348	77	79

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

28 Other assets

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Current taxation recoverable	676	335	550	208
Assets held for sale	8,117	257	8,005	6
Prepayments and accrued income	3,135	3,218	1,558	1,468
Accrued interest receivable	14,524	11,678	5,774	5,813
Acceptances and endorsements	31,750	25,892	21,001	17,041
Other accounts	42,002	19,527	20,050	7,337
	100,204	60,907	56,938	31,873

Assets held for sale comprised assets acquired by repossession of collateral for realisation, own properties held for sale and assets of businesses to be sold.

On 21 December 2011, the group entered into an agreement to sell HSBC's private banking business in Japan to Credit Suisse AG and Credit Suisse Securities (Japan) Limited. The transaction is subject to regulatory approvals and is expected to complete during the first half of 2012.

On 25 January 2012, the group entered into an agreement to sell HSBC's retail banking and wealth management business in Thailand to Bank of Ayudhya Public Company Limited. The transaction is subject to regulatory approvals and is expected to complete during the first half of 2012.

29 Customer accounts

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Current accounts	696,435	643,850	410,911	376,925
Savings accounts	1,826,893	1,765,835	1,275,503	1,204,293
Other deposit accounts	1,041,673	903,559	533,658	463,446
	3,565,001	3,313,244	2,220,072	2,044,664

30 Trading liabilities

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Certificates of deposit in issue	5,790	2,694	1,379	1,667
Other debt securities in issue	15,738	17,919	14,999	14,710
Short positions in securities	44,891	51,089	18,780	31,665
Deposits by banks	6,642	11,103	5,911	10,428
Customer accounts	98,370	68,729	37,890	32,714
	171,431	151,534	78,959	91,184

31 Financial liabilities designated at fair value

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Deposits by banks	302	288	302	288
Customer accounts	1,618	1,688	1,618	1,688
Debt securities in issue	3,990	4,605	3,990	4,605
Liabilities to customers under investment contracts	34,482	33,746	–	–
	40,392	40,327	5,910	6,581

At 31 December 2011, the carrying amount of financial liabilities designated at fair value was HK\$56m higher than the contractual amount at maturity (2010: the carrying amount was HK\$38m lower than the contractual amount). At 31 December 2011, the accumulated gain in fair value attributable to changes in credit risk was HK\$9m (2010: the accumulated loss was HK\$5m).

32 Debt securities in issue

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Certificates of deposit	37,281	36,222	18,871	30,368
Other debt securities	40,191	23,061	27,489	12,771
	77,472	59,283	46,360	43,139

Notes on the Financial Statements (continued)**33 Other liabilities and provisions**

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Accruals and deferred income	23,286	22,502	13,441	13,757
Liabilities held for sale	21,970	–	21,970	–
Provisions for liabilities and charges (note 35)	1,686	1,359	1,184	858
Acceptances and endorsements	31,750	25,950	21,001	17,099
Share based payment liability to HSBC Holdings plc	2,729	1,812	2,212	1,413
Other liabilities	26,893	19,323	11,777	10,905
	108,314	70,946	71,585	44,032

34 Liabilities under insurance contracts issued

	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
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
Investment contracts with discretionary participation features	86	–	86
Life (linked)	30,055	(6,666)	23,389
	206,379	(6,894)	199,485
Total liabilities under insurance contracts	209,438	(7,289)	202,149
2010			
Non-life insurance liabilities			
Unearned premiums	1,495	(158)	1,337
Notified claims	1,008	(219)	789
Claims incurred but not reported	295	(43)	252
Other	122	–	122
	2,920	(420)	2,500
Life insurance liabilities to policyholders			
Life (non-linked)	145,960	(161)	145,799
Investment contracts with discretionary participation features	170	–	170
Life (linked)	28,920	(5,567)	23,353
	175,050	(5,728)	169,322
Total liabilities under insurance contracts	177,970	(6,148)	171,822

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

34 Liabilities under insurance contracts issued (continued)

a Movement of liabilities under insurance contracts

(i) Non-life insurance

	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
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	<u>1,674</u>	<u>(157)</u>	<u>1,517</u>
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	<u>1,240</u>	<u>(238)</u>	<u>1,002</u>
2010			
Unearned premiums			
At 1 January	1,233	(113)	1,120
Gross written premiums	3,166	(457)	2,709
Gross earned premiums	(2,931)	416	(2,515)
Foreign exchange and other movements	27	(4)	23
At 31 December	<u>1,495</u>	<u>(158)</u>	<u>1,337</u>
Notified and incurred but not reported claims			
At 1 January	1,273	(273)	1,000
– Notified claims	953	(235)	718
– Claims incurred but not reported	320	(38)	282
Claims paid in current year	(1,290)	160	(1,130)
Claims incurred	1,276	(140)	1,136
Foreign exchange and other movements	44	(9)	35
At 31 December			
– Notified claims	1,008	(219)	789
– Claims incurred but not reported	295	(43)	252
Total at 31 December	<u>1,303</u>	<u>(262)</u>	<u>1,041</u>

Notes on the Financial Statements (continued)**34 Liabilities under insurance contracts issued** (continued)

(ii) Life insurance liabilities to policyholders

	Gross HK\$m	Reinsurance HK\$m	Net HK\$m
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 policyholders' liabilities	<u>206,379</u>	<u>(6,894)</u>	<u>199,485</u>
2010			
Life (non-linked)			
At 1 January	116,180	(67)	116,113
Benefits paid	(4,030)	157	(3,873)
Increase in liabilities to policyholders	32,896	(154)	32,742
Foreign exchange and other movements	914	(97)	817
At 31 December	<u>145,960</u>	<u>(161)</u>	<u>145,799</u>
Life (linked)			
At 1 January	25,846	(6,237)	19,609
Benefits paid	(2,330)	298	(2,032)
Increase in liabilities to policyholders	5,002	960	5,962
Foreign exchange and other movements	402	(588)	(186)
At 31 December	<u>28,920</u>	<u>(5,567)</u>	<u>23,353</u>
Investment contracts with discretionary participation features			
At 1 January	269	–	269
Benefits paid	(122)	–	(122)
Increase in liabilities to policyholders	3	–	3
Foreign exchange and other movements	20	–	20
At 31 December	<u>170</u>	<u>–</u>	<u>170</u>
Total policyholders' liabilities	<u>175,050</u>	<u>(5,728)</u>	<u>169,322</u>

35 Provisions for liabilities and charges

Provisions for liabilities and charges

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
At 1 January	1,359	1,226	858	800
Additional provisions/increase in provisions	767	195	707	184
Provisions utilised	(276)	(114)	(243)	(96)
Amounts reversed	(85)	(68)	(54)	(52)
Exchange and other movements	(79)	120	(84)	22
At 31 December	1,686	1,359	1,184	858

Of which: provisions for restructuring costs

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
At 1 January	83	22	77	–
Additional provisions/increase in provisions	631	134	580	122
Provisions utilised	(233)	(77)	(211)	(45)
Amounts reversed	(8)	(2)	(2)	–
Exchange and other movements	3	6	(5)	–
At 31 December	476	83	439	77

36 Subordinated liabilities

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

		2011 HK\$m	2010 HK\$m
<i>The Bank</i>			
US\$1,200m	Undated floating rate primary capital notes	9,386	9,404
		9,386	9,404
<i>The group</i>			
A\$200m	Floating rate subordinated notes due 2016, callable from 2011 ¹	–	1,583
A\$42m	Floating rate subordinated notes due 2018, callable from 2013 ²	332	332
A\$200m	Floating rate subordinated notes due 2020, callable from 2015	1,580	1,583
US\$450m	Floating rate subordinated notes due 2016, callable from 2011 ³	–	3,495
US\$300m	Floating rate subordinated notes due 2017, callable from 2012 ⁴	2,328	2,328
RM500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017 ⁵	1,227	1,263
RM500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022 ⁶	1,261	1,266
		16,114	21,254

1 The A\$200m callable subordinated floating rate notes due 2016 were redeemed in May 2011.

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

3 The US\$450m callable subordinated floating rate notes due 2016 were redeemed in July 2011.

4 The interest rate on the US\$300m callable subordinated floating rate notes due 2017 will increase by 0.5% from July 2012.

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

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

Notes on the Financial Statements (continued)**37 Preference shares***Authorised*

At both 31 December 2011 and 31 December 2010, the authorised preference share capital of the Bank was US\$13,450,500,000 comprising 3,750,500,000 cumulative redeemable preference shares of US\$1 each, 7,500,000,000 non-cumulative irredeemable preference shares of US\$1 each and 2,200,000,000 cumulative irredeemable preference shares of US\$1 each.

At a group level, there was an additional Rs.900,000,000 (2010: Rs.900,000,000) of authorised preference share capital comprising 9,000,000 compulsorily convertible preference shares of Rs.100 each in the share capital of a subsidiary.

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Issued and fully paid				
Redeemable preference shares	24,862	29,153	24,862	29,153
Irredeemable preference shares	68,354	68,422	68,227	68,270
Share premium	3,880	3,883	3,880	3,883
	97,096	101,458	96,969	101,306

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. 1,750,000,000 cumulative redeemable preference shares were issued in 2007, which have mandatory redemption dates between 29 March and 24 November 2017 but may be redeemed at the Bank's option on or after dates starting between 29 March and 24 November 2012, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1 per share.

400,000,000 cumulative redeemable preferences shares were issued in 2008, which have a mandatory redemption date of 29 March 2023 but may be redeemed at the Bank's option on or after 29 March 2018, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1 per share. 1,050,000,000 cumulative redeemable preferences shares were issued in 2009, which have a mandatory redemption date of 2 January 2024 but may be redeemed at the Bank's option on or after 2 January 2019, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US\$1 per share. 550,000,000 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 2011 was 3,200,500,000 (2010: 3,750,500,000). No cumulative redeemable preference shares were issued during the year (2010: nil).

The non-cumulative irredeemable preference shares were issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. 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 2011 was 6,653,000,000 (2010: 6,653,000,000). No non-cumulative irredeemable preference shares were issued during the year (2010: nil).

37 Preference shares (continued)

The cumulative irredeemable preference shares were issued at nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, holders of the shares shall be entitled to receive the issue price of US\$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of cancellation, subject to the Bank having sufficient distributable profits. The number of issued cumulative irredeemable preference shares at 31 December 2011 was 2,130,000,000 (2010: 2,130,000,000). No cumulative irredeemable preference shares were issued during the year (2010: nil).

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

8,700,000 compulsorily convertible preference shares (CCPS) were issued by HSBC InvestDirect Securities (India) Limited ("HSBC InvestDirect") in 2009 at a nominal value of Rs.100 each. The shares are irredeemable and may be converted into fully paid equity shares of HSBC InvestDirect 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.

38 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2011 was HK\$50,000m (2010: HK\$30,000m) divided into 20,000m (2010: 12,000m) ordinary shares of HK\$2.50 each subsequent to the increase in authorised ordinary share capital by the creation of HK\$20,000m divided into 8,000m new ordinary shares of HK\$2.5 each on 21 December 2011. 3,078,560,000 new ordinary shares were issued during 2011 (2010: nil).

Issued and fully paid

	The group and the Bank	
	2011 HK\$m	2010 HK\$m
Ordinary share capital	30,190	22,494

	The group and the Bank	
	2011 Number	2011 HK\$m
Ordinary shares of HK\$2.50 each		
At 1 January	8,997,587,294	22,494
Issued during the year	3,078,560,000	7,696
At 31 December	12,076,147,294	30,190

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

Notes on the Financial Statements (continued)

39 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. The effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders.

In accordance with updated guidance from the HKMA, the regulatory reserve has been increased to HK\$17,108m (31 Dec 2010: HK\$7,702m).

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.

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

2011	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	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 after one month	-	-	143,663	29,835	17,917	6,872	-	-	-	198,287
Certificates of deposit	-	13,008	18,542	47,138	5,559	4,399	45	-	-	88,691
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
Goodwill and intangible assets	-	-	-	-	-	-	-	-	-	34,839
Property, plant and equipment	-	-	-	-	-	-	-	-	-	85,294
Deferred tax assets	-	-	-	-	-	-	-	-	-	2,325
Retirement benefits	-	-	-	-	-	-	-	-	-	111
Other assets	12,288	20,434	15,898	22,152	4,034	8,817	16,581	-	-	100,204
Total assets at 31 December 2011	658,925	727,358	687,309	771,881	942,846	675,903	306,873	835,725	660	5,607,480

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										
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 at 31 December 2011	2,926,267	652,300	376,403	226,384	68,918	45,801	347,706	589,095	3,263	5,236,137

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										
Assets										
Cash and short-term funds	214,248	151,511	176,113	70,393	-	-	-	-	-	612,265
Items in the course of collection	-	-	-	-	-	-	-	-	-	-
from other banks	-	29,821	-	-	-	-	-	-	-	29,821
Placements with banks maturing	-	-	84,073	9,024	15,283	493	-	-	-	108,873
after one month	-	5,987	6,467	9,943	1,584	-	6	-	-	23,987
Certificates of deposit	-	-	-	-	-	-	-	-	-	-
Hong Kong Government certificates	162,524	-	-	-	-	-	-	-	-	162,524
of indebtedness	-	-	-	-	-	-	-	317,321	-	317,321
Trading assets	-	-	-	-	-	-	-	-	-	-
Financial assets designated at	-	-	728	172	1,383	-	-	-	-	2,283
fair value	-	-	728	172	1,383	-	-	-	-	2,283
Debt securities	-	-	-	-	-	-	-	-	-	-
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
Retirement benefits	-	-	-	-	-	-	73	-	-	73
Other assets	2,822	11,478	9,417	14,752	3,162	428	14,879	-	-	56,938
Total assets at 31 December 2011	519,871	443,332	465,298	425,758	525,472	344,360	188,796	702,137	317	3,615,341

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
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 at	2,002,523	462,083	190,583	113,825	42,127	41,138	90,280	487,929	1,453	3,431,941
31 December 2011										

40 Maturity analysis of assets and liabilities (continued)

The group

2010	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	291,330	284,382	138,644	93,629	—	—	—	—	—	807,985
Items in the course of collection from other banks	—	16,878	—	—	—	—	—	—	—	16,878
Placements with banks maturing after one month	—	—	114,975	27,338	3,800	3,444	—	—	—	149,557
Certificates of deposit	—	7,874	14,583	42,371	5,459	2,917	43	—	—	73,247
Hong Kong Government certificates of indebtedness	148,134	—	—	—	—	—	—	—	—	148,134
Trading assets	—	—	—	—	—	—	—	390,208	—	390,208
Financial assets designated at fair value	—	395	371	1,947	10,625	4,588	36,678	—	—	54,604
Debt securities	—	395	371	1,947	9,994	4,588	4	—	—	17,299
Equity shares	—	—	—	—	—	—	36,674	—	—	36,674
Other	—	—	—	—	631	—	—	—	—	631
Derivatives	—	—	—	—	—	—	—	301,304	1,318	302,622
Loans and advances to customers	112,775	246,351	205,109	312,261	550,396	477,162	(12,994)	—	—	1,891,060
Financial investments	—	40,743	61,393	236,663	323,684	90,122	74,057	—	—	826,662
Debt securities held to maturity	—	279	892	5,868	48,549	66,155	—	—	—	121,743
Debt securities available for sale	—	40,464	60,501	230,795	275,135	23,967	1,222	—	—	632,084
Equity shares available for sale	—	—	—	—	—	—	72,835	—	—	72,835
Amounts due from Group companies	23,727	39,922	8,494	13,577	7,884	3,632	—	40,397	—	137,633
Interests in associates and joint ventures	—	—	—	—	—	—	—	—	—	—
Goodwill and intangible assets	—	—	—	—	—	—	75,568	—	—	75,568
Property, plant and equipment	—	—	—	—	—	—	29,690	—	—	29,690
Deferred tax assets	—	—	—	—	—	—	72,347	—	—	72,347
Retirement benefits	—	—	—	—	—	—	2,515	—	—	2,515
Other assets	3,295	17,093	13,464	12,997	1,680	7,783	301	—	—	301
Total assets at 31 December 2010	579,261	653,638	557,033	740,783	903,528	589,648	282,800	731,909	1,318	5,039,918

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
2010										
Liabilities										
Hong Kong currency notes in circulation	148,134	—	—	—	—	—	—	—	—	148,134
Items in the course of transmission to other banks	—	26,495	—	—	—	—	—	—	—	26,495
Deposits by banks	80,553	79,196	5,694	1,384	699	301	—	—	—	167,827
Customer accounts	2,528,031	384,068	227,183	160,456	13,112	394	—	—	—	3,313,244
Trading liabilities	—	—	—	—	—	—	—	151,534	—	151,534
Financial liabilities designated at fair value	99	—	740	—	5,681	448	33,359	—	—	40,327
Derivatives	—	—	—	—	—	—	—	307,225	2,613	309,838
Debt securities in issue	1,933	15,438	16,902	14,559	5,806	4,645	—	—	—	59,283
Retirement benefit liabilities	—	—	—	—	—	—	4,713	—	—	4,713
Amounts due to Group companies	23,032	15,324	2,118	3,510	7,813	6,168	—	25,163	—	83,128
Other liabilities and provisions	5,121	18,072	24,764	16,020	2,825	196	3,948	—	—	70,946
Liabilities under insurance contracts issued	853	—	—	—	—	—	177,117	—	—	177,970
Current tax liabilities	1	590	650	3,178	—	—	—	—	—	4,419
Deferred tax liabilities	—	—	—	—	—	—	11,913	—	—	11,913
Subordinated liabilities	—	—	—	5,078	4,243	2,529	9,404	—	—	21,254
Preference shares	—	—	—	—	—	33,036	68,422	—	—	101,458
Total liabilities at 31 December 2010	2,787,757	539,183	278,051	204,185	40,179	47,717	308,876	483,922	2,613	4,692,483

40 Maturity analysis of assets and liabilities (continued)

The Bank

2010	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	201,340	139,998	131,708	77,957	–	–	–	–	–	551,003
Items in the course of collection from other banks	–	12,143	–	–	–	–	–	–	–	12,143
Placements with banks maturing after one month	–	–	52,915	17,816	3,667	393	–	–	–	74,791
Certificates of deposit	–	4,229	7,014	15,243	1,402	–	–	–	–	27,888
Hong Kong Government certificates of indebtedness	148,134	–	–	–	–	–	–	–	–	148,134
Trading assets	–	–	–	–	–	–	–	297,929	–	297,929
Financial assets designated at fair value	–	–	149	233	1,704	–	–	–	–	2,086
Debt securities	–	–	149	233	1,704	–	–	–	–	2,086
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–	294,739	740	295,479
Loans and advances to customers	64,594	119,356	109,816	174,537	310,755	246,227	(8,973)	–	–	1,016,312
Financial investments	–	31,135	29,481	169,206	196,586	15,180	62,164	–	–	503,752
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available for sale	–	31,135	29,481	169,206	196,586	15,180	748	–	–	442,336
Equity shares available for sale	–	–	–	–	–	–	61,416	–	–	61,416
Amounts due from Group companies	33,748	54,700	11,981	21,085	16,469	16,999	–	43,340	–	198,322
Investments in subsidiaries	–	–	–	–	–	–	52,924	–	–	52,924
Interests in associates and joint ventures	–	–	–	–	–	–	28,139	–	–	28,139
Goodwill and intangible assets	–	–	–	–	–	–	4,713	–	–	4,713
Property, plant and equipment	–	–	–	–	–	–	45,061	–	–	45,061
Deferred tax assets	–	–	–	–	–	–	1,104	–	–	1,104
Retirement benefits	–	–	–	–	–	–	179	–	–	179
Other assets	1,727	10,685	7,635	6,856	1,030	488	3,452	–	–	31,873
Total assets at 31 December 2010	449,543	372,246	350,699	482,933	531,613	279,287	188,763	636,008	740	3,291,832

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
2010										
Liabilities										
Hong Kong currency notes in circulation	148,134	–	–	–	–	–	–	–	–	148,134
Items in the course of transmission to other banks	–	17,951	–	–	–	–	–	–	–	17,951
Deposits by banks	59,636	63,872	4,762	1,322	583	301	–	–	–	130,476
Customer accounts	1,635,640	249,273	85,495	65,231	8,693	332	–	–	–	2,044,664
Trading liabilities	–	–	–	–	–	–	–	91,184	–	91,184
Financial liabilities designated at fair value	–	–	740	–	5,681	132	28	–	–	6,581
Derivatives	–	–	–	–	–	–	–	302,365	1,517	303,882
Debt securities in issue	1,933	15,257	13,972	8,789	1,370	1,818	–	–	–	43,139
Retirement benefit liabilities	–	–	–	–	–	–	2,465	–	–	2,465
Amounts due to Group companies	40,794	49,588	15,396	10,172	8,067	6,348	–	15,529	–	145,894
Other liabilities and provisions	2,957	11,287	16,460	8,831	2,124	169	2,204	–	–	44,032
Current tax liabilities	1	336	333	2,016	–	–	–	–	–	2,686
Deferred tax liabilities	–	–	–	–	–	–	5,525	–	–	5,525
Subordinated liabilities	–	–	–	–	–	–	9,404	–	–	9,404
Preference shares	–	–	–	–	–	33,036	68,270	–	–	101,306
Total liabilities at 31 December 2010	1,889,095	407,564	137,158	96,361	26,518	42,136	87,896	409,078	1,517	3,097,323

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 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
At 31 December 2010						
Hong Kong currency notes						
in circulation	148,134	–	–	–	–	148,134
Items in the course of transmission						
to other banks	–	26,495	–	–	–	26,495
Deposits by banks	80,558	84,971	1,399	741	344	168,013
Customer accounts	2,528,174	614,212	165,007	14,834	486	3,322,713
Trading liabilities	151,534	–	–	–	–	151,534
Financial liabilities designated at						
fair value	99	803	205	6,128	33,795	41,030
Derivatives	307,286	334	953	1,163	124	309,860
Debt securities in issue	1,933	32,676	15,144	6,713	6,382	62,848
Amounts due to Group companies ..	48,200	17,453	3,532	7,837	6,201	83,223
Other financial liabilities	4,542	38,925	15,034	2,253	191	60,945
Subordinated liabilities	–	211	5,508	6,475	16,078	28,272
Preference shares	–	919	1,499	9,670	122,519	134,607
	3,270,460	816,999	208,281	55,814	186,120	4,537,674
Loan commitments	1,044,586	289,498	25,961	11,050	19	1,371,114
Financial guarantee and credit risk						
related guarantee contracts	40,752	–	–	–	–	40,752
	4,355,798	1,106,497	234,242	66,864	186,139	5,949,540

Notes on the Financial Statements (continued)**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 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
At 31 December 2010						
Hong Kong currency notes						
in circulation	148,134	–	–	–	–	148,134
Items in the course of transmission						
to other banks	–	17,951	–	–	–	17,951
Deposits by banks	59,640	68,678	1,336	623	344	130,621
Customer accounts	1,635,681	335,626	66,849	9,679	396	2,048,231
Trading liabilities	91,184	–	–	–	–	91,184
Financial liabilities designated at						
fair value	–	803	205	6,128	148	7,284
Derivatives	302,368	210	583	586	145	303,892
Debt securities in issue	1,933	29,392	8,993	1,541	2,142	44,001
Amounts due to Group companies ..	56,328	65,001	10,187	8,091	6,404	146,011
Other financial liabilities	2,708	25,256	8,398	1,660	158	38,180
Subordinated liabilities	–	120	205	1,298	12,573	14,196
Preference shares	–	919	1,499	9,670	122,368	134,456
	2,297,976	543,956	98,255	39,276	144,678	3,124,141
Loan commitments	640,773	213,000	7,665	6,537	19	867,994
Financial guarantee and credit risk						
related guarantee contracts	23,353	–	–	–	–	23,353
	2,962,102	756,956	105,920	45,813	144,697	4,015,488

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.

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

	2011 HK\$m	2010 HK\$m
Operating profit	76,287	66,703
Net interest income	(75,672)	(61,876)
Dividend income	(729)	(564)
Depreciation and amortisation	5,638	5,089
Amortisation of prepaid operating lease payments	18	18
Loan impairment charges and other credit risk provisions	3,059	4,619
Loans and advances written off net of recoveries	(4,138)	(5,557)
Other provisions for liabilities and charges	723	161
Provisions utilised	(276)	(114)
Surplus arising on property revaluation	(8)	(102)
Gains on investment properties	(1,033)	(483)
Loss/(Profit) on disposal of property, plant and equipment and assets held for sale	3	(13)
Loss/(Profit) on disposal of subsidiaries, associates and business portfolios	9	(603)
Gains less losses from financial investments	(128)	(2,016)
Share based payments granted cost free	2,274	1,427
Interest received	90,790	70,449
Interest paid	(27,458)	(19,535)
Operating profit before changes in working capital	69,359	57,603
Change in treasury bills with original term to maturity of more than three months	(56,042)	56,186
Change in placings with banks maturing after one month	(48,730)	(42,482)
Change in certificates of deposit with original term to maturity of more than three months	(15,773)	(35,189)
Change in trading assets	(39,833)	(94,985)
Change in trading liabilities	19,897	(2,832)
Change in financial assets designated as fair value	(3,066)	(6,517)
Change in financial liabilities designated as fair value	65	3,618
Change in derivative assets	(74,674)	(67,451)
Change in derivative liabilities	73,414	76,992
Change in financial investments held for backing liabilities to long-term policyholders	(19,813)	18,682
Change in loans and advances to customers	(243,760)	(539,117)
Change in amounts due from Group companies	(15,097)	(3,045)
Change in other assets	(54,932)	(24,354)
Change in deposits by banks	54,755	56,620
Change in customer accounts	251,757	368,701
Change in amounts due to Group companies	22,043	32,735
Change in debt securities in issue	18,189	15,887
Change in liabilities under insurance contracts issued	31,468	33,042
Change in other liabilities	47,405	(3,465)
Exchange adjustments	(49)	(8,553)
Cash generated from/(used in) operations	16,583	(107,924)

Notes on the Financial Statements (continued)**43 Analysis of cash and cash equivalents****a** *Change in cash and cash equivalents during the year*

	2011 HK\$m	2010 HK\$m
Balance at 1 January	618,199	675,234
Net cash inflow/(outflow) before the effect of foreign exchange movements	70,898	(85,858)
Effect of foreign exchange movements	(424)	28,823
Balance at 31 December	688,673	618,199

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

	2011 HK\$m	2010 HK\$m
Cash in hand and sight balances with central banks	110,107	81,381
Items in the course of collection from other banks	34,546	16,878
Placings with banks	481,842	472,774
Treasury bills	96,443	60,149
Certificates of deposit	11,421	12,331
Other eligible bills	1,477	1,181
Less: items in the course of transmission to other banks	(47,163)	(26,495)
	688,673	618,199

c *Analysis of net outflow of cash and cash equivalents in respect of the acquisition of and increased shareholding in subsidiaries*

	2011 HK\$m	2010 HK\$m
Cash consideration	(187)	(188)
Cash and cash equivalents acquired	44	61
	(143)	(127)

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

	2011 HK\$m	2010 HK\$m
Sale proceeds	43	7
Cash and cash equivalents transferred	(42)	(20)
	1	(13)

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

	2011 HK\$m	2010 HK\$m
Sale proceeds	5,649	-
Cash and cash equivalents transferred	-	-
	5,649	-

44 Contingent liabilities and commitments

a Off-balance sheet contingent liabilities and commitments

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	192,428	164,145	128,827	118,568
Other contingent liabilities	359	213	454	386
	192,787	164,358	129,281	118,954
Commitments				
Documentary credits and short-term trade-related transactions	44,524	45,572	33,233	33,476
Forward asset purchases and forward forward deposits placed	2,524	1,299	255	–
Undrawn formal standby facilities, credit lines and other commitments to lend	1,425,590	1,324,243	896,961	834,518
	1,472,638	1,371,114	930,449	867,994

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

Notes on the Financial Statements (continued)**44 Contingent liabilities and commitments** (continued)**b Guarantees** (including financial guarantee contracts)

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

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Guarantees in favour of third parties				
Financial guarantee contracts ¹	26,694	23,538	12,904	12,970
Standby letters of credit which are financial guarantee contracts ²	19,684	17,374	10,294	9,960
Other direct credit substitutes ³	38,211	36,798	32,311	30,782
Performance bonds ⁴	54,429	46,116	39,289	35,479
Bid bonds ⁴	2,169	1,911	1,602	1,539
Standby letters of credit related to particular transactions ⁴	12,169	8,653	7,630	4,872
Other transaction-related guarantees ⁴	31,892	25,034	17,678	16,636
	185,248	159,424	121,708	112,238
Guarantees in favour of other HSBC Group entities	7,180	4,721	7,119	6,330
	192,428	164,145	128,827	118,568

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.

c Contingencies

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

45 Assets pledged as security for liabilities and collateral accepted as security for assets

Liabilities of the group amounting to HK\$112,721m (2010: HK\$64,772m) and of the Bank amounting to HK\$70,013m (2010: HK\$45,264m) are secured by the deposit of assets, including assets pledged in respect of sale and repurchase agreements, to cover short positions and to facilitate settlement processes with clearing houses. The amount of assets pledged by the group to secure these liabilities is HK\$117,963m (2010: HK\$73,002m) and by the Bank is HK\$74,594m (2010: HK\$54,890m). These assets comprise treasury bills, debt securities, equities, and deposits.

In respect of reverse repo and stock borrowing transactions, the fair value of collateral held by the group which was permitted to be sold or repledged amounted to HK\$120,319m (2010: HK\$151,012m), and by the Bank HK\$88,197m (2010: HK\$101,438m). The fair value of such collateral actually sold or repledged by the group amounted to HK\$14,504m (2010: HK\$26,242m) and by the Bank HK\$5,980m (2010: HK\$7,792m).

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

46 Capital commitments

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Expenditure contracted for	3,511	1,011	3,355	913
Expenditure authorised by the Directors but not contracted for	6	42	2	–
	3,517	1,053	3,357	913

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Premises				
Amounts payable within				
– one year or less	3,734	2,652	1,414	1,446
– five years or less but over one year	4,603	4,161	2,385	2,067
– over five years	1,103	659	761	254
	9,440	7,472	4,560	3,767
Equipment				
Amounts payable within				
– one year or less	71	67	6	4
– five years or less but over one year	100	113	9	2
	171	180	15	6

Notes on the Financial Statements (continued)

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.

From 1 January 2011 the Asset Management Group, previously reported within GB&M, was combined with the global business previously reported as Personal Financial Services (PFS) to form Retail Banking and Wealth Management ('RBWM'). Global business comparative information has been restated accordingly.

48 Segmental analysis (continued)

Total assets

	2011		2010	
	HK\$m	%	HK\$m	%
Hong Kong	3,594,991	64.1	3,276,432	65.0
Rest of Asia-Pacific	2,429,228	43.3	2,117,894	42.0
Intra region	(416,739)	(7.4)	(354,408)	(7.0)
	5,607,480	100.0	5,039,918	100.0

Total liabilities

	2011		2010	
	HK\$m	%	HK\$m	%
Hong Kong	3,436,629	65.6	3,130,937	66.7
Rest of Asia-Pacific	2,216,247	42.3	1,915,954	40.8
Intra region	(416,739)	(7.9)	(354,408)	(7.5)
	5,236,137	100.0	4,692,483	100.0

Interests in associates and joint ventures

	2011		2010	
	HK\$m	%	HK\$m	%
Hong Kong	1,525	1.7	1,607	2.1
Rest of Asia-Pacific	90,260	98.3	73,961	97.9
	91,785	100.0	75,568	100.0

Credit commitments (contract amounts)

	2011		2010	
	HK\$m	%	HK\$m	%
Hong Kong	769,088	46.2	743,732	48.4
Rest of Asia-Pacific	896,337	53.8	791,740	51.6
	1,665,425	100.0	1,535,472	100.0

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

	2011		2010	
	HK\$m	%	HK\$m	%
Hong Kong	1,740	59.9	2,590	41.9
Rest of Asia-Pacific	1,167	40.1	3,596	58.1
	2,907	100.0	6,186	100.0

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

Consolidated income statement:

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Intra-segment elimination HK\$m	Total HK\$m
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 policyholders' liabilities	(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)

	Hong Kong HK\$m	Rest of Asia-Pacific HK\$m	Intra-segment elimination HK\$m	Total HK\$m
2010				
Interest income	37,687	50,325	(2,489)	85,523
Interest expense	(5,951)	(20,202)	2,506	(23,647)
Net interest income	31,736	30,123	17	61,876
Fee income	24,972	17,628	(943)	41,657
Fee expense	(3,892)	(3,425)	943	(6,374)
Net trading income	8,699	12,034	(17)	20,716
Net income from financial instruments designated at fair value	3,454	303	–	3,757
Gains less losses from financial investments	937	1,079	–	2,016
Dividend income	545	19	–	564
Net earned insurance premiums	33,713	3,480	–	37,193
Other operating income	12,714	2,282	(4,992)	10,004
Total operating income	112,878	63,523	(4,992)	171,409
Net insurance claims incurred and movement in policyholders' liabilities	(37,022)	(2,821)	–	(39,843)
Net operating income before loan impairment charges and other credit risk provisions	75,856	60,702	(4,992)	131,566
Loan impairment charges and other credit risk provisions	(883)	(3,736)	–	(4,619)
Net operating income	74,973	56,966	(4,992)	126,947
Operating expenses	(33,053)	(32,183)	4,992	(60,244)
Operating profit	41,920	24,783	–	66,703
Share of profit in associates and joint ventures	270	10,912	–	11,182
Profit before tax	42,190	35,695	–	77,885
Tax expense	(7,353)	(7,255)	–	(14,608)
Profit for the year	34,837	28,440	–	63,277
Profit attributable to shareholders	30,419	27,178	–	57,597
Profit attributable to non-controlling interests	4,418	1,262	–	5,680
Net operating income				
– external	68,348	57,499	–	125,847
– inter-company/inter-segment	6,625	(533)	(4,992)	1,100
Depreciation and amortisation included in operating expenses	(3,675)	(1,414)	–	(5,089)
Restructuring costs	(86)	(271)	–	(357)

Notes on the Financial Statements (continued)**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 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
Year ended 31 December 2010							
External	46,254	25,910	51,923	(20)	1,780	–	125,847
Intercompany/intersegment	8,309	2,012	(8,178)	343	5,986	(7,372)	1,100

Information by country

	Net external operating income ¹		Non-current assets ²	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Hong Kong	70,903	68,348	91,177	67,424
Mainland China	11,952	6,069	91,687	75,410
Australia	7,115	6,020	1,629	1,652
India	9,684	8,445	2,342	2,901
Indonesia	4,715	4,045	5,349	5,532
Malaysia	7,232	5,784	1,033	982
Singapore	8,028	6,774	1,256	830
Taiwan	3,717	3,165	2,564	2,619
Vietnam	1,606	1,288	2,742	282
Other	17,039	15,909	5,151	7,476
Total	141,991	125,847	204,930	165,108

1 Net external operating income is attributable to countries based on the location of the principal operations of the subsidiary or branch.

2 Non-current assets consist of property, plant and equipment, goodwill, other intangible assets, interests in associates and joint ventures and certain other assets expected to be recovered more than 12 months after the reporting date.

49 Related party transactions

a Immediate and ultimate holding company

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

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 payment of interest on preference shares. As at 31 December 2011, the Bank has issued HK\$96,969m of preference shares to its immediate holding company (2010: HK\$101,306m). 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 2011, the Bank has issued HK\$9,599m of subordinated liabilities to its ultimate holding company (2010: HK\$6,106m). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Interest expense ¹	2,337	2,659	172	23
Other operating income	–	–	150	252
Other operating expenses	30	28	1,584	1,341

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Amounts due from ¹	–	–	167	319
Amounts due to ²	98,243	102,669	9,990	6,351

The Bank

	Immediate holding company		Ultimate holding company	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Amounts due from ¹	–	–	167	319
Amounts due to ²	98,243	102,669	9,916	6,287

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\$96,969m (2010: HK\$101,306m). Amounts due to the ultimate holding company included subordinated liabilities of HK\$9,599m (2010: HK\$6,106m).

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK\$283m (2010: HK\$353m).

Notes on the Financial Statements (continued)**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 Holdings plc whereby share options or shares of HSBC Holdings plc 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 these share options and share awards is treated as a capital contribution and is recorded under 'Other reserves'. In respect of share awards, the group recognises a liability due to the ultimate holding company and a corresponding reduction in capital contribution on a straight-line basis over the vesting period for the amount of share awards expected to vest. The liability is measured at the fair value of the shares at each reporting date. The balances of the capital contribution and the liability as at 31 December 2011 amounted to HK\$2,915m and HK\$2,729m respectively (2010: HK\$2,223m and HK\$1,812m respectively).

c Pension funds

At 31 December 2011, HK\$12.5bn (2010: HK\$13.4bn) 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\$53m for the year (2010: HK\$49m).

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

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

Income and expenses for the year

	Fellow subsidiaries	
	2011 HK\$m	2010 HK\$m
Interest income	445	547
Interest expense	797	488
Fee income	2,470	1,969
Fee expense	935	1,065
Other operating income	3,227	2,576
Other operating expenses ¹	5,169	4,002

¹ In 2011 payments were made of HK\$1,271m (2010: HK\$922m) for software costs which were capitalised as intangible assets in the balance sheet of the group.

49 Related party transactions (continued)

Balances at 31 December

The group

	Fellow subsidiaries	
	2011 HK\$m	2010 HK\$m
Assets		
Trading assets	11,120	40,396
Financial assets designated at fair value	5,390	5,453
Other assets	136,051	91,465
	152,561	137,314
Liabilities		
Trading liabilities	37,675	25,164
Financial liabilities designated at fair value	5	3
Other liabilities	59,605	50,399
	97,285	75,566
Guarantees	7,180	4,721
Commitments	6,689	17,615

The Bank

	Subsidiaries		Fellow subsidiaries	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Assets				
Trading assets	3,486	4,549	10,970	38,792
Financial assets designated at fair value	–	–	–	–
Other assets	113,761	77,244	119,616	77,418
	117,247	81,793	130,586	116,210
Liabilities				
Trading liabilities	7,421	8,165	25,837	7,364
Financial liabilities designated at fair value	–	–	–	–
Other liabilities	54,655	77,571	53,803	45,144
	62,076	85,736	79,640	52,508
Guarantees	1,039	2,507	6,080	3,823
Commitments	38,484	24,334	3,639	15,363

Notes on the Financial Statements (continued)**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

	2011		2010	
	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	31	31
– unsubordinated	23,418	19,183	16,312	12,930
Amounts due from joint ventures				
– subordinated	13	6	8	8
– unsubordinated	1,107	966	1,493	699
	24,572	20,188	17,844	13,668
Amounts due to associates	4,536	3,672	5,329	4,077
Amounts due to joint ventures	1,488	1,013	1,140	1,013
	6,024	4,685	6,469	5,090
Commitments	1,431	711	470	337

The Bank

	2011		2010	
	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	7,509	3,825	7,045	4,513
Amounts due from joint ventures				
– unsubordinated	881	876	1,293	608
	8,390	4,701	8,338	5,121
Amounts due to associates	1,065	1,065	1,158	738
Amounts due to joint ventures	1,486	1,011	1,139	1,013
	2,551	2,076	2,297	1,751
Commitments	1,012	351	226	226

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

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

49 Related party transactions (continued)

f Key Management Personnel

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the Bank and the group. It includes members of the Board of Directors and Executive Committee of the Bank and the Board of Directors and Group Managing Directors of HSBC Holdings plc.

The following table shows the expense in respect of compensation for Key Management Personnel of the Bank for services rendered to the Bank:

	2011 HK\$m	2010 HK\$m
Salaries and other short term benefits	220	207
Retirement benefits		
– Defined contribution plans	8	12
– Defined benefit plans	2	1
Share-based payments	110	118
	340	338

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:

	2011 HK\$m	2010 HK\$m
For the year		
Average assets	22,177	17,282
Average liabilities	27,536	24,206
Contribution to the group's profit before tax	818	439
At the year end		
Guarantees	3,874	2,487
Commitments	6,417	5,842

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.

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:

	Aggregate amount of loans outstanding at 31 December		Maximum aggregate amount of loans outstanding during the year	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
By the Bank	73	70	83	117
By subsidiaries	13	4	15	22
	86	74	98	139

Notes on the Financial Statements (continued)

50 Share-based payments

a Income statement charge

	2011 HK\$m	2010 HK\$m
Restricted share awards	1,907	1,044
Performance share awards	17	8
Savings-related share option plans	350	375
	2,274	1,427
Equity-settled share-based payments	2,274	1,427
Cash-settled share-based payments	–	–

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.

HSBC Share Awards

Award	Policy	Purpose
Restricted share awards	<ul style="list-style-type: none"> Vesting of awards based on continued employment with HSBC of between one and five years from the date of award Shares awarded without corporate performance conditions Certain shares awarded subject to a retention requirement until cessation of employment 	<ul style="list-style-type: none"> Rewards employee performance, potential and retention requirements To aid recruitment Part-deferral of annual bonuses
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

b Movement on HSBC share awards

The group	Restricted share awards		Performance share awards ¹		Achievement share awards ¹	
	2011 Number (000s)	2010 Number (000s)	2011 Number (000s)	2010 Number (000s)	2011 Number (000s)	2010 Number (000s)
Outstanding at 1 January	38,476	21,759	283	676	2,911	5,203
Additions during the year	17,380	23,912	10	17	33	123
Released in the year	(4,674)	(4,554)	(61)	(140)	(2,886)	(2,103)
Transferred in the year	744	340	–	(37)	(12)	(50)
Lapsed in the year	(1,701)	(2,981)	(232)	(233)	(46)	(262)
Outstanding at 31 December	50,225	38,476	–	283	–	2,911
Weighted average remaining vesting period (years)	0.68	1.30	–	0.23	–	0.25

¹ Additions during the year comprised reinvested dividend equivalents.

50 Share-based payments (continued)

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% (2010: 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 the next page 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.

c 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
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
2010			
Risk-free interest rate ¹ (%)	0.7	1.9	2.9
Expected life ² (years)	1	3	5
Expected volatility ³ (%)	30	30	30
Share price at grant date (£)	6.82	6.82	6.82

1 The risk-free rate was determined from the UK gilts yield curve. A similar yield curve was used for the International Savings-Related Share Option Plans.

2 The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historical observable data and is not a single input parameter but a function of various behavioural assumptions.

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

The expected US dollar denominated dividend yield was determined to be 4.5% per annum in line with consensus analyst forecasts (2010: 4.5%) which vested in subsequent years.

Notes on the Financial Statements (continued)**50 Share-based payments** (continued)**d 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\$
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
2010						
Outstanding at 1 January	22,379	7.03	16,151	3.67	48,513	38.49
Granted during the year	–	–	3,755	5.46	4,796	62.98
Forfeited/expired in the year	(1,305)	6.89	(1,734)	4.32	(3,116)	44.10
Exercised during the year	(1,226)	6.43	(2,859)	3.91	(4,847)	38.26
Transferred in the year	47	6.92	91	3.87	(40)	49.10
Outstanding at 31 December	19,895	7.07	15,404	3.99	45,306	40.72
Exercisable at 31 December	19,895	7.07	233	6.09	69	94.51
At 31 December 2010						
Weighted average fair value of options granted during the year...		–		1.48		19.02
Weighted average share price at the date the options were exercised .		6.65		6.53		79.38
Weighted average remaining contractual life (years)		2.15		2.45		2.89
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 utilised. 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. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (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

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.

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(b).

Notes on the Financial Statements (continued)

51 Fair value of financial instruments (continued)

Credit risk adjustment methodology

A separate credit risk adjustment is calculated for each legal entity of the group, and within each entity for each counterparty to which the entity has exposure. The calculation of the monoline credit risk adjustment and sensitivity to different assumptions is described below. The credit risk adjustment is calculated by applying the probability of default of the counterparty to the expected positive exposure to the counterparty, and multiplying the result by the loss expected in the event of default. The calculation is performed over the life of the potential exposure.

The probability of default is 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 through the use of historic rating transition matrices. For most products, to calculate the expected positive exposure to a counterparty, a simulation methodology is used 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. The group does not adjust derivative liabilities for the group's own credit risk; such an adjustment is often referred to as a 'debit valuation adjustment'.

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.

All third party counterparties are included in the credit risk adjustment calculation and credit risk adjustments are not netted across group entities.

During 2011, no material changes were made to the methodologies used to calculate the credit risk adjustment.

Fair value valuation bases

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

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.

51 Fair value of financial instruments (continued)

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 ABSs including residential MBSs, 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 valuations output is benchmarked for consistency against observable data for securities of a similar nature.

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.

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 below 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.

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.

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 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
At 31 December 2010						
Assets						
Trading assets	263,579	124,594	2,035	390,208	–	390,208
Financial assets designated at fair value	38,300	13,867	2,437	54,604	–	54,604
Derivatives	2,533	236,479	1,372	240,384	62,238	302,622
Available-for-sale investments ¹	494,178	534,623	22,155	1,050,956	–	1,050,956
Liabilities						
Trading liabilities	56,846	80,174	14,514	151,534	–	151,534
Financial liabilities designated at fair value	–	40,327	–	40,327	–	40,327
Derivatives	2,617	234,996	1,612	239,225	70,613	309,838

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 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
At 31 December 2010						
Assets						
Trading assets	230,705	65,256	1,968	297,929	–	297,929
Financial assets designated at fair value	–	1,974	112	2,086	–	2,086
Derivatives	1,753	227,519	1,075	230,347	65,132	295,479
Available-for-sale investments ¹	449,296	317,363	17,708	784,367	–	784,367
Liabilities						
Trading liabilities	37,123	46,270	7,791	91,184	–	91,184
Financial liabilities designated at fair value	–	6,581	–	6,581	–	6,581
Derivatives	2,332	226,901	1,495	230,728	73,154	303,882

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	Held for trading HK\$m	Designated at fair value through profit or loss HK\$m	Derivatives HK\$m
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)
At 1 January 2010	24,161	2,591	5,890	1,891	11,357	–	2,981
Total gains or losses recognised in profit or loss	308	371	492	184	35	–	(192)
Total gains or losses recognised in other comprehensive income	1,878	15	12	34	506	–	16
Purchases	3,367	279	460	–	–	–	–
Issues	–	–	–	–	2,827	–	–
Sales	(1,347)	(2,045)	(216)	–	–	–	–
Deposits / settlements	(539)	475	(170)	1,421	127	–	772
Transfers out	(17,961)	(2,171)	(5,423)	(2,462)	(2,952)	–	(2,351)
Transfers in	12,288	2,520	1,392	304	2,614	–	386
At 31 December 2010	22,155	2,035	2,437	1,372	14,514	–	1,612
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period ¹	63	58	190	97	(114)	–	(78)

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	Held for trading HK\$m	Designated at fair value through profit or loss HK\$m	Derivatives HK\$m
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)
At 1 January 2010	21,711	1,733	167	1,759	4,859	–	2,911
Total gains or losses recognised in profit or loss	640	2	21	77	119	–	(300)
Total gains or losses recognised in other comprehensive income	1,025	13	–	33	93	–	15
Purchases	2,959	278	–	–	–	–	–
Issues	–	–	–	–	2,220	–	–
Sales	(1,338)	(1,445)	–	–	–	–	–
Deposits / settlements	(241)	475	–	1,283	708	–	786
Transfers out	(16,800)	(1,542)	(76)	(2,381)	(862)	–	(2,303)
Transfers in	9,752	2,454	–	304	654	–	386
At 31 December 2010	17,708	1,968	112	1,075	7,791	–	1,495
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period ¹	140	58	21	52	(60)	–	34

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)

For available-for sale securities and assets held for trading, 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 also occurred in respect of certain debt securities as valuations of these assets became unobservable during the year.

For assets designated at fair value through profit or loss, the observability of valuations of certain debt securities and equity shares 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, increase in the observability of interest rate basis spreads and equity volatilities during the year resulted in transfers out of level 3. In addition, the unobservability of credit default swaps resulted in derivative assets and liabilities being transferred into level 3.

For held-for-trading liabilities, transfers into level 3 were primarily due to a reduction in the observability of volatilities. 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 (expense) / income 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 value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions.

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 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)
At 31 December 2010				
Derivatives/trading assets/trading liabilities	492	(494)	–	–
Financial assets/liabilities designated at fair value	234	(234)	–	–
Financial investments: available-for-sale	–	–	2,073	(2,073)

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 2011				
Derivatives/trading assets/trading liabilities	223	(153)	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Financial investments: available-for-sale	–	–	1,232	(1,232)
At 31 December 2010				
Derivatives/trading assets/trading liabilities	444	(445)	–	–
Financial assets/liabilities designated at fair value	2	(2)	–	–
Financial investments: available-for-sale	–	–	1,632	(1,632)

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
At 31 December				
Derivatives/trading assets/trading liabilities	(369)	(37)	(173)	84
Financial assets/liabilities designated at fair value	60	190	–	21

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 2011		31 December 2010	
	Carrying value HK\$m	Fair value HK\$m	Carrying value HK\$m	Fair value HK\$m
Assets				
Placings with banks	654,581	654,756	597,081	597,144
Loans and advances to customers	2,130,871	2,101,243	1,891,060	1,889,974
Debt securities	143,062	151,363	128,033	132,832
Liabilities				
Deposits by banks	222,582	222,697	167,827	167,832
Customer accounts	3,565,001	3,565,036	3,313,244	3,313,148
Debt securities in issue	77,472	77,330	59,283	59,343
Subordinated liabilities	16,114	14,157	21,254	19,771
Preference shares	97,096	86,932	101,458	93,232

The Bank

	31 December 2011		31 December 2010	
	Carrying value HK\$m	Fair value HK\$m	Carrying value HK\$m	Fair value HK\$m
Assets				
Placings with banks	341,527	341,970	318,912	318,983
Loans and advances to customers	1,176,602	1,159,635	1,016,312	1,015,787
Liabilities				
Deposits by banks	158,746	158,743	130,476	130,475
Customer accounts	2,220,072	2,220,031	2,044,664	2,044,807
Debt securities in issue	46,360	46,245	43,139	43,160
Subordinated liabilities	9,386	7,354	9,404	7,992
Preference shares	96,969	86,805	101,306	93,081

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 of 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 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 off-balance sheet products such as guarantees and derivatives, 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.

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 Audit and Risk Committee ('ARC') also has responsibility for oversight and advice to the Board on risk matters. The key responsibilities of the ARC 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 ARC 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 ARC 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

	2011 HK\$m	2010 HK\$m
Cash and short-term funds	919,906	807,985
Items in the course of collection from other banks	34,546	16,878
Placings with banks maturing after one month	198,287	149,557
Certificates of deposit	88,691	73,247
Hong Kong Government certificates of indebtedness	162,524	148,134
Trading assets	432,908	372,410
Debt securities	168,849	200,379
Treasury bills and other eligible bills	230,959	140,873
Other	33,100	31,158
Financial assets designated at fair value	17,402	17,930
Debt securities	16,762	17,299
Other	640	631
Derivatives	377,296	302,622
Loans and advances to customers	2,130,871	1,891,060
Financial investments: Debt securities	677,256	753,827
Amounts due from Group companies	152,730	137,633
Other assets	77,521	56,452
Acceptances and endorsements	31,750	25,892
Other	45,771	30,560
Financial guarantees and other credit-related contingent liabilities	48,432	40,752
Loan commitments and other credit-related commitments	1,683,589	1,543,697
At 31 December	7,001,959	6,312,184

The Bank

	2011 HK\$m	2010 HK\$m
Cash and short-term funds	612,265	551,003
Items in the course of collection from other banks	29,821	12,143
Placings with banks maturing after one month	108,873	74,791
Certificates of deposit	23,987	27,888
Hong Kong Government certificates of indebtedness	162,524	148,134
Trading assets	302,343	280,309
Debt securities	120,575	155,174
Treasury bills and other eligible bills	160,911	112,602
Other	20,857	12,533
Financial assets designated at fair value: debt securities	2,283	2,086
Derivatives	370,678	295,479
Loans and advances to customers	1,176,602	1,016,312
Financial investments: Debt securities	325,136	442,336
Amounts due from group companies	248,001	198,322
Other assets	43,059	28,980
Acceptances and endorsements	21,001	17,041
Other	22,058	11,939
Financial guarantees and other credit-related contingent liabilities	25,448	23,353
Loan commitments and other credit-related commitments	1,067,049	948,987
At 31 December	4,498,069	4,050,123

52 Risk Management (continued)

(ii) 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 utilise 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.

Personal lending

Residential mortgages including loan commitments by level of collateral

	2011 HK\$m	2010 HK\$m
Not collateralised	1,290	896
Fully collateralised	659,976	611,137
– Less than 25% LTV	60,167	53,608
– 25% to 50% LTV	230,027	192,134
– 51% to 75% LTV	278,216	275,830
– 76% to 90% LTV	81,597	79,525
– 91% to 100% LTV	9,969	10,040
Partially collateralised		
– Greater than 100% LTV	4,156	605
– Collateral value	3,912	461
Total residential mortgages	665,422	612,638

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.

Notes on the Financial Statements (continued)**52 Risk Management** (continued)*Other personal lending*

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

Corporate, commercial and financial (non-bank) 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

	2011	2010
	HK\$m	HK\$m
Rated CRR/EL 1 to 7	280,706	266,548
Not collateralised	120,602	103,321
Fully collateralised	144,975	149,236
Partially collateralised (A)	15,129	13,991
– collateral value on A	6,770	8,382
Rated CRR/EL 8 to 10	616	899
Not collateralised	95	67
Fully collateralised	193	337
Partially collateralised (B)	328	495
– collateral value on B	203	345
Total commercial real estate loans and advances	281,322	267,447

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 including loan commitments by level of collateral

	2011 HK\$m	2010 HK\$m
Rated CRR/EL 8 to 10	12,501	15,006
Not collateralised	8,882	11,053
Fully collateralised	1,634	1,498
Partially collateralised (A)	1,985	2,455
– collateral value on A	1,015	1,246

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

	2011 HK\$m	2010 HK\$m
Not collateralised	615,783	541,913
Fully collateralised	64,411	75,494
Partially collateralised (A)	3,847	218
– collateral value on A	1,996	184
Total loans and advances to banks	684,041	617,625

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 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 institutional 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'.

52 Risk Management (continued)

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	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Residential properties	103	37	35	4
Commercial and industrial properties	6	12	–	2
Other assets	3	2	–	–
	112	51	35	6

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.

(iii) 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	Expected loss %
Strong	A– and above	CRR 1 to CRR 2	0 – 0.169	EL 1 to EL 2	0 – 0.999
Medium	B+ to BBB+, and unrated	CRR 3 to CRR 5	0.170 – 4.914	EL 3 to EL 5	1.000 – 19.999
Sub-standard	B and below	CRR 6 to CRR 8	4.915 – 99.999	EL 6 to EL 8	20.000 – 99.999
Impaired	Impaired	CRR 9 to CRR 10	100	EL 9 to EL 10	100+ or defaulted ²

¹ We observe the disclosure 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.

Notes on the Financial Statements (continued)

52 Risk Management (continued)

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 disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ('Expected Loss') grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

The group's policy in respect of impairment on loans and advances and debt securities is set out in notes 3(d) and 3(g) on the Financial Statements. Analysis of impairment allowances as at 31 December 2011 and the movement of such allowances during the year are disclosed in note 19.

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.

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 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.

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 2010							
Items in the course of collection from other banks	15,294	1,584	–	–	–	–	16,878
Trading assets	319,851	51,858	701	–	–	–	372,410
– treasury and other eligible bills	133,799	7,074	–	–	–	–	140,873
– debt securities	160,916	39,306	157	–	–	–	200,379
– loans and advances to banks	24,140	1,509	471	–	–	–	26,120
– loans and advances to customers	996	3,969	73	–	–	–	5,038
Financial assets designated at fair value	15,994	1,936	–	–	–	–	17,930
– debt securities	15,363	1,936	–	–	–	–	17,299
– loans and advances to customers	631	–	–	–	–	–	631
Derivatives	264,605	37,114	903	–	–	–	302,622
Loans and advances held at amortised cost	1,577,126	847,090	35,382	25,256	16,281	(12,994)	2,488,141
– loans and advances to banks	537,729	56,777	1,739	836	–	–	597,081
– loans and advances to customers	1,039,397	790,313	33,643	24,420	16,281	(12,994)	1,891,060
Financial investments	1,017,926	87,053	993	121	61	–	1,106,154
– treasury and other eligible bills	259,134	19,946	–	–	–	–	279,080
– debt securities ²	758,792	67,107	993	121	61	–	827,074
Other assets	18,565	36,409	903	501	74	–	56,452
– endorsements and acceptances	6,481	18,617	694	41	59	–	25,892
– other	12,084	17,792	209	460	15	–	30,560
Total	3,229,361	1,063,044	38,882	25,878	16,416	(12,994)	4,360,587

1 Includes HK\$78,778m 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\$26m of impaired debt securities overdue for between 6 months and 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 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.

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 2010							
Items in the course of collection from other banks	10,649	1,494	–	–	–	–	12,143
Trading assets	235,598	44,010	701	–	–	–	280,309
– treasury and other eligible bills	105,596	7,006	–	–	–	–	112,602
– debt securities	122,531	32,486	157	–	–	–	155,174
– loans and advances to banks	6,500	1,509	471	–	–	–	8,480
– loans and advances to customers	971	3,009	73	–	–	–	4,053
Financial assets designated at fair value: debt securities	863	1,223	–	–	–	–	2,086
Derivatives	260,596	34,171	712	–	–	–	295,479
Loans and advances held at amortised cost	858,392	449,484	14,290	11,435	10,596	(8,973)	1,335,224
– loans and advances to banks	296,100	21,119	860	833	–	–	318,912
– loans and advances to customers	562,292	428,365	13,430	10,602	10,596	(8,973)	1,016,312
Financial investments	647,365	74,411	993	121	61	–	722,951
– treasury and other eligible bills	234,567	18,160	–	–	–	–	252,727
– debt securities	412,798	56,251	993	121	61	–	470,224
Other assets	9,563	18,495	796	58	68	–	28,980
– endorsements and acceptances	4,478	11,831	632	41	59	–	17,041
– other	5,085	6,664	164	17	9	–	11,939
Total	2,023,026	623,288	17,492	11,614	10,725	(8,973)	2,677,172

1 Includes HK\$72,641m 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 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 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
31 December 2010						
Loans and advances held at amortised cost ...	20,264	3,305	1,324	298	65	25,256
– loans and advances to banks	836	–	–	–	–	836
– loans and advances to customers ¹	19,428	3,305	1,324	298	65	24,420
Financial investments	121	–	–	–	–	121
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	121	–	–	–	–	121
Other assets	144	111	123	57	66	501
	20,529	3,416	1,447	355	131	25,878

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 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
31 December 2010						
Loans and advances held at amortised cost ...	9,341	1,386	586	107	15	11,435
– loans and advances to banks	833	–	–	–	–	833
– loans and advances to customers ¹	8,508	1,386	586	107	15	10,602
Financial investments	121	–	–	–	–	121
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	121	–	–	–	–	121
Other assets	52	4	1	–	1	58
	9,514	1,390	587	107	16	11,614

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 2011, and the movement of such allowances during the year, are disclosed in note 19.

b Liquidity risk

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

Liquidity risk is the risk that we do not have sufficient financial resources to meet our obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

The objective of our liquidity and funding management framework is to ensure that all foreseeable funding commitments can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To this end, we maintain a diversified funding base comprising core retail and corporate customer deposits and institutional balances. We augment this with wholesale funding and portfolios of highly liquid assets diversified by currency and maturity which are held to enable us to respond quickly and smoothly to unforeseen liquidity requirements.

Operating entities are required to maintain strong liquidity positions and to manage the liquidity profiles of their assets, liabilities and commitments with the objective of ensuring that their cash flows are balanced appropriately and that all their anticipated obligations can be met when due.

We adapt our liquidity and funding risk management framework in response to changes in the mix of business that we undertake, and to changes in the nature of the markets in which we operate. We also continuously seek to evolve and strengthen our liquidity and funding risk management framework.

It is the responsibility of local management to ensure compliance with local regulatory requirements and limits set by the HSBC Group/regional head office. Liquidity is managed on a daily basis by local treasury functions, with the larger treasury sites providing support to smaller entities where required.

Compliance with liquidity and funding requirements is monitored by local Asset and Liability Management Committees ('ALCO') which report to the group's Head Office on a regular basis. This process includes:

- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to 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)*

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.

A maturity analysis of assets and liabilities is disclosed in note 40, while an analysis of possible cash flows under contractual terms is disclosed in note 41.

We use a number of principal measures to manage liquidity risk, as described below.

Inherent liquidity risk categorisation

We categorise our operating entities into one of three categories to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the operating entities' host country, and also factors specific to the entity itself, such as the local footprint, market share, balance sheet strength and control framework. This assessment is used to determine the severity of the liquidity stress that we expect our operating entities to be able to withstand, as expressed in our principal liquidity risk metrics, being the stressed one month coverage ratio and the advances to core funding ratio.

Core deposits

Our internal framework is based on our categorisation of customer deposits into core and non-core. This characterisation takes into account the inherent liquidity risk categorisation of the entity originating the deposit, the nature of the customer and the size and pricing of the deposit.

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 discourages reliance on short-term professional funding. This is achieved by placing limits on banking entities which restrict their ability to increase loans and advances to customers without a corresponding growth in core customer deposits or long term debt funding, this measure is referred to as the 'advances to core funding' ratio.

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. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio.

Projected cash flow scenario analysis

The group uses a number of standard projected cash flow scenarios designed to model both group-specific and market-wide liquidity crises, in which the rate and timing of deposit withdrawals and drawdowns on committed lending facilities are varied, and the ability to access interbank funding and term debt markets and to generate funds from asset portfolios is restricted. The scenarios are modelled by all group banking entities. The appropriateness of the assumptions under each scenario is regularly reviewed. In addition to the group's standard projected cash flows scenarios, individual entities are required to design their own scenarios to reflect specific local market conditions, products and funding bases.

Notes on the Financial Statements (continued)**52 Risk Management** (continued)*Stressed one month coverage ratio*

The stressed one month coverage ratios tabulated below are derived from projected cash flow scenario analyses, and express the stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. Group sites are required to target a ratio of 100% or greater.

Advances to core funding ratios and the stressed one 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	
	2011 %	2010 %	2011 %	2010 %
Year-end	75.0	70.3	122.9	144.6
Maximum	78.9	70.3	144.6	165.4
Minimum	70.3	55.5	116.4	132.6
Average	75.9	63.6	124.0	148.8

Liquidity behaviouralisation will be applied to reflect our conservative 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 conservatively assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour.

Contingent liquidity risk

In the normal course of business, group entities provide customers with committed and standby facilities. These facilities increase the funding requirements of the group when customers choose to raise drawdown levels over and above their normal utilisation rates. The liquidity risk consequences of increased levels of drawdown are analysed in the form of projected cash flows under different stress scenarios. Limits are set for non-cancellable contingent funding commitments by the group after due consideration of each entity's ability to fund them. The limits are split according to the borrower and the size of the committed line.

Liquidity ratio under 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.

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.

52 Risk Management *(continued)*

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 was as follows:

	The group		The Bank	
	2011 HK\$m	2010 HK\$m	2011 HK\$m	2010 HK\$m
Total VAR				
Year end	393	433	279	331
Average	306	466	235	377
Maximum	463	596	326	528
Minimum	190	271	156	230
Total interest rate VAR				
Year end	151	174	105	158
Average	141	264	121	249
Maximum	187	350	161	332
Minimum	108	139	92	144
Total foreign exchange VAR				
Year end	49	68	51	58
Average	50	44	52	45
Maximum	116	116	111	115
Minimum	28	19	29	15
Total credit spread VAR²				
Year end	343	264	196	173
Average	246	335	166	245
Maximum	380	464	247	347
Minimum	136	188	96	149
Total trading VAR				
Year end	184	136	156	122
Average	131	169	118	170
Maximum	208	255	184	242
Minimum	73	84	69	76
Interest rate trading VAR				
Year end	98	79	101	68
Average	91	148	87	150
Maximum	150	208	120	227
Minimum	62	76	59	67
Foreign exchange trading VAR				
Year end	46	64	48	53
Average	47	41	47	43
Maximum	99	118	95	122
Minimum	24	15	27	14
Credit spread trading VAR				
Year end	109	47	82	42
Average	67	66	57	62
Maximum	115	103	96	97
Minimum	36	39	32	37
Equity trading VAR¹				
Year end	15	9	15	9
Average	18	15	18	15
Maximum	37	45	37	45
Minimum	5	3	5	3

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 2011, a 10% decrease in equity prices would reduce profit before tax and net assets by HK\$186m (2010: HK\$119m) and a 100 basis points decrease in interest rates would reduce profit before tax and net assets by HK\$156m (2010: HK\$27m).

2 Total credit spread VAR includes credit spread VAR for the accrual book from March 2010 onwards.

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\$267,382m (78% of shareholders' funds) at 31 December 2011, a decrease of HK\$5,501m from HK\$272,883m (85% of shareholders' funds) at 31 December 2010. 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 2011				
Chinese renminbi	117,895	145,347	32,290	39,809
At 31 December 2010				
Chinese renminbi	122,017	143,909	52,598	62,035
Indian rupees	179,314	31,178	127,064	22,093

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*

The group is exposed to the uncertainty surrounding the timing and severity of claims under insurance contracts. The principal insurance risk faced by the group is that, over time, the combined cost of claims, benefits, administration and acquisition of the contracts may exceed the aggregate amount of premiums received and investment income. The cost of a claim can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities. Contracts under which the transfer of insurance risk from the policyholder to the group is not significant are classified as investment contracts.

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

All insurance products, whether internally manufactured or provided by a third party manufacturer, are reviewed by the Product and Pricing Committee. Several methods are used to assess and monitor insurance risk exposures both for individual types of risks insured and overall risks. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

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, random, 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 with minimum volatility. The Asset and Liability Management Committee reviews and approves target portfolios on a periodic basis, establishes investment guidelines and limits, and provides oversight of the asset and liability management process.

The group establishes target asset portfolios for each major insurance product category consistent with local regulatory requirements. The investment strategy and asset allocations consider yield, duration, sensitivity, market risk, volatility, liquidity, asset concentration, foreign exchange and credit quality.

The following table shows the composition of assets and liabilities for each major insurance product category. 92% of both assets and liabilities are derived from Hong Kong.

Statement of financial position of insurance subsidiaries by type of contract

	Life linked contracts ¹ HK\$m	Life non-linked contracts ² HK\$m	Non-life insurance HK\$m	Other assets ³ HK\$m	Total HK\$m
At 31 December 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

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 2010					
Financial assets:					
– financial assets designated at fair value	28,652	21,753	417	917	51,739
– derivatives	–	474	3	3	480
– financial investments	–	127,213	1,280	7,896	136,389
– other financial assets	2,296	24,132	1,369	705	28,502
Total financial assets	30,948	173,572	3,069	9,521	217,110
Reinsurance assets	5,567	161	420	89	6,237
PVIF ⁴	–	–	–	14,767	14,767
Other assets	4	1,923	190	3,766	5,883
Total assets	36,519	175,656	3,679	28,143	243,997
Liabilities under investment contracts designated at fair value					
	7,478	26,268	–	–	33,746
Liabilities under insurance contracts					
	28,920	146,130	2,920	–	177,970
Deferred tax	–	121	1	2,497	2,619
Other liabilities	–	–	–	2,705	2,705
Total liabilities	36,398	172,519	2,921	5,202	217,040
Total equity	–	–	–	26,957	26,957
Total equity and liabilities	36,398	172,519	2,921	32,159	243,997

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 outcome.

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 retained sum assured so that it falls within the specified insurance risk appetite. The group also utilises reinsurance to manage financial risk arising from guaranteeing minimum investment performance under a specific unit-linked insurance product, and uses reinsurance agreements with non-affiliated reinsurers to manage its exposure to losses resulting from certain catastrophes.

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

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, underwriting guidelines, reinsurance and centralised management of reinsurance and monitoring of emerging issues.

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, where the majority is Hong Kong.

52 Risk Management (continued)

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 181.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies 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. By definition, the group is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 34. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

Analysis of non-life insurance risk – net written insurance premiums¹

	2011 HK\$m	2010 HK\$m
Accident and health	1,504	1,411
Fire and other damage	307	306
Motor	325	332
Liability	164	180
Marine, aviation and transport	105	111
Other (non-life)	458	369
Total net written insurance premiums	2,863	2,709

¹ Net written insurance premiums represent gross written premiums less gross written premiums ceded to reinsurers.

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 underwriting subsidiaries at 31 December 2011 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 operations**

	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
	At 31 December 2010				
	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	506	13,226	417	917	15,066
– Equity securities	28,146	8,527	–	–	36,673
	28,652	21,753	417	917	51,739
Financial investments					
Held-to-maturity:					
– Debt securities	–	119,791	1,186	7,057	128,034
Available-for-sale:					
– Treasury bills	–	–	–	–	–
– Debt securities	–	7,418	94	808	8,320
– Equity securities	–	4	–	31	35
	–	7,422	94	839	8,355
Derivatives	–	474	3	3	480
Other financial assets	2,296	24,132	1,369	705	28,502
	30,948	173,572	3,069	9,521	217,110

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 12.1% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2011 (2010: 14.3%). The table also shows that approximately 69.3% of financial assets were invested in debt securities at 31 December 2011 (2010: 69.7%) with 16.1% (2010: 16.9%) invested in equity securities.

Market risk

Market risk can be sub-categorised into interest rate risk, equity risk 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 related to non-linked policies 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 2011 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 2011		31 December 2010	
	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	1,065	(390)	515	(194)
- 100 basis points shift in yield curves	(977)	547	(556)	173

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

Equity risk

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

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

	31 December 2011		31 December 2010	
	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	629	629	473	474
10% decrease in equity prices	(1,075)	(1,076)	(471)	(471)

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

Foreign currency risk

Substantial amounts of the assets and liabilities are denominated in two main currencies, United States dollars and Hong Kong 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 loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place and limits are established to manage credit quality and concentration risk. The following table presents the analysis of the treasury bills, other eligible bills and debt securities within the group's insurance business. The definition of the four credit quality classifications is included on page 166. 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. 91.1% (2010: 96.5%) 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 2011							
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 funds¹							
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

52 Risk Management (continued)

31 December 2010	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	13,087	556	–	–	–	–	13,643
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,087	556	–	–	–	–	13,643
Financial investments	123,893	4,596	–	–	–	–	128,489
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	123,893	4,596	–	–	–	–	128,489
Supporting shareholders funds¹							
Financial assets designated at fair value	898	19	–	–	–	–	917
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	898	19	–	–	–	–	917
Financial investments	7,755	110	–	–	–	–	7,865
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	7,755	110	–	–	–	–	7,865
Total							
Financial assets designated at fair value	13,985	575	–	–	–	–	14,560
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	13,985	575	–	–	–	–	14,560
Financial investments	131,648	4,706	–	–	–	–	136,354
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	131,648	4,706	–	–	–	–	136,354

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 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
31 December 2010							
Linked insurance contracts	1	5,566	–	–	–	–	5,567
Non-linked insurance contracts	444	66	–	71	–	–	581
Total	445	5,632	–	71	–	–	6,148
Reinsurance debtors	35	8	–	46	–	–	89

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 2011, the exposure to the third party was HK\$6,663m (2010: HK\$5,566m).

Liquidity risk

There are three components of liquidity risk. The first of these arises in normal market conditions and is referred to as funding liquidity risk, specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, there is market liquidity risk where the size of a particular holding may be sufficiently large that a sale cannot be completed at or around the market price. Finally, there is standby liquidity risk which refers to the capacity to meet payment conditions in abnormal conditions.

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

52 Risk Management (continued)

The following table shows the expected maturity of insurance contract liabilities at 31 December 2011:

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 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
At 31 December 2010					
Non-life insurance	1,736	875	256	54	2,921
Life insurance (non-linked)	11,752	76,103	128,920	141,714	358,489
Life insurance (linked)	1,562	10,338	25,126	66,725	103,751
	15,050	87,316	154,302	208,493	465,161

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 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
– due after 10 years	–	–	–	–
– undated ¹	6,157	27,828	–	33,985
	6,632	27,849	86	34,567
At 31 December 2010				
Remaining contractual maturity				
– due within 1 year	41	58	84	183
– due between 1 and 5 years	–	–	86	86
– due between 5 and 10 years	316	–	–	316
– due after 10 years	–	–	–	–
– undated ¹	7,121	26,210	–	33,331
	7,478	26,268	170	33,916

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 2011 was HK\$20,232m (2010: HK\$14,767m), 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 during the year 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 now set on an active basis with reference to market risk free yields and have been reduced as a result of removing the implicit adjustments, as shown in the key assumptions table in Note 25b. It should be noted that these refinements will introduce greater volatility within the insurance results in the future which is reflected in higher sensitivity impacts, including sensitivities to lapse, mortality and/or morbidity. A one-off gain of HK\$1,133m resulted from these refinements, which is included in "Other operating income" in the consolidated income statement.

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 2011 of reasonably possible changes in the main economic assumption:

	Impact on results	
	2011 HK\$m	2010 HK\$m
+ 100 basis points shift in risk-free rate	1,101	1,613
- 100 basis points shift in risk-free rate	(687)	(1,218)

The effects on PVIF shown above are illustrative only and employ simplified scenarios. They do not incorporate actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

Non-economic assumptions

Non-economic assumptions including, for non-life 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. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2011 across all insurance underwriting subsidiaries is as follows:

	Impact on 2011 results		Impact on 2010 results	
	Profit after tax HK\$m	Net assets HK\$m	Profit after tax HK\$m	Net assets HK\$m
20% increase in claims costs	(194)	(194)	(183)	(183)
20% decrease in claims costs	194	194	183	183
10% increase in mortality and/or morbidity rates	(406)	(406)	(176)	(176)
10% decrease in mortality and/or morbidity rates	407	407	167	167
50% increase in lapse rates	(605)	(605)	351	351
50% decrease in lapse rates	1,524	1,524	(58)	(58)
10% increase in expense rates	(286)	(286)	(171)	(171)
10% decrease in expense rates	285	285	171	171

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. The group raises non-equity core capital and subordinated debt in accordance with HSBC Group's guidelines on market and investor concentration, cost, market conditions, timing, effect on composition and maturity profile. 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.

The group uses the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. The group uses the internal ratings-based (securitisation) approach to determine credit risk for its securitisation exposures. For market risk, the group uses an internal models approach to calculate its general market risk, specific risk for the interest rate risk category and market risk relating to equity options. The group uses the standardised (market risk) approach for calculating other market risk positions 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)

53 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.

54 Nature of business

The group provides domestic and international banking and related financial services, principally in the Asia-Pacific region.

55 Events after the balance sheet date

There have been no events after the balance sheet date that would require disclosure in these financial statements.

56 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 27 February 2012.

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