The Hongkong and Shanghai Banking Corporation Limited

Annual Report and Accounts 2014

HSBC

Annual Report and Accounts 2014

Contents

Financial Highlights	2
Report of the Directors	3
Financial Review	11
Risk Report	23
Capital	67
Statement of Directors' Responsibilities	76
Auditor's Report	77
Financial Statements	78
Consolidated income statement	79
Consolidated statement of comprehensive income	80
Consolidated balance sheet	81
Consolidated statement of changes in equity	82
Consolidated statement of cash flows	84
Bank balance sheet	85
Bank statement of changes in equity	86
Notes on the Financial Statements	88

Certain defined terms

This document comprises the *Annual Report and Accounts 2014* for The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group'). References to 'HSBC', 'the Group' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People's Republic of China is referred to as 'Hong Kong'. The abbreviations 'HK$m' and 'HK$bn' represent millions and billions (thousands of millions) of Hong Kong dollars respectively.

Cautionary statement regarding forward-looking statements

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

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

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

Chinese translation

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

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

Financial Highlights

	2014 HK$m	2013 HK$m
For the year		
Net operating income before loan impairment charges	**173,389**	202,596
Profit before tax	**111,189**	144,756
Profit attributable to shareholders	**86,428**	119,009
At the year-end		
Shareholders' equity	**557,835**	480,809
Total equity	**608,346**	522,224
Total capital	**425,037**	378,110
Customer accounts	**4,479,992**	4,253,698
Total assets	**6,876,746**	6,439,355
Ratios	**%**	%
Return on average shareholders' equity	**16.9**	25.9
Post-tax return on average total assets	**1.39**	2.08
Cost efficiency ratio	**42.1**	33.9
Net interest margin	**1.91**	1.94
Capital ratios		
– Common equity tier 1 capital	**14.4**	14.1
– Tier 1 capital	**14.4**	14.1
– Total capital	**15.7**	15.2

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. It is the largest bank incorporated in Hong Kong and one of Hong Kong's three note-issuing banks.

Serving the financial and wealth management needs of an international customer base, the group provides a range of personal, commercial and corporate banking and related financial services in 20 countries and territories in Asia-Pacific, with the largest network of any international financial institution in the region. Employing some 68,000 people, of whom 37,000 work for the Bank itself.

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 organised into five geographical regions: Europe, Asia, 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
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Report of the Directors

Principal Activities

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

Asia Strategy

HSBC Group's aim is to be the world's leading international bank. As a subsidiary of the HSBC Group, the group applies a disciplined approach in managing its portfolio of businesses to focus on areas where it has a clear competitive advantage. The Group has set three interconnected priorities to deliver its strategy: (i) grow the business and dividends by capitalising on our global platform; (ii) implement global standards as a competitive advantage and increase quality of earnings; and (iii) further streamline the organisation to fund growth and investments in global standards.

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

Financial Statements

The state of affairs of the Bank and the group, and the consolidated profit of the group, are shown on pages 78 to 224.

Share Capital

Details of the movements in share capital of the Bank during the financial year are set out in notes 35 and 36 to the financial statements.

Reserves and Dividends

Profits attributable to shareholders, before dividends, of HK$86,428m have been transferred to reserves. During the year, a surplus of HK$3,779m, 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 2014 are set out in note 9 to the financial statements. The Directors do not recommend the payment of a final dividend.

Directors

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

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

* *independent non-executive Director*
\# *non-executive Director*

All the Directors served throughout the year save for John Robert Slosar and Jennifer Li Xinzhe who were appointed on 12 May and 22 September 2014 respectively. Christopher D Pratt resigned on 14 March 2014 and Andreas Sohmen-Pao retired on 19 May 2014.

Report of the Directors (continued)

Directors' Interests in Contracts

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

Directors' Rights to Acquire Shares or Debentures

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

The GPSP was developed to incentivise senior executives to deliver sustainable long-term business performance which aligns interests between senior executives of HSBC Group and shareholders. For executive Directors and Group Managing Directors of HSBC Holdings plc, there is further alignment as they are required to hold the shares once the awards have vested, until retirement. The GPSP is a long-term incentive plan under the HSBC Share Plan 2011. The award levels of GPSP are determined by considering performance up to the date of grant against enduring performance measures set out in the long-term performance scorecard. The GPSP award is subject to a five year vesting period. The vesting of conditional deferred awards over shares in HSBC Holdings plc granted to executive Directors under the HSBC Share Plan 2011 are generally subject to the individual remaining an employee on the vesting date.

All unvested deferred awards made under the HSBC Share Plan 2011 including GPSP are subject to application of malus, i.e. the cancellation and reduction of unvested deferred awards. Effective from 1 January 2015, all paid or vested variable pay awards made to Identified Staff and Material Risk Takers ('MRTs') will be subject to clawback on all or part of the award.

Generally, the vesting period of conditional deferred share awards is staggered over three years. Immediately vested conditional share awards which are subject to retention only are also granted under the HSBC Share Plan 2011. These include the Fixed Pay Allowance ('FPA') share awards which are non-forfeitable, immediately vested but subject to retention, which were introduced as part of a new remuneration policy approved by HSBC Holdings plc shareholders at its AGM in May 2014. For the retention period of FPA shares awards made to executive Directors in 2014, 20% of the net shares (net of estimated tax and social security obligations) are to be retained until March 2015 while 80% of the net shares are to be retained until March 2020.

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

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

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

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

Donations

Donations made by the Bank and its subsidiaries during the year amounted to HK$212m (2013: HK$184m).

Compliance with the Banking (Disclosure) Rules

The Directors are of the view that the Accounts and Supplementary Notes for the year ended 31 December 2014, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance.

Auditor

The Accounts have been audited by KPMG. On 2 August 2013, HSBC Group announced its intention to appoint PricewaterhouseCoopers LLP as auditor of the HSBC Group companies for the year ending 31 December 2015. It is expected that PricewaterhouseCoopers ('PwC') will be appointed on 23 February 2015 to fill the casual vacancy that will arise from KPMG's resignation following signing of the Auditor's Report on the Accounts. A resolution to appoint PwC as auditor of the Bank will be proposed at the forthcoming Annual General Meeting.

Corporate Governance

The Bank is committed to high standards of corporate governance. As an Authorised Institution, the Bank is subject to and complies with the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'. During 2014, the 'comply or explain' Corporate Governance Code for HSBC Group companies, which was introduced by the Group in 2013, has been implemented by the Bank and its subsidiaries. The corporate governance report is included in the Report of the Directors.

Board of Directors

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

Directors

The Bank has a unitary Board. The authority of each Director is exercised in Board meetings where the Board acts collectively. As at 23 February 2015, the Board comprised the Chairman, Deputy Chairman and Chief Executive, two Deputy Chairmen who are independent non-executive Directors, two other Directors with executive responsibilities for the Bank's or a subsidiary's operations, one non-executive Director and another eleven independent non-executive Directors.

Independence of non-executive Directors

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

Report of the Directors (continued)

Chairman and Chief Executive

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

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

Board Committees

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

Executive Committee

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

The Bank's Deputy Chairman and Chief Executive, Peter Wong Tung Shun, is Chairman of the Committee. The current members of the Committee are: Pui Mun Chan *(Head of Regulatory Compliance Asia-Pacific)*, Raymond Cheng Siu Hong *(Chief Operating Officer Asia-Pacific)*, Gordon William French *(Head of Global Banking and Markets Asia-Pacific)*, Guy D Harvey-Samuel *(Chief Executive Officer Singapore)*, Mukhtar M Hussain *(Chief Executive Officer Malaysia)*, Sarah C Legg *(Chief Financial Officer)*, Kevin Ross Martin *(Regional Head of Retail Banking and Wealth Management Asia-Pacific)*, M T McKeown *(Chief Risk Officer, Asia-Pacific)*, Stuart P Milne *(Chief Executive Officer India)*, Kenneth Ng Sing Yip *(Regional General Counsel Asia-Pacific)*, Noel P Quinn *(Regional Head of Commercial Banking Asia-Pacific)*, Bernard James Rennell *(Regional Head Global Private Banking Asia-Pacific)*, Jayant Rikhye *(Head of Strategy Planning, Asia-Pacific and Head of International Asia-Pacific)*, Donna Wong Ka Yuk *(Head of Human Resources Asia-Pacific)*, Helen Wong Pik Kuen *(Chief Executive Officer China)*. P A Stafford *(Corporation Secretary)* is the Committee Secretary. In attendance are: Malcolm Wallis *(Head of Communications Asia-Pacific)* and William S M Tam *(Deputy Secretary)*.

Helen Wong Pik Kuen, currently Chief Executive Officer China, will be appointed Chief Executive Officer of Greater China, with responsibility for mainland China, Hong Kong and Taiwan. The new role, subject to regulatory approval, will be effective from 1 March 2015. She will remain as a member of the Executive Committee. David Liao Yi Chien will, subject to regulatory approval, succeed Helen Wong as Chief Executive Officer China and join the Executive Committee with effect from the same date.

Asset and Liability Management Committee

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

Risk Management Committee

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

Audit Committee

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

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

Governance structure

The Audit Committee monitors the integrity of the financial statements and oversees the internal control systems over financial reporting, covering all material controls, to review the adequacy of resources, qualification and experience of staff of the accounting and financial reporting function and their training programmes and budget, and to review their effectiveness. The Committee reviews the financial statements before submission to the Board. It also monitors and reviews the effectiveness of the internal audit function and reviews the Bank's financial and accounting policies and practices. The Committee advises the Board on the appointment of the external auditor and is responsible for oversight of the external auditor. As part of the monitoring process, the Committee reviews the minutes of meetings of subsidiaries' Audit Committees and the Asset and Liability Management Committee.

Risk Committee

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

Risk governance and culture

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

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

Risk management

The Board and the Risk Committee oversee the maintenance and development of a strong risk management framework by continually monitoring the risk environment, top and emerging risks facing the group and mitigating actions planned and taken. The Risk Committee recommends the approval of group's risk appetite statement to the Board and monitors performance against the key performance/risk indicators included within the statement. The Risk Committee monitors the risk profiles for all of the risk categories within the group's business. The Committee also monitors the effectiveness of the Bank's risk management and internal controls, including operational and compliance controls, and risk management systems.

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

Risk appetite

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

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

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

Top and emerging risks

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

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

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

Stress testing

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

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

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

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

Nomination Committee

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

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

Chairman's Committee

A Chairman's Committee was established on 16 February 2015 to act on behalf of the Board either in accordance with authority delegated by the Board from time to time or as specifically set out within its terms of reference. Between scheduled Board meetings, the Committee can implement previously agreed strategic decisions, approve specified matters subject to their prior review by the full Board and act exceptionally on urgent matters within its terms of reference. On formation of the Chairman's Committee, the powers, authorities and discretions delegated to the Acquisitions and Disposals Committee were revoked and that Committee was demised.

The current members of the Committee comprise the Chairman of the Board, the Deputy Chairman and Chief Executive, the non-executive Deputy Chairmen and the Chairmen of the Audit and Risk Committees.

Group Remuneration Committee

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

Remuneration policy

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

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

Report of the Directors (continued)

In accordance with the 'Guideline on a Sound Remuneration System', details of the remuneration strategy are contained within the Annual Report and Accounts 2014 and Capital and Risk Management Pillar 3 Disclosures as at 31 December 2014 of HSBC Holdings plc.

Banking structural reform and recovery and resolution planning

Globally there have been a number of developments relating to banking structural reform and the introduction of recovery and resolution regimes.

We have initiated plans to mitigate or remove critical inter-dependencies to further facilitate the resolution of the HSBC Group. In particular, in order to remove operational dependencies (where one subsidiary bank provides critical services to another), the HSBC Group has determined to transfer such critical services from the subsidiary banks to a separately incorporated group of service companies ('ServCo Group'). The services will then be provided to the subsidiary banks by the ServCo Group. The Servco Group is owned directly by HSBC Holdings plc.

The plans are currently subject to discussion and further planning, and is ultimately subject to the approval of the Board of Directors and the applicable regulators. The implementation date for the resolution strategy of the HSBC Group would depend upon the date on which the final requirements and legislation are agreed.

On behalf of the Board
Stuart T Gulliver, *Chairman*
23 February 2015

Financial Review

Summary of Financial Performance

Results for 2014

Profit before tax for 2014 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') decreased by HK$33,567m, or 23%, to HK$111,189m.

Profit before tax

	2014 HK$m	2013 HK$m
Hong Kong	**62,966**	59,791
Rest of Asia-Pacific	**48,223**	84,965
Total	**111,189**	144,756

Geographical Regions

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

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

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

Products and services

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

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

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
2014				
Net interest income	**50,774**	**44,333**	**2**	**95,109**
Net fee income	**29,996**	**14,626**	**-**	**44,622**
Net trading income	**11,663**	**8,559**	**(2)**	**20,220**
Net income from financial instruments designated at fair value	**3,134**	**914**	**–**	**4,048**
Gains less losses from financial investments	**2,286**	**103**	**–**	**2,389**
Dividend income	**1,362**	**12**	**–**	**1,374**
Net insurance premium income	**50,226**	**7,081**	**–**	**57,307**
Net loss on reclassification of associates	**–**	**(251)**	**–**	**(251)**
Other operating income	**10,872**	**1,944**	**(4,063)**	**8,753**
Total operating income	**160,313**	**77,321**	**(4,063)**	**233,571**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(52,916)**	**(7,266)**	**–**	**(60,182)**
Net operating income before loan impairment charges and other credit risk provisions	**107,397**	**70,055**	**(4,063)**	**173,389**
Loan impairment charges and other credit risk provisions	**(2,478)**	**(2,447)**	**–**	**(4,925)**
Net operating income	**104,919**	**67,608**	**(4,063)**	**168,464**
Operating expenses	**(42,270)**	**(34,743)**	**4,063**	**(72,950)**
Operating profit	**62,649**	**32,865**	**–**	**95,514**
Share of profit in associates and joint ventures	**317**	**15,358**	**–**	**15,675**
Profit before tax	**62,966**	**48,223**	**–**	**111,189**
2013				
Net interest income	45,682	41,729	(46)	87,365
Net fee income	28,794	15,129	(77)	43,846
Net trading income	11,156	5,375	46	16,577
Net income from financial instruments designated at fair value	2,008	467	–	2,475
Gains less losses from financial investments	323	119	–	442
Dividend income	1,165	10	–	1,175
Net insurance premium income	47,173	6,490	–	53,663
Net gain on reclassification of associates	–	8,157	–	8,157
Gain on sale of Ping An	–	34,070	–	34,070
Other operating income	13,803	2,186	(4,571)	11,418
Total operating income	150,104	113,732	(4,648)	259,188
Net insurance claims and benefits paid and movement in liabilities to policyholders	(50,960)	(5,632)	–	(56,592)
Net operating income before loan impairment charges and other credit risk provisions	99,144	108,100	(4,648)	202,596
Loan impairment charges and other credit risk provisions	(1,032)	(2,500)	–	(3,532)
Net operating income	98,112	105,600	(4,648)	199,064
Operating expenses	(38,845)	(34,531)	4,648	(68,728)
Operating profit	59,267	71,069	–	130,336
Share of profit in associates and joint ventures	524	13,896	–	14,420
Profit before tax	59,791	84,965	–	144,756

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
2014							
Net interest income/(expense)	**25,464**	**15,367**	**11,896**	**782**	**(2,287)**	**(448)**	**50,774**
Net fee income	**16,443**	**7,568**	**4,816**	**1,017**	**152**	**–**	**29,996**
Net trading income/(expense)	**937**	**1,429**	**8,086**	**810**	**(47)**	**448**	**11,663**
Net income/(expense) from financial instruments designated at fair value	**3,290**	**(65)**	**(19)**	**–**	**(72)**	**–**	**3,134**
Gains less losses from financial investments	**3**	**33**	**1,111**	**–**	**1,139**	**–**	**2,286**
Dividend income	**1**	**–**	**6**	**–**	**1,355**	**–**	**1,362**
Net insurance premium income	**46,159**	**4,067**	**–**	**–**	**–**	**–**	**50,226**
Other operating income	**3,277**	**331**	**572**	**10**	**8,616**	**(1,934)**	**10,872**
Total operating income	**95,574**	**28,730**	**26,468**	**2,619**	**8,856**	**(1,934)**	**160,313**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(48,870)**	**(4,046)**	**–**	**–**	**–**	**–**	**(52,916)**
Net operating income before loan impairment charges and other credit risk provisions	**46,704**	**24,684**	**26,468**	**2,619**	**8,856**	**(1,934)**	**107,397**
Loan impairment (charges)/releases and other credit risk provisions	**(1,149)**	**(684)**	**(652)**	**7**	**–**	**–**	**(2,478)**
Net operating income	**45,555**	**24,000**	**25,816**	**2,626**	**8,856**	**(1,934)**	**104,919**
Operating expenses	**(16,969)**	**(6,445)**	**(11,016)**	**(1,361)**	**(8,413)**	**1,934**	**(42,270)**
Operating profit	**28,586**	**17,555**	**14,800**	**1,265**	**443**	**–**	**62,649**
Share of profit in associates and joint ventures	**311**	**2**	**4**	**–**	**–**	**–**	**317**
Profit before tax	**28,897**	**17,557**	**14,804**	**1,265**	**443**	**–**	**62,966**
2013							
Net interest income/(expense)	24,687	13,406	10,380	116	(2,690)	(217)	45,682
Net fee income	15,749	7,473	5,405	105	62	–	28,794
Net trading income	1,045	1,417	8,334	78	66	216	11,156
Net income/(expense) from financial instruments designated at fair value	1,965	–	56	–	(14)	1	2,008
Gains less losses from financial investments	–	–	323	–	–	–	323
Dividend income	1	7	47	–	1,110	–	1,165
Net insurance premium income	43,530	3,659	–	–	–	(16)	47,173
Other operating income	4,799	706	591	–	9,856	(2,149)	13,803
Total operating income	91,776	26,668	25,136	299	8,390	(2,165)	150,104
Net insurance claims and benefits paid and movement in liabilities to policyholders	(46,730)	(4,230)	–	–	–	–	(50,960)
Net operating income before loan impairment charges and other credit risk provisions	45,046	22,438	25,136	299	8,390	(2,165)	99,144
Loan impairment (charges)/releases and other credit risk provisions	(1,065)	(122)	154	–	1	–	(1,032)
Net operating income	43,981	22,316	25,290	299	8,391	(2,165)	98,112
Operating expenses	(15,501)	(5,955)	(10,084)	(224)	(9,246)	2,165	(38,845)
Operating profit/(loss)	28,480	16,361	15,206	75	(855)	–	59,267
Share of profit in associates and joint ventures	518	2	4	–	–	–	524
Profit/(loss) before tax	28,998	16,363	15,210	75	(855)	–	59,791

Financial Review (continued)

Geographical Regions *(continued)*

Hong Kong reported pre-tax profits of HK$62,966m compared with HK$59,791m in 2013, an increase of 5%. The increase in pre-tax profits was mainly due to disposal gains on our investment in Bank of Shanghai of HK$3,320m and our interest in private equity funds of HK$961m, partly offset by the impairment charge against our investment in Industrial Bank of HK$2,103m in 2014. Excluding these disposal gains and impairment, pre-tax profits increased marginally.

Revenue increased by HK$8,253m, or 8%, mainly reflecting the full year impact from the acquisition of GPB business and the disposal gains and impairment in 2014 as mentioned above. Excluding these factors, revenue rose primarily in CMB and RBWM and, to a lesser extent, in GB&M.

Revenue in CMB increased by 10%, mainly due to higher net interest income from growth in term lending across a range of sectors, higher average Payments and Cash Management deposit balances and higher fees from remittance volumes, as well as improved lending spreads.

Revenue in RBWM increased by 4% compared with 2013, driven by higher net interest income from increased average lending balances, mainly credit cards and other personal lending, and from growth in average deposit balances, though the benefit was partly offset by spread compression. Net fee income also increased, principally from volume growth in unit trusts, credit card transactions and securities brokerage. In our insurance operations, revenue growth mainly reflected higher premium income, which also contributed to growth in the debt securities portfolio; although this was partly offset by less positive movements in the present value of in-force long term insurance business ('PVIF') asset in 2014, compared with a larger increase in 2013 as a result of favourable interest rate assumption updates.

Revenue in GB&M increased by 5%, mainly in Balance Sheet Management due to portfolio growth and in Capital Financing from higher average term lending balances. This was partly offset by lower net fee income in Markets due to reduced client flows, and in Capital Financing reflecting fee compression and fewer large M&A mandates completed in 2014.

Loan impairment charges were HK$2,478m compared with HK$1,032m in 2013, primarily due to a rise in individually assessed impairment charges against a small number of GB&M and CMB customers in 2014.

Operating expenses rose by HK$3,425m or 9% in 2014, reflecting investment in Regulatory programmes and Compliance initiatives. Cost growth also reflected the inclusion of our GPB business, wage inflation and additional headcount to support business growth, mainly in CMB, as well as increased marketing activity and higher premises and equipment spend including IT, facility maintenance and property rental.

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
2014							
Net interest income	**13,331**	**11,299**	**15,909**	**590**	**2,053**	**1,151**	**44,333**
Net fee income/(expense)	**4,949**	**4,286**	**5,075**	**417**	**(101)**	**–**	**14,626**
Net trading income/(expense)	**635**	**1,466**	**7,384**	**288**	**(63)**	**(1,151)**	**8,559**
Net income/(expense) from financial instruments designated at fair value	**920**	**15**	**5**	**–**	**(26)**	**–**	**914**
Gains less losses from financial investments	**5**	**5**	**79**	**–**	**14**	**–**	**103**
Dividend income	**5**	**1**	**–**	**–**	**6**	**–**	**12**
Net insurance premium income	**4,981**	**2,115**	**–**	**–**	**1**	**(16)**	**7,081**
Net loss on reclassification of associates	**–**	**–**	**–**	**–**	**(251)**	**–**	**(251)**
Other operating income	**724**	**404**	**489**	**3**	**1,026**	**(702)**	**1,944**
Total operating income	**25,550**	**19,591**	**28,941**	**1,298**	**2,659**	**(718)**	**77,321**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**(5,246)**	**(2,032)**	**–**	**–**	**–**	**12**	**(7,266)**
Net operating income before loan impairment charges and other credit risk provisions	**20,304**	**17,559**	**28,941**	**1,298**	**2,659**	**(706)**	**70,055**
Loan impairment (charges)/releases and other credit risk provisions	**(1,319)**	**(1,080)**	**(50)**	**1**	**1**	**–**	**(2,447)**
Net operating income	**18,985**	**16,479**	**28,891**	**1,299**	**2,660**	**(706)**	**67,608**
Operating expenses	**(15,326)**	**(8,271)**	**(9,629)**	**(885)**	**(1,338)**	**706**	**(34,743)**
Operating profit	**3,659**	**8,208**	**19,262**	**414**	**1,322**	**–**	**32,865**
Share of profit in associates and joint ventures	**2,042**	**11,019**	**2,295**	**–**	**2**	**–**	**15,358**
Profit before tax	**5,701**	**19,227**	**21,557**	**414**	**1,324**	**–**	**48,223**
2013							
Net interest income	13,328	10,660	14,926	159	1,606	1,050	41,729
Net fee income/(expense)	5,411	4,304	5,398	143	(127)	–	15,129
Net trading income/(expense)	617	1,467	7,811	44	(3,514)	(1,050)	5,375
Net income from financial instruments designated at fair value	460	2	–	–	5	–	467
Gains less losses from financial investments	(8)	4	117	–	6	–	119
Dividend income	3	1	–	–	6	–	10
Net insurance premium income	5,053	1,452	–	1	–	(16)	6,490
Net gain on reclassification of associates	–	–	–	–	8,157	–	8,157
Gain on sale of Ping An	–	–	–	–	34,070	–	34,070
Other operating income	1,119	44	626	3	923	(529)	2,186
Total operating income	25,983	17,934	28,878	350	41,132	(545)	113,732
Net insurance claims and benefits paid and movement in liabilities to policyholders	(4,531)	(1,113)	–	(1)	–	13	(5,632)
Net operating income before loan impairment charges and other credit risk provisions	21,452	16,821	28,878	349	41,132	(532)	108,100
Loan impairment (charges)/releases and other credit risk provisions	(1,635)	(970)	103	–	2	–	(2,500)
Net operating income	19,817	15,851	28,981	349	41,134	(532)	105,600
Operating expenses	(16,405)	(7,938)	(9,580)	(227)	(913)	532	(34,531)
Operating profit	3,412	7,913	19,401	122	40,221	–	71,069
Share of profit in associates and joint ventures	1,782	10,323	1,956	–	(165)	–	13,896
Profit before tax	5,194	18,236	21,357	122	40,056	–	84,965

Financial Review (continued)

Geographical Regions *(continued)*

Rest of Asia-Pacific reported pre-tax profits of HK$48,223m compared with HK$84,965m in 2013, a decrease of 43%. The decrease in pre-tax profits reflected a number of events in 2013, mainly the Ping An net disposal gain of HK$30,747m, the accounting gain on reclassification of Industrial Bank of HK$8,454m, and a net gain of HK$685m following disposals of our non-core insurance business in Vietnam, South Korea, Taiwan and Singapore.

Revenue decreased by HK$38,045m, or 35% compared to 2013, mainly due to the gains on disposals and reclassifications of investments as mentioned above. Excluding these, revenues increased mainly in mainland China, and to a lesser extent India and Australia, coupled with the inclusion of full-year financial results from our GPB business in Singapore, partly offset by a decrease in South Korea from the run-off of the RBWM business.

In mainland China, we reported higher net interest income in GB&M from Balance Sheet Management due to portfolio growth and higher re-investment rates, coupled with a rise in average term lending balances. Additionally, trading income improved in Rates from higher interest income on debt securities and revaluation gains on trading bonds as yields fell, and in Foreign Exchange from increased client flows. Revenue in RBWM increased mainly from wider deposit spreads as market interest rates rose in the first half of 2014, while in CMB, revenue growth was mainly driven by higher average deposit and lending balances.

Elsewhere in Asia, revenue in India rose by 7% excluding the effect of foreign currency, primarily in GB&M from higher Rates trading income, coupled with higher net interest income from portfolio growth in Balance Sheet Management. In Australia, we achieved an increase in revenue of 6% after adjusting for the effect of foreign currency, predominantly in GB&M from higher trading income in Rates and Foreign Exchange. This was partly offset by lower revenue in South Korea following the run-off of our RBWM operations in 2013.

Loan impairment charges of HK$2,447m decreased marginally compared with 2013, primarily due to the non-recurring charge arising from the review of our RBWM provisioning models in 2013, coupled with lower provisions in Malaysia and Australia in 2014. This was broadly offset by increases in GB&M and CMB, mainly arising from a small number of individually assessed impairment charges in mainland China; although New Zealand, Malaysia and Vietnam reported lower individually assessed impairment charges in 2014.

Operating expenses rose marginally by HK$212m, following investments in Regulatory programmes and increase in compliance costs, as well as additional headcount supporting business growth notably in mainland China, coupled with wage inflation. These increases were partly offset by a reduction in South Korea due to the non-recurrence of a write-down of our insurance joint venture of HK$558m, and restructuring provisions relating to the run-off of our RBWM operation in 2013.

Share of profit from associates and joint ventures rose by HK$1,462m, mainly due to the impairment charge of HK$819m on our banking associate in Vietnam in 2013. The increase was also due to a higher share of profits from Bank of Communications.

Net interest income

	2014 HK$m	2013 HK$m
Net interest income	**95,109**	87,365
Average interest-earning assets	**4,977,727**	4,512,319
Net interest margin	**%**	%
Spread	**1.79**	1.81
Contribution from net free funds	**0.12**	0.13
Total	**1.91**	1.94
Net interest margin by region		
Hong Kong:		
The Bank	**1.30**	1.34
Hang Seng Bank	**2.16**	2.13
Rest of Asia-Pacific	**1.93**	2.06

Net interest income rose by HK$7,744m, or 9% compared with 2013, primarily from growth in customer lending, deposit and from Balance Sheet Management in Hong Kong and mainland China, partly offset by a reduction in the net interest margin.

Average interest-earning assets increased by HK$465bn or 10% compared with 2013. Average customer lending grew by 12% notably in term lending and mortgages, while financial investments increased by 6%.

Net interest margin decreased by three basis points to 1.91% compared with 2013. The net interest spread decreased by two basis points, while the contribution from net free funds dropped by one basis point. The decrease in net interest margin resulted from compressed spreads on customer lending, coupled with an increase in the commercial surplus deployed in lower yielding assets following the acquisition of the GPB business in Hong Kong and Singapore in late 2013.

In Hong Kong, the Bank recorded a decrease in net interest margin of four basis points from reduced asset spreads on customer lending, notably on term lending, coupled with narrower deposit spreads.

At Hang Seng Bank, the net interest margin increased by three basis points and the net interest spread increased by two basis points. The spread on customer lending improved, mainly on term lending, although the benefit was partly offset by narrower deposit spreads in Hong Kong in a competitive deposit market.

In the Rest of Asia-Pacific, the net interest margin decreased by 13 basis points from compressed asset spreads on customer lending, notably in mortgages and term lending, while deposit spreads remained relatively stable.

Financial Review (continued)

Net fee income

	2014 HK$m	2013 HK$m
Brokerage	**7,697**	7,344
Cards	**7,082**	7,146
Unit trust	**6,531**	5,672
Import/export	**4,968**	4,986
Funds under management	**4,193**	4,114
Remittances	**3,508**	3,364
Credit facilities	**2,997**	3,176
Account services	**2,925**	2,782
Underwriting	**1,949**	1,908
Insurance	**1,400**	1,401
Other	**7,412**	8,294
Fee income	**50,662**	50,187
Fee expense	**(6,040)**	(6,341)
Net fee income	**44,622**	43,846

Net trading income

	2014 HK$m	2013 HK$m
Dealing profits	**13,674**	15,104
Net loss from hedging activities	**(6)**	(37)
Net interest income on trading assets and liabilities	**5,168**	3,859
Dividend income from trading securities	**1,384**	974
Ping An contingent forward sale contract	**–**	(3,323)
Net trading income	**20,220**	16,577

Gains less losses from financial investments

	2014 HK$m	2013 HK$m
Gain on sale of Ping An	**–**	34,070
Gains on disposal of available-for-sale securities	**4,608**	470
Impairment of available-for-sale equity investments	**(2,219)**	(28)
Gains less losses from financial investments	**2,389**	442

Gains less losses from financial investments in 2014 included disposal gain of our investment in Bank of Shanghai and the profit from intra-group sale of our interest in private equity funds.

In 2014, an impairment charge of HK$2,103m was made on our shareholding in Industrial Bank.

Other operating income

	2014 HK$m	2013 HK$m
Gain on reclassification of Industrial Bank	–	8,454
Loss on reclassification of Yantai Bank	–	(297)
Loss on reclassification of Techcom Bank	(251)	–
Net gain/(loss) on reclassification of associates	(251)	8,157
Movement in present value of in-force insurance business	3,581	4,735
Gains on investment properties	670	1,389
Gain on disposal of property, plant and equipment, and assets held for sale	61	299
Gain on disposal of subsidiaries, associates and business portfolios	104	758
Rental income from investment properties	422	312
Other	3,915	3,925
Other operating income	8,753	11,418

Insurance income

Included in the net operating income are the following revenues earned by the insurance business:

	2014 HK$m	2013 HK$m
Net interest income	9,439	8,702
Net fee income	2,083	1,864
Net trading loss	(512)	(349)
Net income from financial instruments designated at fair value	4,159	2,426
Net insurance premium income	57,307	53,663
Movement in present value of in-force business	3,581	4,735
Other operating income	173	1,052
	76,230	72,093
Net insurance claims and benefits paid and movement in liabilities to policyholders	(60,182)	(56,592)
Total insurance income	16,048	15,501

Net interest income increased by 8% driven by growth in the debt securities portfolio, reflecting net inflows from new and renewal insurance business.

Net income from financial instruments designated at fair value was HK$4,159m compared with HK$2,426m in 2013, reflecting improved equity market performance and increased bond prices. To the extent that revaluation is attributed to policyholders, there is an offsetting movement reported under 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

Net insurance premium income rose by 7% as a result of increases in new business premiums from sales of deferred annuity products and a high net-worth product, as well as renewals. These were partly offset by lower unit-linked insurance premiums. The growth in premiums resulted in a corresponding increase in 'Net insurance claims and benefits paid and movement in liabilities to policyholders'.

The movement in present value of in-force business decreased by HK$1,154m, mainly due to a gain from the favourable interest rate assumption updates in 2013. Excluding the impact from the annual assumption updates for both years, the movement in present value of in-force business increased by HK$1,000m from a favourable investment market conditions update and an increase in the value of new business.

Other operating income in 2013 included the gains on sale of our interests in Bao Viet Holdings and Hana HSBC Life Insurance Company Limited, offset by the disposal loss on the life insurance business in Taiwan.

Financial Review (continued)

Loan impairment charges and other credit risk provisions

	2014 HK$m	2013 HK$m
Individually assessed impairment charges		
New charges	**4,202**	2,433
Releases	**(1,420)**	(1,426)
Recoveries	**(156)**	(198)
	2,626	809
Collectively assessed impairment charges	**2,272**	2,602
Other credit risk provisions	**27**	121
Loan impairment charges and other credit risk provisions	**4,925**	3,532

Individually assessed impairment charges increased in 2014, primarily in CMB and GB&M, comprising charges against a small number of customers in Hong Kong and mainland China. The collectively assessed impairment charge in 2013 included the impact from the review of our RBWM provisioning models.

There were no impairment losses or provisions against available-for-sale debt securities included in other credit risk provisions (2013: nil), or relating to held-to-maturity investments (2013: nil).

Operating expenses

	2014 HK$m	2013 HK$m
Employee compensation and benefits	**38,894**	36,938
General and administrative expenses	**28,278**	26,127
Depreciation of property plant and equipment	**4,107**	3,988
Amortisation and impairment of intangible assets	**1,671**	1,675
	72,950	68,728
Of which: restructuring costs	**67**	662
	2014 %	2013 %
Cost efficiency ratio	**42.1**	33.9

Employee compensation and benefits increased by HK$1,956m. Wages and salaries increased in 2014, reflecting the full year impact from the acquisition of Global Private Banking business in Hong Kong and Singapore in November 2013 (HK$1.1bn), together with increased headcounts to support IT infrastructure, Risk and Compliance initiatives and business growth, coupled with wage inflation. These increases were partly offset by lower restructuring costs primarily due to the provisions relating to the rundown of the RBWM business in South Korea in 2013.

General administrative expenses increased by HK$2,151m in 2014, mainly due to higher marketing expenses, higher property rental and higher investments in Regulatory programmes and Compliance initiatives.

Operating expenses *(continued)*

Staff numbers by region (full time equivalent)	At 31 December	
	2014	2013
Hong Kong:		
The bank and wholly owned subsidiaries	**21,153**	20,189
Hang Seng Bank Hong Kong	**8,215**	7,945
Total Hong Kong	**29,368**	28,134
Rest of Asia-Pacific:		
Australia	**1,682**	1,654
Mainland China	**9,106**	8,711
Malaysia	**4,665**	4,694
India	**4,737**	4,961
Indonesia	**5,496**	5,773
Singapore	**3,077**	3,048
Taiwan	**2,320**	2,249
Sri Lanka	**1,410**	1,404
Others	**6,433**	6,393
Total Rest of Asia-Pacific	**38,926**	38,887
Total	**68,294**	67,021

Tax expense

The tax expense in the consolidated income statement comprises:

	2014	2013
	HK$m	HK$m
Current income tax		
Hong Kong profits tax	**8,862**	8,479
Overseas taxation	**8,696**	8,158
Deferred taxation	**1,454**	(936)
	19,012	15,701

The effective rate of tax for 2014 was 17.1% compared with 10.8% in 2013. The lower effective tax rate in 2013 was largely due to non-taxable gains arising from the reclassification of Industrial Bank and the disposal of Ping An.

Assets

	2014		2013	
	HK$m	**%**	HK$m	%
Cash and sight balances at central bank	**156,475**	**2.3**	158,879	2.5
Reverse repurchase agreements – non-trading	**218,901**	**3.3**	150,584	2.4
Placings with and advances to banks	**488,313**	**7.3**	564,521	9.0
Loans and advances to customers	**2,815,216**	**42.3**	2,619,245	42.0
Financial investments	**1,456,493**	**21.9**	1,379,771	22.1
Other[1]	**1,526,694**	**22.9**	1,370,801	22.0
	6,662,092	**100.0**	6,243,801	100.0

1 *Excluding Hong Kong Government certificates of indebtedness.*

Gross loans and advances to customers in Hong Kong increased by HK$157bn, or 10%, during 2014 largely from growth in corporate and commercial lending of HK$88bn, reflecting our continued support to customers. Residential mortgage lending and other personal lending increased by HK$23bn and HK$19bn respectively.

In Rest of Asia-Pacific, gross loans and advances to customers increased by HK$40bn, or 4%. Excluding the unfavourable foreign exchange translation effects of HK$46bn, the underlying increase of HK$86bn was mainly from growth in corporate and commercial lending of HK$62bn from business growth in mainland China, Taiwan, India and Singapore.

Financial Review (continued)

Customer accounts

Customer accounts by type	2014 HK$m	2013 HK$m
Current accounts	**919,343**	862,138
Savings accounts	**2,379,651**	2,246,618
Other deposit accounts	**1,180,998**	1,144,942
Total	**4,479,992**	4,253,698
Customer accounts by region		
Hong Kong excluding Hang Seng Bank	**2,173,472**	2,067,700
Hang Seng Bank Hong Kong	**844,537**	769,399
Rest of Asia-Pacific	**1,461,983**	1,416,599
Total	**4,479,992**	4,253,698

	2014 %	2013 %
Advances-to-deposits ratio	**62.8**	61.6

Customer accounts increased by HK$226bn, notably in Hong Kong, mainland China, Taiwan and Singapore. The group's advances-to-deposits ratio remained steady at 62.8% at 31 December 2014.

Equity

Equity increased by HK$86bn, or 16%, to HK$608bn. The increase in equity was mainly due to the issue of additional share capital and Basel III-compliant additional tier 1 capital instruments during the year, together with increases in retained profits and available-for-sale reserve.

The Directors have declared a fourth interim dividend in respect of the financial year ended 31 December 2014 of HK$14,250m (HK$0.37 per ordinary share).

Risk Report

Risk Management *(Unaudited)*

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

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

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

We examined a scenario in 2014 of a significant slowdown in economic activity in Hong Kong and China. The result of this stress test demonstrated that the group would remain satisfactorily capitalised after taking account of assumed management actions.

Description of risks - banking operations
(Audited)

Risks	Arising from	Measurement, monitoring and management of risk
Credit risk		
The risk of financial loss if a customer or counterparty fails to meet an obligation under a contract.	• Credit risk arises principally from direct lending, trade finance and leasing business, but also from certain other products such as guarantees and derivatives.	Credit risk: • is measured as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark to market value of the contract and the expected potential change in that value over time caused by movements in market rates; • is monitored within limits approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the group could be subjected should the customer or counterparty fail to perform its contractual obligations; and • is managed through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.
Liquidity and funding risk		
The risk that we do not have sufficient financial resources to meet our obligations as they fall due or that we can only do so at excessive cost.	• Liquidity risk arises from mismatches in the timing of cash flows. • Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.	Liquidity and funding risk: • is measured using internal metrics including stressed operational cash flow projections, coverage ratio and advances to core funding ratios; • is monitored against the Group's liquidity and funding risk framework and overseen by regional Asset and Liability Management Committees ('ALCO's), Group ALCO and the Risk Management Meeting; and • is managed on a stand-alone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established market practice.

Risk Report (continued)

Risks	Arising from	Measurement, monitoring and management of risk
Market risk		
The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.	Exposure to market risk is separated into two portfolios: • Trading portfolios comprise positions arising from market-making and warehousing of customer derived positions. • Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held to maturity, and exposures arising from our insurance operations.	Market risk: • is measured in terms of value at risk, which is used to estimate potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence, augmented with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables; • is monitored using measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to the market risk positions within each risk type; and • is managed using risk limits approved by the Risk Management Committee for the group. These units are allocated across business lines and to the group's operating entities.
Operational risk		
The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk .	Operational risk arises from day to day operations or external events, and is relevant to every aspect of our business.	Operational risk: • is measured using both the scenario analysis process and the risk and control assessment process, which assess the level of risk and effectiveness of controls; • is monitored using key indicators and other internal control activities; and • is primarily managed by global business and functional managers. They identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls using the operational risk management framework. The Global Operational Risk function is responsible for the framework and for overseeing the management of operational risks within businesses and functions.
Other material risks		
Reputational risk		
The risk that illegal, unethical or inappropriate behaviour by the group itself, members of staff or clients or representatives of the group will damage our reputation, leading, potentially, to a loss of business, fines or penalties.	Reputational risk encompasses negative reaction not only to activities which may be illegal or against regulations, but also to activities that may be counter to societal standards, values and expectations. It arises from a wide variety of causes, including how we conduct our business and the way in which clients to whom we provide financial services, and bodies who represent us, conduct themselves.	Reputational risk: • is measured by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees; • is monitored through a reputational risk management framework, taking into account the results of the compliance risk monitoring activity; and • is managed by every member of staff and is covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk, including the Group Reputational Risk Policy Committee and regional/business equivalents.

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

Description of risks - insurance manufacturing operations

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

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

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

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

Risk Report (continued)

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

Global business	**RBWM**	**CMB**	**GB&M**	**GPB**	**Other**
Business activities	• Deposits • Accounts services • Credit and lending • Asset management • Wealth solutions and financial planning • Broking • Life insurance manufacturing	• Deposits • Payments and cash management • Credit and lending • Global trade and receivable finance • Global markets (via GB&M) • Capital financing (via GB&M) • Insurance and investments	• Deposits • Payments and cash management • Balance sheet management • Credit and lending • Asset and trade finance • Corporate finance • Markets • Securities services	• Deposits • Account services • Credit and lending • Asset management • Financial advisory • Broking • Corporate finance (via GB&M) • Alternative investments	• The Bank's central operations
Balance sheet[1]	HK$bn • Assets 1,290 • Customer accounts 2,224	HK$bn • Assets 1,232 • Customer accounts 1,207	HK$bn • Assets 4,227 • Customer accounts 814	HK$bn • Assets 115 • Customer accounts 232	HK$bn • Assets 13 • Customer accounts 3
RWAs	HK$bn • Credit risk 242 • Operational risk 60	HK$bn • Credit risk 816 • Counterparty credit risk 2 • Operational risk 59	HK$bn • Credit risk 831 • Counterparty credit risk 118 • Operational risk 147 • Market risk 143	HK$bn • Credit risk 18 • Counterparty credit risk 1 • Operational risk 5	HK$bn • Credit risk 247 • Operational risk 19
Risk Profile	Liquidity and funding risk, Reputational risk and Insurance risk. The latter is predominantly in RBWM and CMB.				

Credit Risk

(Audited)

Credit risk generates the largest regulatory capital requirement of the risks we incur. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities. The group's principal credit risk management procedures and policies, which follow policies established by HSBC Group Head Office, include the following:

- Formulating credit policies which are consistent with the Group credit policy and documenting these in detail in dedicated manuals.
- Establishing and maintaining the group's large credit exposure policy. This policy delineates the group's maximum exposures to individual customers, customer groups and other risk concentrations.
- Establishing and complying with lending guidelines on the group's attitude towards, and appetite for, lending to specified market sectors and industries.
- Undertaking an objective assessment of risk. All commercial non-bank credit facilities originated by the group in excess of designated limits are subject to review prior to the facilities being committed to customers.
- Controlling exposures to banks and other financial institutions. The group's credit and settlement risk limits to counterparties in the finance and government sectors are designed to optimise the use of credit availability and avoid excessive risk concentration.
- Managing exposures to debt securities by establishing controls in respect of the liquidity of securities held for trading and setting issuer limits for financial investments. Separate portfolio limits are established for asset-backed securities and similar instruments.
- Controlling cross-border exposures to manage country and cross-border risk through the imposition of country limits with sub-limits by maturity and type of business.
- Controlling exposures to selected industries. When necessary, restrictions are imposed on new business, or exposures in the group's operating entities are capped.
- Maintaining and developing risk ratings in order to categorise exposures meaningfully and facilitate focused management of the attendant risks. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk-rating processes are increasingly used for the larger facilities, ultimate responsibility for setting risk grades rests in each case with the final approving executive. Risk grades are reviewed frequently and amendments, where necessary, are implemented promptly.

Both the group's Risk Management Committee ('RMC') and HSBC Group Head Office receive regular reports on credit exposures. These include information on large credit exposures, concentrations, industry exposures, levels of impairment provisioning and country exposures.

RMC has the responsibility for risk approval authorities and approving definitive risk policies and controls. It monitors risk inherent to the financial services business, receives reports, determines action to be taken and reviews the efficacy of the risk management framework.

The Executive Committee ('EXCO') and RMC are supported by a dedicated group risk function headed by the Chief Risk Officer, who is a member of both EXCO and RMC and reports to the Chief Executive.

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

(i) Credit exposure

Maximum exposure to credit risk
(Audited)

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

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

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

The group	**2014 HK$m**	2013 HK$m
Cash and sight balances at central banks	**156,475**	158,879
Items in the course of collection from other banks	**21,122**	16,346
Hong Kong Government certificates of indebtedness	**214,654**	195,554
Trading assets	**365,846**	279,760
Debt securities	**231,734**	150,145
Treasury and other eligible bills	**102,028**	109,174
Other	**32,084**	20,441
Derivatives	**389,934**	388,727
Financial assets designated at fair value	**17,238**	19,900
Debt securities	**17,238**	19,871
Other	**–**	29
Reverse repurchase agreements – non-trading	**218,901**	150,584
Placings with and advances to banks	**488,313**	564,521
Loans and advances to customers	**2,815,216**	2,619,245
Personal	**1,002,613**	963,372
Corporate and commercial	**1,704,184**	1,580,517
Financial (non-bank financial institutions)	**108,419**	75,356
Financial investments	**1,407,362**	1,344,975
Debt securities	**862,826**	819,277
Treasury and other eligible bills	**544,536**	525,698
Amounts due from Group companies	**191,694**	161,975
Other assets	**82,000**	77,895
Acceptances and endorsements	**31,200**	34,239
Other	**50,800**	43,656
Financial guarantees and other credit-related contingent liabilities	**61,666**	83,647
Loan commitments and other credit-related commitments[1]	**2,265,453**	1,944,536
At 31 December	**8,695,874**	8,006,544

1 *Includes both revocable and irrevocable commitments.*

The Bank

	2014 HK$m	2013 HK$m
Cash and sight balances at central banks	**120,468**	112,585
Items in the course of collection from other banks	**15,888**	10,922
Hong Kong Government certificates of indebtedness	**214,654**	195,554
Trading assets	**257,333**	204,069
Debt securities	**166,447**	111,588
Treasury and other eligible bills	**68,147**	82,003
Other	**22,739**	10,478
Derivatives	**374,876**	377,183
Financial assets designated at fair value: debt securities	**1,257**	1,561
Reverse repurchase agreements – non-trading	**116,113**	86,601
Placings with and advances to banks	**206,309**	250,918
Loans and advances to customers	**1,590,711**	1,483,910
Personal	**562,034**	538,117
Corporate and commercial	**956,572**	894,856
Financial (non-bank financial institutions)	**72,105**	50,937
Financial investments	**717,978**	755,572
Debt securities	**307,966**	329,861
Treasury and other eligible bills	**410,012**	425,711
Amounts due from Group companies	**404,136**	366,889
Other assets	**37,400**	37,255
Acceptances and endorsements	**16,625**	19,845
Other	**20,775**	17,410
Financial guarantees and other credit-related contingent liabilities	**40,589**	41,783
Loan commitments and other credit-related commitments[1]	**1,562,132**	1,282,148
At 31 December	**5,659,844**	5,206,950

1 *Includes both revocable and irrevocable commitments.*

Total exposure to credit risk remained broadly unchanged in 2014 with loans and advances remaining the largest element.

(ii) Credit quality of financial instruments
(Audited)

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

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

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

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

Quality classification definitions
(Audited)

- Strong: Exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.
- Medium: Exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery processes.
- Sub-standard: Exposures require varying degrees of special attention and default risk of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.
- Impaired: Exposures have been assessed, individually or collectively, as impaired. The group observes the convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any retail EL ('Expected Loss') grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

Granular risk rating scales
(Audited)

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

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

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

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

Distribution of financial instruments by credit quality
(Audited)

The group

	Neither past due nor impaired						
31 December 2014	**Strong HK$m**	**Medium[1] HK$m**	**Sub-standard HK$m**	**Past due not impaired HK$m**	**Impaired HK$m**	**Impairment allowances HK$m**	**Total HK$m**
Items in the course of collection from other banks	19,595	1,527	–	–	–	–	21,122
Trading assets	280,265	85,456	125	–	–	–	365,846
– treasury and other eligible bills	92,277	9,751	–	–	–	–	102,028
– debt securities	175,655	55,954	125	–	–	–	231,734
– loans and advances to banks	8,589	5,740	–	–	–	–	14,329
– loans and advances to customers	3,744	14,011	–	–	–	–	17,755
Derivatives	319,670	69,971	293	–	–	–	389,934
Financial assets designated at fair value	14,621	2,617	–	–	–	–	17,238
– debt securities	14,621	2,617	–	–	–	–	17,238
– loans and advances to customers	–	–	–	–	–	–	–
Reverse repurchase agreements – non-trading	152,021	66,880	–	–	–	–	218,901
Placings with and advances to banks held at amortised cost	425,580	60,458	2,273	2	–	–	488,313
Loans and advances to customers held at amortised cost	1,362,131	1,388,858	25,821	33,039	15,887	(10,520)	2,815,216
– personal	863,201	114,637	597	22,339	3,808	(1,969)	1,002,613
– corporate and commercial	453,699	1,213,449	24,954	8,545	11,984	(8,447)	1,704,184
– financial (non-bank financial institutions)	45,231	60,772	270	2,155	95	(104)	108,419
Financial investments	1,272,781	134,575	–	–	6	–	1,407,362
– treasury and other eligible bills	507,519	37,017	–	–	–	–	544,536
– debt securities	765,262	97,558	–	–	6	–	862,826
Other assets	31,720	48,744	1,144	287	105	–	82,000
– acceptances and endorsements	5,400	24,749	1,002	5	44	–	31,200
– other	26,320	23,995	142	282	61	–	50,800
Total	3,878,384	1,859,086	29,656	33,328	15,998	(10,520)	5,805,932

1 *Includes HK$126,328m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

2 *The above table does not include inter-company balances.*

Risk Report (continued)

31 December 2013	Neither past due nor impaired: Strong HK$m	Medium[1] HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	14,515	1,829	2	–	–	–	16,346
Trading assets	230,974	48,032	754	–	–	–	279,760
– treasury and other eligible bills	95,145	13,994	35	–	–	–	109,174
– debt securities	124,035	25,391	719	–	–	–	150,145
– loans and advances to banks	8,956	2,941	–	–	–	–	11,897
– loans and advances to customers	2,838	5,706	–	–	–	–	8,544
Derivatives	328,218	60,236	273	–	–	–	388,727
Financial assets designated at fair value	16,809	3,091	–	–	–	–	19,900
– debt securities	16,809	3,062	–	–	–	–	19,871
– loans and advances to customers	–	29	–	–	–	–	29
Reverse repurchase agreements – non-trading	83,353	67,231	–	–	–	–	150,584
Placings with and advances to banks held at amortised cost	489,537	72,361	2,537	86	–	–	564,521
Loans and advances to customers held at amortised cost	1,296,748	1,256,461	29,756	32,646	13,135	(9,501)	2,619,245
– personal	857,139	82,358	535	21,425	4,078	(2,163)	963,372
– corporate and commercial	415,314	1,126,041	28,540	9,280	8,450	(7,109)	1,580,516
– financial (non-bank financial institutions)	24,295	48,062	681	1,941	607	(229)	75,357
Financial investments	1,223,652	118,552	2,765	–	6	–	1,344,975
– treasury and other eligible bills	493,213	32,157	328	–	–	–	525,698
– debt securities[1]	730,439	86,395	2,437	–	6	–	819,277
Other assets	23,708	52,813	1,105	216	53	–	77,895
– acceptances and endorsements	6,393	26,823	1,006	15	2	–	34,239
– other	17,315	25,990	99	201	51	–	43,656
Total	3,707,514	1,680,606	37,192	32,948	13,194	(9,501)	5,461,953

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

2 *The above table does not include inter-company balances.*

The Bank

31 December 2014	Neither past due nor impaired: Strong HK$m	Medium[1] HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	**14,919**	**969**	**–**	**–**	**–**	**–**	**15,888**
Trading assets	**185,399**	**71,809**	**125**	**–**	**–**	**–**	**257,333**
– treasury and other eligible bills	**58,398**	**9,749**	**–**	**–**	**–**	**–**	**68,147**
– debt securities	**118,315**	**48,007**	**125**	**–**	**–**	**–**	**166,447**
– loans and advances to banks	**4,998**	**263**	**–**	**–**	**–**	**–**	**5,261**
– loans and advances to customers	**3,688**	**13,790**	**–**	**–**	**–**	**–**	**17,478**
Derivatives	**313,416**	**61,258**	**202**	**–**	**–**	**–**	**374,876**
Financial assets designated at fair value:							
– debt securities	**–**	**1,257**	**–**	**–**	**–**	**–**	**1,257**
Reverse repurchase agreements – non-trading	**82,307**	**33,806**	**–**	**–**	**–**	**–**	**116,113**
Placings with and advances to banks held at amortised cost	**178,195**	**27,853**	**259**	**2**	**–**	**–**	**206,309**
Loans and advances to customers held at amortised cost	**772,677**	**785,417**	**14,151**	**15,159**	**9,179**	**(5,872)**	**1,590,711**
– personal	**470,714**	**82,434**	**232**	**8,005**	**1,506**	**(857)**	**562,034**
– corporate and commercial	**270,519**	**664,610**	**13,649**	**5,128**	**7,579**	**(4,912)**	**956,573**
– financial (non-bank financial institutions)	**31,444**	**38,373**	**270**	**2,026**	**94**	**(103)**	**72,104**
Financial investments	**621,926**	**96,046**	**–**	**–**	**6**	**–**	**717,978**
– treasury and other eligible bills	**378,107**	**31,905**	**–**	**–**	**–**	**–**	**410,012**
– debt securities	**243,819**	**64,141**	**–**	**–**	**6**	**–**	**307,966**
Other assets	**13,345**	**23,151**	**779**	**28**	**97**	**–**	**37,400**
– acceptances and endorsements	**3,255**	**12,603**	**722**	**1**	**44**	**–**	**16,625**
– other	**10,090**	**10,548**	**57**	**27**	**53**	**–**	**20,775**
Total	**2,182,184**	**1,101,566**	**15,516**	**15,189**	**9,282**	**(5,872)**	**3,317,865**

1 *Includes HK$106,865m of treasury and eligible bills and debt securities that have been classified as BBB+ to BBB- using the ratings of Standard & Poor's.*

2 *The above table does not include inter-company balances.*

Risk Report (continued)

31 December 2013	Neither past due nor impaired: Strong HK$m	Neither past due nor impaired: Medium[1] HK$m	Neither past due nor impaired: Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	9,485	1,435	2	–	–	–	10,922
Trading assets	161,204	42,682	183	–	–	–	204,069
– treasury and other eligible bills	68,009	13,994	–	–	–	–	82,003
– debt securities	88,506	22,899	183	–	–	–	111,588
– loans and advances to banks	1,862	110	–	–	–	–	1,972
– loans and advances to customers	2,827	5,679	–	–	–	–	8,506
Derivatives	321,165	55,814	204	–	–	–	377,183
Financial assets designated at fair value:							
– debt securities	555	1,006	–	–	–	–	1,561
Reverse repurchase agreements – non-trading	63,939	22,662	–	–	–	–	86,601
Placings with and advances to banks held at amortised cost	215,206	35,537	89	86	–	–	250,918
Loans and advances to customers held at amortised cost	716,398	727,808	22,445	15,346	7,119	(5,206)	1,483,910
– personal	482,802	47,036	245	7,441	1,620	(1,027)	538,117
– corporate and commercial	218,475	647,746	21,687	5,998	4,906	(3,956)	894,856
– financial (non-bank financial institutions)	15,121	33,026	513	1,907	593	(223)	50,937
Financial investments	665,990	89,450	126	–	6	–	755,572
– treasury and other eligible bills	395,977	29,734	–	–	–	–	425,711
– debt securities	270,013	59,716	126	–	6	–	329,861
Other assets	8,472	27,906	804	56	17	–	37,255
– acceptances and endorsements	4,524	14,568	736	15	2	–	19,845
– other	3,948	13,338	68	41	15	–	17,410
Total	2,162,414	1,004,300	23,853	15,488	7,142	(5,206)	3,207,991

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

2 *The above table does not include inter-company balances.*

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

The amounts in the following table reflect exposures designated as past due but not impaired. Examples of exposures designated as past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment and short-term trade facilities past due more than 90 days for technical reasons, such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

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 2014						
Loans and advances to customers held at amortised cost[1]	**27,445**	**4,217**	**1,370**	**7**	**–**	**33,039**
– personal	**17,433**	**3,689**	**1,211**	**6**	**–**	**22,339**
– corporate and commercial	**7,938**	**447**	**159**	**1**	**–**	**8,545**
– financial (non-bank financial institutions)	**2,074**	**81**	**–**	**–**	**–**	**2,155**
Placings with and advances to banks held at amortised cost	**2**	**–**	**–**	**–**	**–**	**2**
Other assets	**131**	**30**	**26**	**42**	**58**	**287**
	27,578	**4,247**	**1,396**	**49**	**58**	**33,328**
31 December 2013						
Loans and advances to customers held at amortised cost[1]	25,921	4,968	1,504	160	93	32,646
– personal	16,405	3,899	1,074	46	1	21,425
– corporate and commercial	7,873	773	430	114	90	9,280
– financial (non-bank financial institutions)	1,643	296	–	–	2	1,941
Placings with and advances to banks held at amortised cost	86	–	–	–	–	86
Other assets	131	24	25	24	12	216
	26,138	4,992	1,529	184	105	32,948

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 2014						
Loans and advances to customers held at amortised cost[1]	**12,314**	**2,291**	**553**	**1**	**–**	**15,159**
– personal	**5,701**	**1,849**	**455**	**–**	**–**	**8,005**
– corporate and commercial	**4,668**	**361**	**98**	**1**	**–**	**5,128**
– financial (non-bank financial institutions)	**1,945**	**81**	**–**	**–**	**–**	**2,026**
Placings with and advances to banks held at amortised cost	**2**	**–**	**–**	**–**	**–**	**2**
Other assets	**16**	**5**	**7**	**–**	**–**	**28**
	12,332	**2,296**	**560**	**1**	**–**	**15,189**
31 December 2013						
Loans and advances to customers held at amortised cost[1]	12,067	2,407	758	92	22	15,346
– personal	5,562	1,510	369	–	–	7,441
– corporate and commercial	4,888	609	389	92	20	5,998
– financial (non-bank financial institutions)	1,617	288	–	–	2	1,907
Placings with and advances to banks held at amortised cost	86	–	–	–	–	86
Other assets	32	5	10	4	5	56
	12,185	2,412	768	96	27	15,488

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

(iv) Impaired loans and advances
(Audited)

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

Analyses of impairment allowances at 31 December 2014, and the movement of such allowances during the year, are disclosed in note 17.

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

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

(v) Impairment assessment
(Audited)

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

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

Impairment and credit risk mitigation

The existence of collateral has an impact when calculating impairment on individually assessed impaired loans. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for an impairment allowance. No impairment allowance is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

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

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

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

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

(vi) Collateral and other credit enhancements
(Audited)

Loans and advances

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

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

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

Risk Report (continued)

Personal lending

(Audited)

Residential mortgages including loan commitments by level of collateral

	At 31 December 2014 HK$m	2013 HK$m
Unimpaired loans		
Fully collateralised	**769,890**	762,451
– Less than 25% LTV	**119,091**	98,986
– 25% to 50% LTV	**348,753**	331,186
– 51% to 75% LTV	**241,549**	266,496
– 76% to 90% LTV	**53,563**	53,004
– 91% to 100% LTV	**6,934**	12,779
Partially collateralised		
– Greater than 100% LTV (A)	**769**	2,807
– Collateral value on A	**625**	2,379
Not collateralised	**771**	665
	771,430	765,923
Impaired loans		
Fully collateralised	**1,987**	1,978
– Less than 25% LTV	**255**	248
– 25% to 50% LTV	**754**	532
– 51% to 75% LTV	**695**	746
– 76% to 90% LTV	**249**	380
– 91% to 100% LTV	**34**	72
Partially collateralised		
– Greater than 100% LTV (B)	**52**	129
– Collateral value on B	**35**	34
Not collateralised	**6**	22
	2,045	2,129
Total residential mortgages	**773,475**	768,052

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

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

Other personal lending

Other personal lending consists primarily of personal loans, overdrafts and credit cards, all of which are generally unsecured, except lending to private banking customers which are generally secured.

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

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

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

	At 31 December	
	2014	2013
	HK$m	HK$m
Rated CRR/EL 1 to 7	**341,709**	324,558
Not collateralised	**125,131**	109,827
Fully collateralised	**204,177**	196,301
Partially collateralised (A)	**12,401**	18,430
– collateral value on A	**6,989**	13,089
Rated CRR/EL 8	**233**	100
Not collateralised	**52**	81
Fully collateralised	**179**	4
– Less than 25% LTV	**2**	–
– 25% to 50% LTV	**–**	4
– 51% to 75% LTV	**88**	–
– 76% to 90% LTV	**67**	–
– 91% to 100% LTV	**22**	–
Partially collateralised (B)	**2**	15
– collateral value on B	**1**	7
Rated CRR/EL 9 to 10	**603**	130
Not collateralised	**365**	–
Fully collateralised	**119**	89
– Less than 25% LTV	**11**	1
– 25% to 50% LTV	**37**	15
– 51% to 75% LTV	**17**	48
– 76% to 90% LTV	**14**	20
– 91% to 100% LTV	**40**	5
Partially collateralised (C)	**119**	41
– collateral value on C	**41**	36
Total commercial real estate loans and advances	**342,545**	324,788

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

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

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

	At 31 December	
	2014	2013
	HK$m	HK$m
Rated CRR/EL 8	**2,617**	2,006
Not collateralised	**1,842**	1,432
Fully collateralised	**432**	395
– Less than 25% LTV	**–**	123
– 25% to 50% LTV	**100**	168
– 51% to 75% LTV	**2**	37
– 76% to 90% LTV	**68**	63
– 91% to 100% LTV	**262**	4
Partially collateralised (A)	**343**	179
– collateral value on A	**132**	37
Rated CRR/EL 9 to 10	**11,177**	9,610
Not collateralised	**7,239**	6,000
Fully collateralised	**1,112**	1,246
– Less than 25% LTV	**250**	59
– 25% to 50% LTV	**279**	393
– 51% to 75% LTV	**211**	158
– 76% to 90% LTV	**123**	405
– 91% to 100% LTV	**249**	231
Partially collateralised (B)	**2,826**	2,364
– collateral value on B	**1,314**	1,165
Total	**13,794**	11,616

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.

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 lending activities 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. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

Placings with and advances to banks
(*Audited)*

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

	At 31 December	
	2014	2013
	HK$m	HK$m
Rated CRR/EL 1 to 8		
Not collateralised	**498,004**	565,854
Fully collateralised	**12,307**	10,670
Partially collateralised (A)	–	4,346
– collateral value on A	–	3,021
Total placings with and advances to banks	**510,311**	580,870

The collateral used in the assessment of the above lending relates primarily to cash and marketable securities. Placings with and advances to banks are typically unsecured.

Derivatives
(Audited)

The International Swaps and Derivatives Association ('ISDA') Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over the counter ('OTC') products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or another pre-agreed termination event occurs. It is common, and our preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institution clients. Please refer to note 45 "Offsetting of financial assets and liabilities' for further details.

Other credit risk exposures
(Audited)

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

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

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 42 'Contingent liabilities and commitments'.

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

(Audited)	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**80**	53	**72**	20
Commercial and industrial properties	**26**	16	**22**	15
Other assets	**3**	3	–	–
	109	72	**94**	35

Repossessed assets are made available-for-sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The group does not generally occupy repossessed properties for its own business use.

Liquidity and Funding Risk

(Audited)

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

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

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

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

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

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

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

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

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

- maintaining compliance with relevant regulatory requirements of the operating entity;
- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to core funding ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined limits;
- maintaining debt financing plans;
- monitoring of depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Liquidity ratio under the Hong Kong Banking Ordinance
(Audited)

The Banking Ordinance requires banks operating in Hong Kong to maintain a minimum liquidity ratio of 25%, calculated in accordance with the provisions of the Fourth Schedule of the Banking Ordinance. This requirement applies separately to the Hong Kong branches of the Bank and to those subsidiary companies which are Authorised Institutions under the Banking Ordinance in Hong Kong.

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

	2014	2013
	%	%
Hong Kong branches of the Bank	**35.2**	36.5

The management of liquidity and funding risk
(Audited)

Inherent liquidity risk categorisation

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

Core deposits

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

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

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

Repurchase agreements transactions and bank deposits cannot be categorised as core deposits.

Advances to core funding ratio

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

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

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

Stressed coverage ratios

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

The stressed cash inflows include:

- inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and
- contractual cash inflows from maturing assets that are not already reflected as a use of liquid assets.

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

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

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

	Advances to core funding ratio		Stressed one month coverage ratio		Stressed three month coverage ratio	
	2014	2013	**2014**	2013	**2014**	2013
	%	%	**%**	%	**%**	%
Year-end	**79.9**	77.8	**120.2**	122.1	**114.2**	116.3
Maximum	**80.2**	83.1	**122.1**	131.9	**116.3**	127.3
Minimum	**77.8**	77.1	**116.7**	115.7	**113.2**	110.8
Average	**79.6**	79.8	**118.4**	121.2	**114.3**	115.5

Stressed scenario analysis

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

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

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

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

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

Liquid assets
(Unaudited)

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

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

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

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

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

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

Any entity owned and controlled by central or local/regional government but not explicitly guaranteed is treated as a public sector entity and any exposure explicitly guaranteed is reflected as an exposure to the ultimate guarantor.

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

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

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

	At 31 December	
	2014	2013
	HK$m	HK$m
Liquid assets of the group		
Level 1	**1,330,759**	1,238,471
Level 2	**73,940**	80,726
Level 3	**67,916**	67,874
	1,472,615	1,387,071

Liquid assets increased as a result of a rise in customer deposits.

Wholesale debt monitoring
(Unaudited)

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

Sources of funding
(Unaudited)

Our primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice. We also access wholesale funding markets by issuing senior secured and unsecured debt securities (publicly and privately) and borrowing from the secured repo markets against high quality collateral, in order to obtain funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local wholesale market.

Liquidity behaviouralisation
(Audited)

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

Contingent liquidity risk
(Audited)

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

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

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

Encumbered and unencumbered assets

(Unaudited)

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

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

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

Analysis of on-balance sheet encumbered and unencumbered assets

	Encumbered	Unencumbered		Unencumbered- cannot be pledged as collateral		
	Assets pledged as collateral HK$m	Readily realisable assets HK$m	Other realisable assets HK$m	Reverse repo/stock borrowing receivables & derivative assets HK$m	Cannot be pledged as collateral and amounts due from Group companies HK$m	Total HK$m
31 December 2014						
Cash and sight balances at central banks	–	156,474	–	–	1	156,475
Items in the course of collection from other banks	–	–	–	–	21,122	21,122
Hong Kong Government certificates of indebtedness	–	–	–	–	214,654	214,654
Trading assets	23,665	351,229	31,849	283	–	407,026
– treasury and other eligible bills	7,267	94,761	–	–	–	102,028
– debt securities	13,324	218,410	–	–	–	231,734
– equity shares	3,074	38,058	48	–	–	41,180
– placings with and advances to banks	–	–	14,329	–	–	14,329
– loans and advances to customers	–	–	17,472	283	–	17,755
Derivatives	–	–	–	389,934	–	389,934
Financial assets designated at fair value	–	1,257	–	–	96,938	98,195
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	1,257	–	–	15,981	17,238
– equity shares	–	–	–	–	80,957	80,957
– loans and advances to customers	–	–	–	–	–	–
Reverse repurchase agreements – non-trading	–	–	–	218,901	–	218,901
Placings with and advances to banks	–	147	355,781	5,912	126,473	488,313
Loans and advances to customers	1,187	21,012	2,761,751	9,017	22,249	2,815,216
Financial investments	58,081	1,123,293	5,925	–	269,194	1,456,493
– treasury and other eligible bills	25,151	517,858	–	–	1,527	544,536
– debt securities	32,930	562,334	124	–	267,438	862,826
– equity shares	–	43,101	5,801	–	229	49,131
Asset held for sale	–	–	148	–	–	148
Other assets	–	17,396	39,615	–	69,108	126,119
Current tax assets	–	–	–	–	2,418	2,418
Prepayments and accrued income	–	–	–	–	22,191	22,191
Interest in associates and joint ventures	–	–	114,456	–	2,198	116,654
Goodwill and intangible assets	–	–	–	–	45,078	45,078
Property, plant and equipment	–	–	97,492	–	7,187	104,679
Deferred tax	–	–	–	–	1,436	1,436
Amounts due from Group companies	–	–	–	–	191,694	191,694
	82,933	1,670,808	3,407,017	624,047	1,091,941	6,876,746

Risk Report (continued)

	Encumbered	Unencumbered		Unencumbered- cannot be pledged as collateral		
	Assets pledged as collateral HK$m	Readily realisable assets HK$m	Other realisable assets HK$m	Reverse repo/stock borrowing receivables & derivative assets HK$m	Cannot be pledged as collateral and amounts due from Group companies HK$m	Total HK$m
31 December 2013						
Cash and sight balances at central banks	–	158,878	–	–	1	158,879
Items in the course of collection from other banks	–	–	–	–	16,346	16,346
Hong Kong Government certificates of indebtedness	–	–	–	–	195,554	195,554
Trading assets	18,144	272,818	20,430	8	–	311,400
– treasury and other eligible bills	4,759	104,415	–	–	–	109,174
– debt securities	11,402	138,743	–	–	–	150,145
– equity shares	1,983	29,657	–	–	–	31,640
– placings with and advances to banks	–	–	11,897	–	–	11,897
– loans and advances to customers	–	3	8,533	8	–	8,544
Derivatives	–	–	–	388,727	–	388,727
Financial assets designated at fair value	–	1,561	–	–	88,585	90,146
– treasury and other eligible bills	–	–	–	–	–	–
– debt securities	–	1,561	–	–	18,310	19,871
– equity shares	–	–	–	–	70,246	70,246
– loans and advances to customers	–	–	–	–	29	29
Reverse repurchase agreements – non-trading	–	–	–	150,584	–	150,584
Placings with and advances to banks	–	92	430,195	–	134,234	564,521
Loans and advances to customers	2,392	10,775	2,592,862	281	12,935	2,619,245
Financial investments	50,912	1,090,433	7,458	–	230,968	1,379,771
– treasury and other eligible bills	31,005	492,944	–	–	1,749	525,698
– debt securities	19,907	570,095	126	–	229,149	819,277
– equity shares	–	27,394	7,332	–	70	34,796
Asset held for sale	–	–	4,476	–	–	4,476
Other assets	–	13,267	47,637	–	62,049	122,953
Current tax assets	–	–	–	–	2,034	2,034
Prepayments and accrued income	–	–	–	–	19,476	19,476
Interest in associates and joint ventures	–	3	105,816	–	2,033	107,852
Goodwill and intangible assets	–	–	–	–	41,882	41,882
Property, plant and equipment	–	605	94,164	–	6,471	101,240
Deferred tax	–	–	–	–	2,294	2,294
Amounts due from Group companies	–	–	–	–	161,975	161,975
	71,448	1,548,432	3,303,038	539,600	976,837	6,439,355

Additional contractual obligations

(Unaudited)

Under the terms of our current collateral obligations under derivative contracts (which are ISDA compliant CSA contracts), and based on the positions at 31 December 2014, we estimate that we could be required to post additional collateral of up to HK$467m (2013: HK$364m) in the event of a one-notch downgrade in credit ratings, which would increase to HK$641m (2013: HK$530m) in the event of a two-notch downgrade.

Liquidity regulation

(Unaudited)

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

In January 2013, the Basel Committee announced several changes to the calibration of the LCR which included reducing the outflow applied to non-operational non-financial corporate deposits from 75% to 40% and reducing the outflow applied to committed liquidity facilities from 100% to 30%. In response to the updated Basel standard on liquidity, the HKMA's consultation in respect of the LCR has been completed and the Banking (Liquidity) Rules were introduced in 2014 and become effective from 2015.

In January 2014, the Basel committee issued a further consultation paper in respect of the NSFR and in October 2014, the final NSFR standard was issued.

Market Risk

(Audited)

Market risk is the risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.

There were no significant changes to our policies and practices for the management of market risk in 2014.

Exposure to market risk

Exposure to market risk is separated into two portfolios:

- *Trading portfolios* comprise positions arising from market-making and warehousing of customer-derived positions.
- *Non-trading portfolios* comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held to maturity, and exposures arising from our insurance operations.

Where appropriate, the group applies similar risk management policies and measurement techniques to both trading and non-trading portfolios. The group's objective is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the status as one of the world's largest banking and financial services organisations.

The nature of the hedging and risk mitigation strategies performed across the group corresponds to the market risk management instruments available within each operating jurisdiction. These strategies range from the use of traditional market instruments, such as interest rate swaps, to more sophisticated hedging strategies to address a combination of risk factors arising at portfolio level.

Market risk governance

(Audited)

Market risk is managed and controlled through limits approved by the GMB for HSBC Holdings and the various global businesses. These limits are allocated across business lines and to the Group's legal entities. The management of market risk is principally undertaken in Global Markets through risk limits. Value at risk ('VaR') Limits are set for portfolios, products, and risk types, with market liquidity and business need being the primary factors in determining the level of limits set.

Model risk is governed through Model Oversight Committees (‘MOC’s) at the regional and Global Wholesale Credit and Market Risk (‘WCMR’) level. They have direct oversight and approval responsibility for all traded risk models utilised for risk measurement and management and stress testing. The MOCs prioritise the development of models, methodologies and practices used for traded risk management and ensure that they remain within our risk appetite and business plans. The Global WCMR MOC reports into the Group MOC, which oversees all risk types at Group level. Group MOC informs the Group Risk Management Meeting (‘RMM’) about material issues at least on a bi-annual basis. The RMM is the Group’s ‘Designated Committee’ according to the regulatory rules and it has delegated day-to-day governance of all traded risk models to the Global WCMR MOC.

Our control of market risk in the trading and non-trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by the Group Risk, of enforcing new product approval procedures, and of restricting trading in the more complex derivative products only to sites with appropriate levels of product expertise and robust control systems.

Market risk measures
(Audited)

Monitoring and limiting market risk exposures

Our objective is to manage and control market risk exposures while maintaining a market profile consistent with our risk appetite. We use a range of tools to monitor and limit market risk exposures including sensitivity analysis, VaR and stress testing.

Sensitivity analysis
(Unaudited)

Sensitivity analysis measures the impact of individual market factor movements on specific instruments or portfolios including interest rates, foreign exchange rates and equity prices, for example, the impact of a one basis point change in yield. We use sensitivity measures to monitor the market risk positions within each risk type.

Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk
(Audited)

VaR is a technique that estimates the potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. The use of VaR is integrated into market risk management and is calculated for all trading positions regardless of how the group capitalises those exposures. Where there is no approved internal model, the group uses the appropriate local rules to capitalise exposures.

In addition, the group calculates VaR for non-trading portfolios in order to have a complete picture of market risk. Our models are predominantly based on historical simulation. VaR is calculated at a 99% confidence level for a one-day holding period. Where VaR is not calculated explicitly, alternative tools are used.

The VaR models are based predominantly on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models used incorporate the following features:

- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- potential market movements utilised for VaR are calculated with reference to data from the past two years; and
- VaR measures are calculated to a 99 per cent confidence level and use a one-day holding period scaled to 10 days.

The nature of the VaR models means that an increase in observed market volatility will lead to an increase in VaR without any changes in the underlying positions.

VaR model limitations

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 holding period assumes that all positions can be liquidated or the risks offset during that period. This may not fully reflect the market risk arising at times of severe illiquidity, when the holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition does not take into account losses that might occur beyond this level of confidence;
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VaR is unlikely to reflect loss potential on exposures that only arise under significant market movements.

Backtesting

We routinely validate the accuracy of the VaR models by back-testing both clean and hypothetical profit and loss against the trading VaR numbers. Hypothetical P&L excludes non-modelled items such as fees, commissions and revenues of intra-day transactions from the actual reported profit and loss.

We would expect on average to see two to three profits, and two or three losses, in excess of VaR at the 99% confidence level over a one-year period. The actual number of profits or losses in excess of VaR over this period can therefore be used to gauge how well the models are performing. To ensure a conservative approach in calculating our risk exposures, it is important to note that profits in excess of VaR are only considered when back-testing the accuracy of models and are not used to calculate the VaR numbers used for risk management or capital purposes. VaR is back-tested at various levels which reflect the full scope of HSBC.

Risk not in VaR framework
(Unaudited)

Our VaR model is designed to capture significant basis risks such as credit default swaps versus bond, asset swap spreads and cross-currency basis. Other basis risks which are not completely covered in VaR, such as the Libor tenor basis, are complemented by risk-not-in-VaR (‘RNIV’) calculations and are integrated into the capital framework.

The RNIV framework aims to manage and capitalise material market risks that are not adequately covered in the VaR model. An example of this is Libor-overnight index swap basis risk for minor currencies. In such instances, the RNIV framework uses stress tests to quantify the capital requirement. On average in 2014, the capital requirement derived from these stress tests represented 2.9% of the total internal model-based market risk requirement.

Risks covered by RNIV represent 11.7% of market risk RWAs for models with regulatory approval and include those resulting from underlying risk factors which are not observable on a daily basis across asset classes and products, such as dividend risk or do not have long enough data history for stressed VaR calculation .

Risk factors are reviewed on a regular basis and either incorporated directly in the VaR models, where possible, or quantified through the VaR-based RNIV approach or a stress test approach within the RNIV framework. The severity of the scenarios is calibrated to be in line with the capital adequacy requirements. The outcome of the VaR-based RNIV is included in the VaR back-testing; a stressed VaR RNIV is also computed for the risk factors considered in the VaR-based RNIV approach.

Stress testing

(Audited)

Stress testing is an important tool that is integrated into our market risk management tool to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables. In such abnormal scenarios, losses can be much greater than those predicted by VaR modelling.

Stress testing is implemented at the legal entity, sites and the overall group levels. A standard set of scenarios is utilised consistently across all sites within the group. At a group level, a set of scenarios are defined to capture the relevant events or market movements at each level. The risk appetite around potential stress losses for the entity is set and monitored against referral limits.

The process is governed by the Stress Testing Review Group forum which, in conjunction with regional risk management, determines the scenarios to be applied at portfolio and consolidated level, as follows:

- single risk factor stress scenarios that are unlikely to be captured within the VaR models, such as the break of a currency peg;
- technical scenarios consider the largest move in each risk factor without consideration of any underlying market correlation;
- hypothetical scenarios consider potential macroeconomic events, for example, the slowdown in mainland China and the potential effects of a sovereign debt default, including its wider contagion effects; and
- historical scenarios incorporate historical observations of market movements during previous periods of stress which would not be captured within VaR.

Market Risk Reverse stress tests are undertaken based upon the premise that there is a fixed loss. The stress test process identifies which scenarios lead to this loss. The rationale behind the reverse stress test is to understand scenarios which are beyond normal business settings that could have contagion and systemic implications.

Stressed VaR and stress testing, together with reverse stress testing and the management of gap risk, provide management with insights regarding the 'tail risk' beyond VaR for which our appetite is limited.

Market risk in 2014

(Unaudited)

Global financial markets generally continued to be supported by the accommodative monetary policies followed by leading central banks in 2014. However, the year was dominated by discussions around how quickly the US Federal Reserve would taper off its asset purchase programme. In addition, market sentiment worsened due to fears of negative spillovers for some emerging markets that had experienced slower economic growth and continued external imbalances. This has led to increased volatility in markets across most asset classes.

Trading portfolios

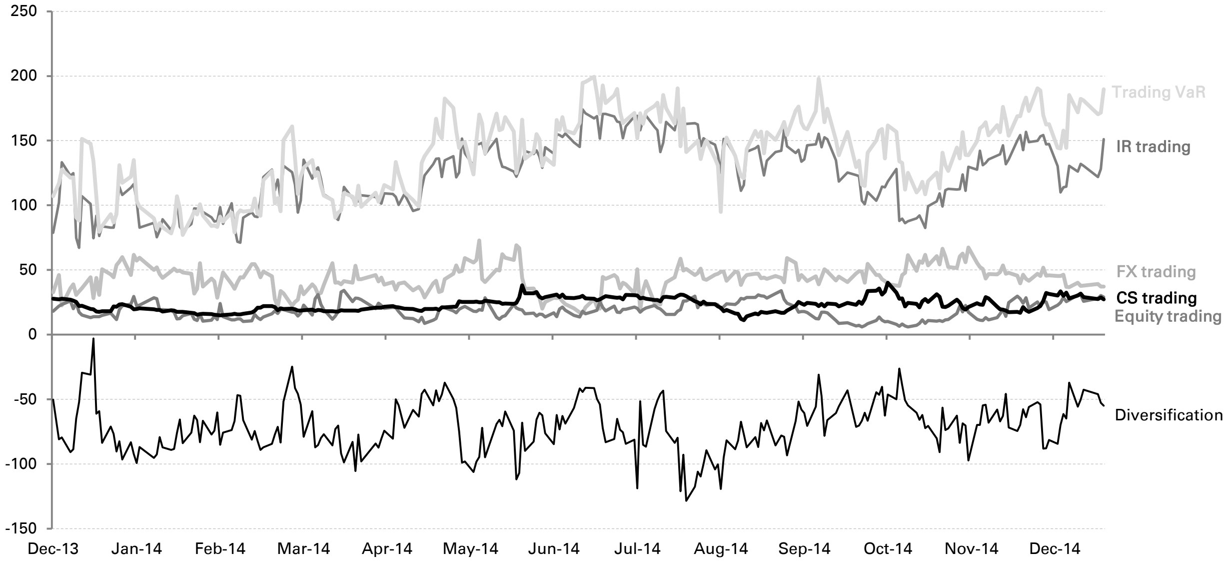
(Audited)

Value at risk of the trading portfolios

Trading VaR predominantly resides within Global Markets. The VaR for trading activity at 31 December 2014 was higher than at 31 December 2013 primarily due to increase in the risk profile of the interest rate business. This leads to a rise in interest rate VaR and trading VaR.

The daily levels of total trading VaR over the last year is set out in the graph below.

Daily VaR (trading portfolios), 99% 1 day (HK$m)
(Unaudited)



The trading VaR for the year is shown in the table below.

Trading value at risk, 99% 1 day[1]
(Audited)

	Foreign exchange and commodity HK$m	Interest rate HK$m	Equity HK$m	Credit spread HK$m	Portfolio diversification[2] HK$m	Total HK$m
At 31 December 2014						
Year end	**37**	**151**	**28**	**27**	**(55)**	**190**
Average	**43**	**124**	**18**	**23**		**138**
Maximum	**72**	**174**	**34**	**40**		**199**
At 31 December 2013						
Year end	33	79	18	28	(54)	107
Average	39	91	22	27		107
Maximum	88	120	42	49		189

1 *Trading portfolios comprise positions arising from the market-making and warehousing of customer-derived positions.*

2 *Portfolio diversification is the market risk dispersion effect of holding a portfolio containing different risk types. It represents the reduction in unsystematic market risk that occurs when combining a number of different risk types, for example, interest rate, equity and foreign exchange, together in one portfolio. It is measured as the difference between the sum of the VaR by individual risk type and the combined total VaR. A negative number represents the benefit of portfolio diversification. As the maximum and minimum occur on different days for different risk types, it is not meaningful to calculate a portfolio diversification benefit for these measures.*

Non-trading portfolios
(Unaudited)

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 embedded optionality within certain investment product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts, and the re-pricing behaviour of managed rate products.

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, Liability and Capital 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 managed with the Balance Sheet Management limits or neutralised through the use of interest rate swaps.

Sensitivity of net interest income

A principal part of our management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling).

The group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream. A large part of the group's exposure to changes in net interest income arising from movements in interest rates relates to its core deposit franchise. The group's core deposit franchise is exposed to changes in the value of the deposits raised and spreads against wholesale funds. The value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is, however, asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.

Structural foreign exchange exposures
(Unaudited)

Structural foreign exchange exposures, monitored using sensitivity analysis, represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than the US dollar. An entity's functional currency is that of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in 'Other comprehensive income'.

We hedge structural foreign exchange exposures only in limited circumstances. Our structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that our consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

We may also transact hedges where a currency in which we have structural exposures is considered likely to revalue adversely, and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

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

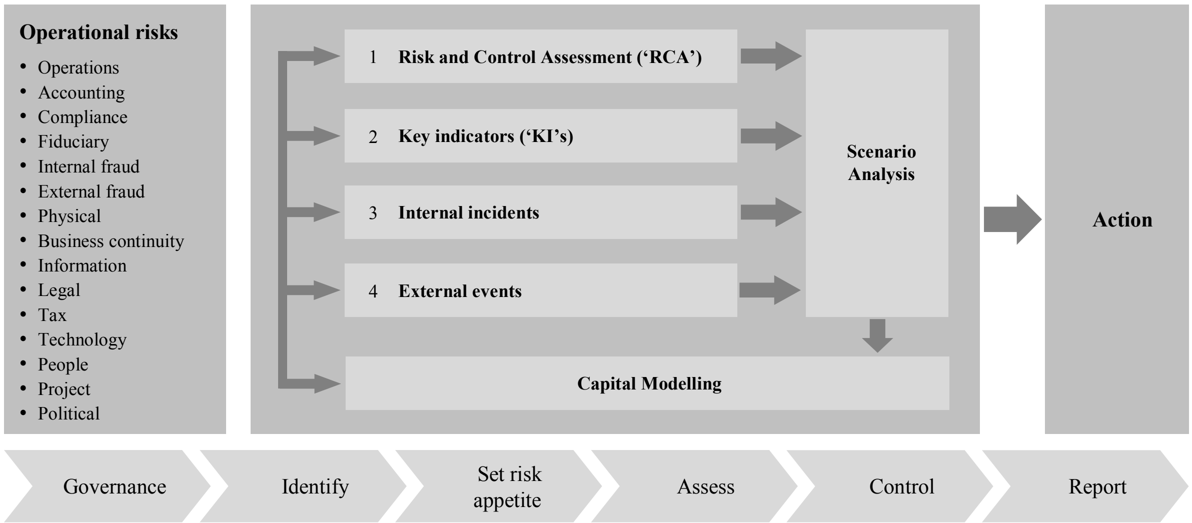
	The group	
	LCYm	HK$m equivalent
At 31 December 2014		
Renminbi	**158,785**	**198,584**
At 31 December 2013		
Renminbi	135,713	172,594

Operational Risk

(Audited)

Operational risk management framework

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



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

Through articulating our risk appetite for material operational risks, the organisation determines the level of risk it is willing to accept. Monitoring operational risk exposure against risk appetite on a regular basis and either mitigating or accepting the exposures drives risk awareness in a more forward-looking manner. It assists management in determining whether further action is required.

Operational risk and control assessments are performed by individual business units and functions. The risk and control assessment process is designed to provide businesses and functions with a forward-looking view of operational risks and an assessment of the effectiveness of controls. It also provides a tracking mechanism for action plans so that they can proactively manage operational risk within acceptable levels. Risk and control assessments are reviewed and updated at least annually.

In addition to the risk and control assessment process, an enhanced scenario analysis process has been implemented to improve the quantification and management of material risks through scenario analysis.

Key operational risks (Unaudited)

- *Fraud and financial crime*: the threat of fraud perpetrated by or against our customers, especially in retail and commercial banking, may increase during adverse economic conditions. We have increased monitoring, root cause analysis and review of internal controls to enhance our defences against external attacks and reduce the level of loss in these areas. In addition, Group Security and Fraud Risk work closely with global businesses to continually assess these threats as they evolve and adapt our controls to mitigate them. The Bank is also exposed to potential criminal activities and has invested heavily in improving its customer due diligence and transaction monitoring and screening controls.

- *Third party risks:* the Bank has procedures in place to conduct due diligence and monitor the performance of third party suppliers and service providers in so far as they may affect the Bank's ability service its customers.

- *Regulatory compliance:* our ability to respond to increasing demands or changes in regulatory requirements in the markets in which we operate remains a critical focus for the Bank. A Global Standards programme is being rolled out to ensure implementation of critical regulatory and financial crime compliance requirements. Various conduct and values initiatives have also been initiated to ensure that exposures to mis-selling or market conduct abuses are minimised.
- *Information security*: the security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and our franchise. A failure of our defences against such attacks could result in financial loss, loss of customer data and other sensitive information which could undermine both our reputation and our ability to retain the trust of our customers.
- *Level of change creating operational complexity:* operational stresses may occur during periods of growth as well as during volatile periods in a market downturn. The Operational Risk function engages with business management in business transformation initiatives to ensure the resilience of the internal control environment. This may involve thematic reviews of new initiatives and analysis of loss or indicator trends, as well as participation and discussion of issues or concerns at relevant governance or management committees.
- *People risk:* attracting and retaining staff with appropriate skills and expertise across the markets in which we operate remains a challenge. Significant investment is made in training and management development initiatives to equip our staff for the business changes we face and for the implementation of global standards.

Reputational Risk

(Unaudited)

Reputational risk is the failure to meet stakeholder expectations as a result of any event, behaviour, action or inaction, either by HSBC itself, our employees or those with whom we are associated, that might cause stakeholders to form a negative view of HSBC.

Reputational risk relates to perceptions, whether based on fact or otherwise. Stakeholders' expectations are constantly changing and thus reputational risk is dynamic and varies between geographies, groups and individuals. As a global bank, we show unwavering commitment to operating, and to be seen to be operating, to the high standards we have set for ourselves in every jurisdiction. Reputational risk might result in financial or non-financial impacts, loss of confidence, adverse effects on our ability to keep and attract customers, or other consequences. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

A number of measures to enhance our anti-money laundering, sanctions and other regulatory compliance frameworks have been taken and/or are ongoing. These measures, which should also serve over time to enhance our reputational risk management, include the following:

- simplifying our business through the progressive implementation of our Group strategy, including the adoption of a global financial crime risk filter, which should help to standardise our approach to doing business in higher risk countries;
- an increase in reputational risk resources in each region in which we operate and the introduction of a central case management and tracking process for reputational risk and client relationship matters;
- the creation of combined reputational risk and client selection committees within the global businesses with a clear process to escalate and address matters at the appropriate level;
- the continued roll-out of training and communication about the HSBC Values Programme that defines the way everyone in the Group should act and seeks to ensure that the Values are embedded into our operations; and
- the continuous development and implementation of the Global Standards around financial crime compliance, which underpin our businesses. This includes ensuring globally consistent application of policies that govern AML and sanctions compliance provisions.

HSBC has zero tolerance for knowingly engaging in any business, activity or association where foreseeable reputational damage has not been considered and mitigated. There must be no barriers to open discussion and escalation of issues that could affect the Group negatively. While there is a level of risk in every aspect of business activity, appropriate consideration of potential harm to HSBC's good name must be a part of all business decisions. Detecting and preventing illicit actors' access to the global financial system calls for constant vigilance and we will continue to cooperate closely with all governments to achieve success. This is integral to the execution of our strategy, to HSBC Values and to preserving and enhancing our reputation.

Insurance Risk

(Audited)

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

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

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

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

Asset and liability management (insurance)

A principal tool used by the group to manage its exposure to insurance risk is asset and liability matching. The group actively manages its assets using an approach that considers asset quality, diversification, cash flow matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return within acceptable parameters. The Investment Committee reviews and approves strategic asset allocation on a periodic basis and establishes investment guidelines. The asset and liability management process is also overseen by the Asset and Liability Management Committee of the group's insurance business.

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

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

Risk Report (continued)

Statement of financial position of insurance manufacturing subsidiaries by type of contract

	Non-linked Contracts[1] HK$m	Linked Contracts[2] HK$m	Other assets[3] HK$m	Total HK$m
At 31 December 2014				
Financial assets:				
– financial assets designated at fair value	**47,048**	**49,343**	**546**	**96,937**
– derivatives	**173**	**3**	**24**	**200**
– financial investments	**212,417**	**–**	**20,353**	**232,770**
– other financial assets	**35,891**	**1,433**	**821**	**38,145**
Total financial assets	**295,529**	**50,779**	**21,744**	**368,052**
Reinsurance assets	**4,341**	**1,454**	**–**	**5,795**
PVIF[4]	**–**	**–**	**32,389**	**32,389**
Other assets	**6,053**	**5**	**2,695**	**8,753**
Total assets	**305,923**	**52,238**	**56,828**	**414,989**
Liabilities under investment contracts designated at fair value	**29,239**	**7,426**	**–**	**36,665**
Liabilities under insurance contracts	**265,743**	**44,439**	**–**	**310,182**
Deferred tax	**225**	**–**	**6,021**	**6,246**
Other liabilities	**–**	**–**	**3,571**	**3,571**
Total liabilities	**295,207**	**51,865**	**9,592**	**356,664**
Total equity	**–**	**–**	**58,325**	**58,325**
Total equity and liabilities	**295,207**	**51,865**	**67,917**	**414,989**

	Non-linked Contracts[1] HK$m	Linked Contracts[2] HK$m	Other assets[3] HK$m	Total HK$m
At 31 December 2013				
Financial assets:				
– financial assets designated at fair value	43,980	44,061	515	88,556
– derivatives	11	2	41	54
– financial investments	188,480	–	17,042	205,522
– other financial assets	30,825	1,527	1,929	34,281
Total financial assets	263,296	45,590	19,527	328,413
Reinsurance assets	2,924	1,700	–	4,624
PVIF[4]	–	–	28,916	28,916
Other assets	6,462	5	1,934	8,401
Total assets	272,682	47,295	50,377	370,354
Liabilities under investment contracts designated at fair value	29,159	7,527	–	36,686
Liabilities under insurance contracts	236,911	39,269	–	276,180
Deferred tax	93	–	4,906	4,999
Other liabilities	–	–	2,886	2,886
Total liabilities	266,163	46,796	7,792	320,751
Total equity	–	–	49,603	49,603
Total equity and liabilities	266,163	46,796	57,395	370,354

1 *Comprises life non-linked insurance contracts, non-linked investment contracts and remaining non-life insurance contracts.*
2 *Comprises life linked insurance contracts and linked investment contracts.*
3 *Comprises shareholder assets.*
4 *Present value of in-force long-term insurance business.*

Underwriting strategy

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

Reinsurance strategy

The group reinsures a portion of the insurance risks it underwrites in order to mitigate its exposures to losses and protect capital resources. The group uses reinsurance to manage financial risk arising from guaranteeing minimum investment performance under a unit-linked insurance product and a traditional non-participating insurance product. Although reinsurance provides a means of managing insurance risk, it exposes the group to credit risk arising from default by the reinsurers. Management of such credit risk exposure is described on page 63.

Nature of risks covered

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

(i) Insurance contracts – non-linked products

The basic feature of non-linked insurance business is to provide guaranteed death benefits determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender benefit, guaranteed maturity benefit, credit rating 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 or terminal bonuses. The group has complete contractual discretion on the bonuses declared. It is the group's goal to maintain a stable dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable.

(ii) Insurance contracts – unit-linked products

The group writes unit-linked life insurance policies, which typically provide policyholders with life insurance protection and a choice of investment in a variety of funds. Premiums received are deposited into the chosen funds. Charges for the cost of insurance and administration are deducted from the funds accumulated. There is a unit-linked product with significant performance guarantee where 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 to invest their contributions. 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.

Concentrations of insurance risks

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

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

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

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

Life business is generally long term in nature and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore an appropriate overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies and a range of assumptions which mainly include interest rate and mortality levels. The process used to determine the assumptions is intended to result in stable and prudent estimates of future outcomes. This is achieved by incorporating risk margins into best estimate assumptions which can withstand a reasonable range of fluctuation of actual experience. An annual review of the relevant experience is performed to assess the adequacy of margins that exist between the assumptions adopted and the most likely estimate of future outcome. Since the group is not exposed to significant insurance risk on investment contracts, they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 32.

Financial risks (insurance)

Managing financial assets backing insurance liabilities may result in the group assuming financial risks. These include market risk, credit risk and liquidity risk. Each of these financial risks is described below, together with a summary of the ways in which the group manages these risks arising from underwriting insurance business.

The group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders. The risk is that the yield on the assets held by the group to meet these guarantees may fall short of the guaranteed return. The framework for the management of this risk is to invest in fixed income securities and adopt a matching approach whereby assets held are managed to meet the liabilities to policyholders. Where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities, a provision is established to provide additional coverage.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries at 31 December 2014 by type of liability, and provides a view of the exposure to financial risk:

Financial assets held by insurance manufacturing subsidiaries

	Non-linked contracts HK$m	Linked contracts HK$m	Other assets HK$m	Total HK$m
At 31 December 2014				
Financial assets designated at fair value				
– Debt securities	**15,424**	**11**	**546**	**15,981**
– Equity securities	**31,624**	**49,332**	**–**	**80,956**
	47,048	**49,343**	**546**	**96,937**
Financial investments				
Held-to-maturity:				
– Debt securities	**163,289**	**–**	**19,336**	**182,625**
Available-for-sale:				
– Treasury bills	**–**	**–**	**–**	**–**
– Debt securities	**49,127**	**–**	**793**	**49,920**
– Equity securities	**1**	**–**	**224**	**225**
	49,128	**–**	**1,017**	**50,145**
Derivatives	**173**	**3**	**24**	**200**
Other financial assets	**35,891**	**1,433**	**821**	**38,145**
	295,529	**50,779**	**21,744**	**368,052**
At 31 December 2013				
Financial assets designated at fair value				
– Debt securities	17,782	13	515	18,310
– Equity securities	26,198	44,048	–	70,246
	43,980	44,061	515	88,556
Financial investments				
Held-to-maturity:				
– Debt securities	162,858	–	16,608	179,466
Available-for-sale:				
– Treasury bills	–	–	–	–
– Debt securities	25,622	–	365	25,987
– Equity securities	–	–	69	69
	25,622	–	434	26,056
Derivatives	11	2	41	54
Other financial assets	30,825	1,527	1,929	34,281
	263,296	45,590	19,527	328,413

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 linked liabilities represented 13.8% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2014 (2013: 13.9%). The table also shows that approximately 67.5% of financial assets were invested in debt securities at 31 December 2014 (2013: 68.1%), with 22.1% (2013: 21.4%) invested in equity securities.

Market risk (insurance)

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

Interest rate risk

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

For participating products, interest rate risk can also be mitigated through sharing of risk with policyholders under the discretionary participation mechanism.

The following table illustrates the effects of selected interest rate scenarios on our profit for the year and total equity of our insurance subsidiaries:

	31 December 2014		31 December 2013	
	Impact on profit for the year	**Impact on net assets**	Impact on profit for the year	Impact on net assets
	HK$m	**HK$m**	HK$m	HK$m
+ 100 basis points parallel shift in yield curves	**1,463**	**(3,221)**	1,179	(1,308)
– 100 basis points parallel shift in yield curves	**(1,720)**	**3,973**	(1,343)	1,263

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

Equity and other price risks

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

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

	31 December 2014		31 December 2013	
	Impact on profit for the year	**Impact on net assets**	Impact on profit for the year	Impact on net assets
	HK$m	**HK$m**	HK$m	HK$m
10% increase in equity prices	**1,173**	**1,173**	948	948
10% decrease in equity prices	**(938)**	**(938)**	(780)	(780)

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and, therefore, the results cannot be extrapolated. The sensitivities reflect the established investment risk sharing mechanism with policyholders for participating products but do not allow for the effect of other management actions which may mitigate the impact of the equity price decline, nor for any resultant changes in policyholder behaviour that might accompany such a fall.

Foreign currency risk

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

Credit risk (insurance)

The insurance operation portfolios of fixed income securities, and to a lesser extent short-term and other investments, are subject to credit risk. This risk is defined as the potential financial loss resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive 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. 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. 89% (2013: 88.4%) of the assets included in the table are invested in investments rated as 'Strong'. There were no investments rated as sub-standard or below.

	As at 31 December 2014			As at 31 December 2013		
	Neither past due nor impaired			Neither past due nor impaired		
	Strong HK$m	**Medium HK$m**	**Total HK$m**	Strong HK$m	Medium HK$m	Total HK$m
Supporting liabilities under non-linked insurance and investment contracts						
Financial assets designated at fair value	**14,123**	**1,301**	**15,424**	15,806	1,976	17,782
– treasury and other eligible bills	**–**	**–**	**–**	–	–	–
– debt securities	**14,123**	**1,301**	**15,424**	15,806	1,976	17,782
Financial investments	**187,906**	**24,510**	**212,416**	165,971	22,509	188,480
– treasury and other eligible bills	**–**	**–**	**–**	–	–	–
– debt securities	**187,906**	**24,510**	**212,416**	165,971	22,509	188,480
Supporting shareholders funds[1]						
Financial assets designated at fair value	**499**	**47**	**546**	448	67	515
– treasury and other eligible bills	**–**	**–**	**–**	–	–	–
– debt securities	**499**	**47**	**546**	448	67	515
Financial investments	**18,718**	**1,411**	**20,129**	15,472	1,501	16,973
– treasury and other eligible bills	**–**	**–**	**–**	–	–	–
– debt securities	**18,718**	**1,411**	**20,129**	15,472	1,501	16,973
Financial assets designated at fair value	**14,622**	**1,348**	**15,970**	16,254	2,043	18,297
– treasury and other eligible bills	**–**	**–**	**–**	–	–	–
– debt securities	**14,622**	**1,348**	**15,970**	16,254	2,043	18,297
Financial investments	**206,624**	**25,921**	**232,545**	181,443	24,010	205,453
– treasury and other eligible bills	**–**	**–**	**–**	–	–	–
– debt securities	**206,624**	**25,921**	**232,545**	181,443	24,010	205,453

1 *Shareholders funds comprise solvency and unencumbered assets.*

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

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong HK$m	**Medium HK$m**	**Sub-standard HK$m**	**Past due not impaired HK$m**	**Impaired HK$m**	**Impairment allowances HK$m**	**Total HK$m**
At 31 December 2014							
Non-linked insurance contracts	**4,128**	**54**	**–**	**–**	**–**	**–**	**4,182**
Linked insurance contracts	**3**	**1,438**	**–**	**–**	**–**	**–**	**1,441**
Total	**4,131**	**1,492**	**–**	**–**	**–**	**–**	**5,623**
Reinsurance debtors	**28**	**35**	**–**	**109**	**–**	**–**	**172**
At 31 December 2013							
Non-linked insurance contracts	2,834	2	–	–	–	–	2,836
Linked insurance contracts	3	1,692	–	–	–	–	1,695
Total	2,837	1,694	–	–	–	–	4,531
Reinsurance debtors	45	7	–	41	–	–	93

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 2014, the exposure to the third party was HK$1,441m (2013: HK$1,695m).

Liquidity risk (insurance)

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

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

The following table shows the expected maturity of insurance contract liabilities at 31 December 2014:

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year HK$m	**1-5 years HK$m**	**5-15 years HK$m**	**Over 15 years HK$m**	**Total HK$m**
At 31 December 2014					
Non-linked insurance contracts...	**24,109**	**91,832**	**223,103**	**242,465**	**581,509**
Linked insurance contracts..........	**2,479**	**11,095**	**51,560**	**100,679**	**165,813**
	26,588	**102,927**	**274,663**	**343,144**	**747,322**
At 31 December 2013					
Non-linked insurance contracts...	28,328	84,543	197,109	226,343	536,323
Linked insurance contracts..........	2,196	8,078	45,963	89,836	146,073
	30,524	92,621	243,072	316,179	682,396

Remaining contractual maturity of investment contract liabilities

	Non-linked investment contracts HK$m	**Linked investment contracts HK$m**	**Total HK$m**
At 31 December 2014			
Remaining contractual maturity			
– due within 1 year	**34**	**156**	**190**
– due between 1 and 5 years	–	–	–
– due between 5 and 10 years	–	–	–
– undated[1]	**29,205**	**7,270**	**36,475**
	29,239	**7,426**	**36,665**
At 31 December 2013			
Remaining contractual maturity			
– due within 1 year	45	119	164
– due between 1 and 5 years	–	–	–
– due between 5 and 10 years	–	–	–
– undated[1]	29,114	7,408	36,522
	29,159	7,527	36,686

1 *In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. The surrender values may be significantly lower than the amounts shown above.*

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

The 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 2014 was HK$32,389m (2013: HK$28,916m), representing the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

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

PVIF is 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 2014 of changes in the main economic assumption:

	Impact on PVIF	
	2014	2013
	HK$m	HK$m
+ 100 basis points shift in risk-free rate	**1,357**	1,392
– 100 basis points shift in risk-free rate	**(813)**	(1,515)

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

Non-economic assumptions

Non-economic assumptions, including, mortality and/or morbidity, lapse rates and expense rates, are also used for the determination of the policyholder liabilities and PVIF, subject to any relevant local regulatory requirements. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2014 across all insurance manufacturing subsidiaries is as follows:

	Impact on 2014 results		Impact on 2013 results	
	Profit after tax	**Net assets**	Profit after tax	Net assets
	HK$m	**HK$m**	HK$m	HK$m
10% increase in mortality and/or morbidity rates	**(294)**	**(294)**	(291)	(291)
10% decrease in mortality and/or morbidity rates	**301**	**301**	299	299
10% increase in lapse rates	**(319)**	**(319)**	(330)	(330)
10% decrease in lapse rates	**370**	**370**	384	384
10% increase in expense rates	**(303)**	**(303)**	(298)	(298)
10% decrease in expense rates	**299**	**299**	289	289

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

Capital

Capital Management

(Audited)

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

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

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

Capital measures:

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

Our capital management process is articulated in our annual capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between the different components of capital. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the approved annual group capital plan. In accordance with 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 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, other equity instruments, retained profits, other reserves, preference shares and subordinated liabilities.

Externally imposed capital requirements
(Audited)

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

Capital (continued)

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

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

Basel III
(Unaudited)

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

The Basel III capital rules set out the minimum common equity tier 1 (CET1) requirement of 4.5% and a minimum total capital requirement of 8% from 1 January 2015.

In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

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

The Banking (Capital) (Amendment) Rules 2014 came into effect on 1 January 2015 to implement the Basel III capital buffer requirements in Hong Kong. The changes include the phasing-in from 2016 to 2019 of the Capital Conservation Buffer ('CCB') which is designed to ensure banks build up capital outside periods of stress of 2.5% of RWAs, the Countercyclical Capital Buffer ('CCyB') which is set on an individual country basis and is built up during periods of excess credit growth to protect against future losses, and the Higher Loss Absorbency requirements for Domestic Systemically Important Banks of up to 2.5% of RWAs. On 27 January 2015, the Hong Kong Monetary Authority announced a CCyB for Hong Kong of 0.625% from 1 January 2016, under the phase-in arrangements of Basel III equivalent to 2.5% of RWAs in Hong Kong once fully phased in.

In addition, the group will be required to set further buffers to reflect risks not included in the regulatory capital calculation, arising from internal assessment of risks and the results of stress tests.

As a consequence of the developments outlined above, there remains uncertainty over the timing and trajectory of implementation of the full Basel III capital requirements and residual uncertainty as to the minimum levels of capital that the group will be required to hold.

Total Loss Absorbing Capacity proposals
(Unaudited)

In November 2014, as part of the 'too big to fail' agenda, the Financial Stability Board ('FSB') published proposals for Total Loss Absorbing Capacity ('TLAC') for Global Systemically Important Banks ('G-SIBs'). The FSB proposals include a minimum TLAC requirement in the range of 16-20% of RWAs and a TLAC leverage ratio of at least twice the Basel III Tier 1 leverage ratio. This is to be applied in accordance with individual resolution strategies. It is expected that a Quantitative Impact Study ('QIS') will be undertaken in 2015, the results of which will inform the final proposals. The conformance period for the TLAC requirement will also be informed by the QIS, but it will not be before 1 January 2019. Once finalised, it is expected that any new TLAC standard should be met alongside the Basel III minimum capital requirement. The proposals are expected to be finalised in 2015 and will then need to be implemented into national legislation.

Leverage Ratio
(Unaudited)

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

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

Capital adequacy at 31 December 2014
(Unaudited)

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

The basis of consolidation for financial accounting purposes is described in note 1 on the Financial Statements and differs from that used for regulatory purposes. Further information on the regulatory consolidation basis is set out in the Supplementary Notes on the Financial Statements 2014 and a full reconciliation between the group's accounting and regulatory balance sheets can be viewed in the Supplementary Notes Appendices on the Financial Statements 2014 that can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk. Subsidiaries not included in consolidation for regulatory purposes are securities and insurance companies and the capital invested by the group in these subsidiaries is deducted from regulatory capital.

The Bank and its banking subsidiaries maintain regulatory reserves to satisfy the provisions of the Banking Ordinance and local regulatory requirements for prudential supervision purposes. At 31 December 2014, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$27,959m (31 December 2013: HK$22,563m).

There are no relevant capital shortfalls in any of the group's subsidiaries at 31 December 2014 (31 December 2013: Nil) which are not included in its consolidation group for regulatory purposes.

Capital ratios
(Unaudited)

	At 31 December 2014	At 31 December 2013
	%	%
Common Equity Tier 1 ('CET1') capital	**14.4**	14.1
Tier 1 capital	**14.4**	14.1
Total capital	**15.7**	15.2

Capital (continued)

Risk weighted assets by risk type
(Unaudited)

	At 31 December 2014 HK$m	At 31 December 2013 HK$m
Credit risk		
– Standardised approach	**248,891**	221,923
– IRB approach	**1,811,343**	1,656,378
– IRB (securitisation) approach	**4,453**	4,250
Counterparty credit risk		
– Standardised approach	**6,406**	5,231
– IRB approach	**113,801**	90,372
– Central Clearing Counterparty (‘CCP’)	**8,435**	12,999
– Credit Valuation Adjustment (‘CVA’)	**81,061**	82,716
Market risk	**143,199**	134,035
Operational risk	**290,342**	274,450
Total	**2,707,931**	2,482,354

Risk weighted assets by global business
(Unaudited)

	At 31 December 2014 HK$m	At 31 December 2013 HK$m
Retail Banking and Wealth Management	**301,844**	283,612
Commercial Banking	**876,596**	761,656
Global Banking and Markets	**1,239,715**	1,156,129
Global Private Banking	**24,256**	25,756
Other	**265,520**	255,201
Total	**2,707,931**	2,482,354

RWA Planning
(Unaudited)

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

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

Credit IRB RWA movement by key driver

(Unaudited)

	Total HK$m
At I January 2014	1,833,716
Foreign exchange movement	(27,858)
Acquisitions and disposals	(31,187)
Book size	171,696
Book quality	6,258
Model updates	6,104
Methodology and policy	51,929
Internal updates	3,873
External updates	48,056
Total RWA movement	176,942
At 31 December 2014	2,010,658

Market risk RWA movement by key driver

(Unaudited)

	RWA HK$m
At 1 January 2014	134,035
Movement in risk levels	25,894
Models updates	(23,748)
Methodology and policy	7,018
Internal updates	1,121
External updates	5,897
Total RWA movement	9,164
At 31 December 2014	143,199

Capital (continued)

Movement in total capital in 2014

(Unaudited)

Source and application of total capital

	Year to 31 December 2014 HK$m
Opening common equity tier 1 capital	**351,105**
Consolidated profit attributable to shareholders of the parent company	**86,428**
Dividends paid	**(42,750)**
Ordinary shares issued	**10,733**
Increase in allowable non-controlling interests	**3,507**
Decrease in goodwill and intangible assets deducted	**1,260**
Increase in significant capital investments in unconsolidated financial sector entities deducted	**(27,991)**
Increase in regulatory reserve deducted	**(5,396)**
Decrease in excess AT1 deductions	**12,599**
Other, including regulatory adjustments	**250**
Closing common equity tier 1 capital	**389,745**
Opening additional tier 1 capital	**–**
Issued perpetual subordinated loans	**14,737**
Redemption of perpetual non-cumulative preference shares	**(5,422)**
Increase in allowable non-controlling interests	**569**
Decrease in significant capital investments in unconsolidated financial sector entities deducted	**2,715**
Decrease in excess AT1 deductions	**(12,599)**
Closing tier 1 capital	**389,745**
Opening tier 2 capital	**27,005**
Redemption of perpetual cumulative preference shares	**(5,311)**
Issued term subordinated debt net of redemption	**6,399**
Increase in impairment allowances and regulatory reserve eligible for inclusion in Tier 2 capital	**1,438**
Increase in allowable in non-controlling interest	**2,667**
Decrease in significant capital investments in unconsolidated financial sector entities deducted	**2,400**
Other, including regulatory adjustments	**694**
Closing tier 2 capital	**35,292**
Closing total capital	**425,037**

Capital Base

(Unaudited)

The following table sets out the composition of the group's capital base under Basel III at 31 December 2014. The position at 31 December 2014 benefits from transitional arrangements which will be phased out.

Capital adequacy at 31 December 2014

Capital base
(Unaudited)

	At 31 December 2014 HK$m	At 31 December 2013 HK$m
Common Equity Tier 1 ('CET1') capital		
Shareholders' equity	**491,545**	436,529
Shareholders' equity per balance sheet	**557,835**	480,809
Revaluation reserve capitalisation issue	**(1,454)**	(1,454)
Other equity instruments	**(14,737)**	–
Unconsolidated subsidiaries	**(50,099)**	(42,826)
Non-controlling interests	**27,971**	24,464
Non-controlling interests per balance sheet	**50,511**	41,415
Non-controlling interests in unconsolidated subsidiaries	**(4,873)**	(4,237)
Surplus non-controlling interests disallowed in CET1	**(17,667)**	(12,714)
Regulatory deductions to CET1 capital	**(129,771)**	(109,888)
Valuation adjustments	**(2,030)**	(2,473)
Goodwill and intangible assets	**(14,683)**	(15,943)
Deferred tax assets net of deferred tax liabilities	**(1,485)**	(2,350)
Cash flow hedging reserve	**182**	(197)
Changes in own credit risk on fair valued liabilities	**(596)**	(1,117)
Defined benefit pension fund assets	**(89)**	(110)
Significant capital investments in unconsolidated financial sector entities	**(28,866)**	(875)
Property revaluation reserves[1]	**(52,657)**	(50,073)
Regulatory reserve	**(27,959)**	(22,563)
Excess AT1 deductions	**(1,588)**	(14,187)
Total CET1 capital	**389,745**	351,105
Additional Tier 1 ('AT1') capital		
Total AT1 capital before regulatory deductions	**48,750**	38,866
Perpetual subordinated loans	**14,737**	–
Perpetual non-cumulative preference shares	**25,229**	30,651
Allowable non-controlling interests in AT1 capital	**8,784**	8,215
Regulatory deductions to AT1 capital	**(48,750)**	(38,866)
Significant capital investments in unconsolidated financial sector entities	**(50,338)**	(53,053)
Excess AT1 deductions	**1,588**	14,187
Total AT1 capital	**–**	–
Total Tier 1 capital	**389,745**	351,105
Tier 2 capital		
Total Tier 2 capital before regulatory deductions	**88,802**	82,915
Perpetual cumulative preference shares	**3,102**	8,413
Cumulative term preferences shares	**8,143**	8,141
Perpetual subordinated debt	**9,337**	9,346
Term subordinated debt	**25,400**	19,463
Property revaluation reserves[1]	**24,350**	23,187
Impairment allowances and regulatory reserve eligible for inclusion in Tier 2 capital	**14,957**	13,519
Allowable non-controlling interests in Tier 2 capital	**3,513**	846
Regulatory deductions to Tier 2 capital	**(53,510)**	(55,910)
Significant capital investments in unconsolidated financial sector entities	**(53,510)**	(55,910)
Total Tier 2 capital	**35,292**	27,005
Total capital	**425,037**	378,110

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

Capital (continued)

A detailed breakdown of the group's CET1 capital, AT1 capital, Tier 2 capital and regulatory deductions can be viewed in the Supplementary Notes Appendices on Financial Statements 2014 that can be found in the Regulatory Disclosures section of our website www.hsbc.com.hk .

The following table shows the pro-forma Basel III end point basis position once all transitional arrangements have been phased out based on the Transition Disclosures Template. It should be noted that the pro-forma Basel III end point basis position takes no account of, for example, any future profits or management actions. In addition, the current regulations or their application may change before full implementation. Given this, the final impact on the group's capital ratios may differ from the pro-forma position, which is a mechanical application of the current rules to the balance sheet at 31 December 2014; it is not a projection. On this pro-forma basis, the group's CET1 ratio is 10.7% (2013: 10.4%), which is above the Basel III minimum requirement, including the capital conservation buffer.

Reconciliation of capital from transitional basis to a pro-forma Basel III end point basis

	At 31 December 2014 HK$m	At 31 December 2013 HK$m
CET1 capital on a transitional basis	**389,745**	351,105
Transitional provisions:		
Significant capital investments in unconsolidated financial sector entities	**(100,676)**	(106,106)
Excess AT1 deductions	**1,588**	14,187
CET1 capital end point basis	**290,657**	259,186
AT1 capital on a transitional basis	**–**	–
Grandfathered instruments:		
Perpetual non-cumulative preference shares	**(25,229)**	(30,651)
Transitional provisions:		
Allowable non-controlling interests in AT1 capital	**(5,389)**	(5,884)
Significant capital investments in unconsolidated financial sector entities	**50,338**	53,053
Excess AT1 deductions	**(1,588)**	(14,187)
AT1 capital end point basis	**18,132**	2,331
Tier 2 capital on a transitional basis	**35,292**	27,005
Grandfathered instruments:		
Perpetual cumulative preference shares	**(3,102)**	(8,413)
Cumulative term preference shares	**(8,143)**	(8,141)
Perpetual subordinated debt	**(9,337)**	(9,346)
Term subordinated debt	**(6,787)**	(13,260)
Transitional provisions:		
Significant capital investments in unconsolidated financial sector entities	**50,338**	53,053
Tier 2 capital end point basis	**58,261**	40,898

Capital instruments

(Unaudited)

The following is a summary of the group's CET1, AT1 and Tier 2 capital instruments at 31 December 2014.

2014	Issued/Par value	Amount recognised in regulatory capital HK$m
CET1 capital instruments		
Ordinary shares:		
38,420,982,901 issued and fully paid ordinary shares	HK$96,052m	**94,598**
AT1 capital instruments		
Floating rate perpetual subordinated loans, callable from 2019	US$1,900m	**14,737**
Perpetual non-cumulative preference shares	US$3,253m	**25,229**
Tier 2 capital instruments		
Perpetual cumulative preference shares	US$400m	**3,102**
Cumulative preference shares due 2024	US$1,050m	**8,143**
Primary capital undated floating rate notes	US$1,200m	**9,337**
Subordinated loan due 2021	US$450m	**3,490**
Subordinated loan due 2022	US$300m	**2,326**
Subordinated loan due 2023	US$500m	**3,878**
Subordinated loan due 2024, callable from 2019	US$1,600m	**12,409**
Floating rate subordinated notes due 2020, callable from 2015	AUD200m	**1,178**
Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017	MYR500m	**1,056**
Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022	MYR500m	**1,063**
		25,400
2013		
CET1 capital instruments		
Ordinary shares:		
34,127,482,901 issued and fully paid ordinary shares	HK$85,319m	83,865
AT1 capital instruments		
Perpetual non-cumulative preference shares	US$3,953m	30,651
Tier 2 capital instruments		
Perpetual cumulative preference shares	US$1,085m	8,413
Cumulative preference shares due 2024	US$1,050m	8,141
Primary capital undated floating rate notes	US$1,200m	9,346
Subordinated loan due 2020	US$775m	6,010
Subordinated loan due 2021	US$450m	3,489
Subordinated loan due 2022	US$300m	2,326
Subordinated loan due 2023	US$500m	3,877
Floating rate subordinated notes due 2020, callable from 2015	AUD200m	1,386
Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017	MYR500m	1,182
Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022	MYR500m	1,193
		19,463

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

Statement of Directors' Responsibilities

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on page 77, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the financial statements.

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

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

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

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

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

- 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 and the Risk Report include a fair review of the development and performance of the business and the position of the group and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that the group faces.

On behalf of the Board

Stuart T Gulliver
Chairman
23 February 2015

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

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries (together 'the group') set out on pages 78 to 224, which comprise the consolidated and the Bank's balance sheets as at 31 December 2014, 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 80 of Schedule 11 to the new Hong Kong Companies Ordinance (Cap.622), 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 2014 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
23 February 2015

Financial Statements

		Page
Financial Statements		
	Consolidated income statement	**79**
	Consolidated statement of comprehensive income	**80**
	Consolidated balance sheet	**81**
	Consolidated statement of changes in equity	**82**
	Consolidated statement of cash flows	**84**
	Bank balance sheet	**85**
	Bank statement of changes in equity	**86**
Notes on the Financial Statements		
1	Basis of preparation	**88**
2	Critical accounting estimates and judgements in applying accounting policies	**92**
3	Summary of significant accounting policies	**94**
4	Operating profit	**114**
5	Insurance income	**118**
6	Employee compensation and benefits	**120**
7	Tax expense	**126**
8	Profit attributable to shareholders	**130**
9	Dividends	**130**
10	Cash and sight balances at central banks	**130**
11	Hong Kong Government certificates of indebtedness	**130**
12	Trading assets	**131**
13	Derivatives	**132**
14	Financial assets designated at fair value	**136**
15	Non-trading reverse repurchase and repurchase agreements	**137**
16	Loans and advances to customers	**138**
17	Impairment allowances against loans and advances to customers	**141**
18	Impairment and rescheduled amounts relating to placings with and advances to banks and other assets	**146**
19	Financial investments	**147**
20	Assets transferred, assets charged as security for liabilities, and collateral accepted as security for assets	**149**
21	Investments in subsidiaries	**150**
22	Interests in associates and joint ventures	**151**
23	Goodwill and intangible assets	**156**
24	Property, plant and equipment	**160**
25	Leasehold land and land use rights	**163**
26	Other assets	**163**
27	Customer accounts	**164**
28	Trading liabilities	**164**
29	Financial liabilities designated at fair value	**164**
30	Debt securities in issue	**164**
31	Other liabilities and provisions	**165**
32	Liabilities under insurance contracts	**165**
33	Provisions for liabilities and charges	**166**
34	Subordinated liabilities	**166**
35	Preference shares	**167**
36	Share capital	**168**
37	Other equity instruments	**169**
38	Maturity analysis of assets and liabilities	**170**
39	Analysis of cash flows payable under financial liabilities by remaining contractual maturities	**178**
40	Reconciliation of operating profit to cash generated from/(used in) operations	**180**
41	Analysis of cash and cash equivalents	**181**
42	Contingent liabilities and commitments	**184**
43	Capital commitments	**185**
44	Lease commitments	**185**
45	Offsetting of financial assets and financial liabilities	**186**
46	Segmental analysis	**188**
47	Related party transactions	**193**
48	Share-based payments	**198**
49	Fair value of financial instruments carried at fair value	**202**
50	Fair value of financial instruments not carried at fair value	**216**
51	Structured entities	**219**
52	Legal proceedings and regulatory matters	**222**
53	Ultimate holding company	**224**
54	Nature of business	**224**
55	Events after the balance sheet date	**224**
56	Approval of accounts	**224**

Consolidated income statement for the year ended 31 December 2014

	Note	**2014 HK$m**	2013 HK$m
Interest income	*4a*	**126,782**	117,039
Interest expense	*4b*	**(31,673)**	(29,674)
Net interest income		**95,109**	87,365
Fee income		**50,662**	50,187
Fee expense		**(6,040)**	(6,341)
Net fee income	*4c*	**44,622**	43,846
Net trading income	*4d*	**20,220**	16,577
Net income from financial instruments designated at fair value	*4e*	**4,048**	2,475
Gains less losses from financial investments	*4f*	**2,389**	442
Dividend income	*4g*	**1,374**	1,175
Net insurance premium income	*5b*	**57,307**	53,663
Net gain/(loss) on reclassification of associates	*4h*	**(251)**	8,157
Gain on sale of Ping An		**–**	34,070
Other operating income	*4i*	**8,753**	11,418
Total operating income		**233,571**	259,188
Net insurance claims and benefits paid and movement in liabilities to policyholders	*5c*	**(60,182)**	(56,592)
Net operating income before loan impairment charges and other credit risk provisions		**173,389**	202,596
Loan impairment charges and other credit risk provisions	*4j*	**(4,925)**	(3,532)
Net operating income		**168,464**	199,064
Employee compensation and benefits	*6a*	**(38,894)**	(36,938)
General and administrative expenses	*4k*	**(28,278)**	(26,127)
Depreciation of property, plant and equipment	*24*	**(4,107)**	(3,988)
Amortisation and impairment of intangible assets	*23c*	**(1,671)**	(1,675)
Total operating expenses		**(72,950)**	(68,728)
Operating profit		**95,514**	130,336
Share of profit in associates and joint ventures		**15,675**	14,420
Profit before tax		**111,189**	144,756
Tax expense	*7*	**(19,012)**	(15,701)
Profit for the year		**92,177**	129,055
Profit attributable to shareholders		**86,428**	119,009
Profit attributable to non-controlling interests		**5,749**	10,046

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2014

	2014 HK$m	2013 HK$m
Profit for the year	**92,177**	129,055
Other comprehensive income/(expense)		
Items that will subsequently be reclassified to the income statement when specific conditions are met:		
Available-for-sale investments:		
– fair value changes taken to equity	**24,365**	(6,456)
– fair value changes transferred to the income statement on disposal	**(4,632)**	(34,643)
– amounts transferred to the income statement on impairment	**2,140**	–
– fair value changes transferred to the income statement on hedged items	**(311)**	2,179
– income taxes	**(1,378)**	1,097
Cash flow hedges:		
– fair value changes taken to equity	**3,870**	5,778
– fair value changes transferred to the income statement	**(4,429)**	(5,789)
– income taxes	**189**	(6)
Share of other comprehensive income/(expense) of associates and joint ventures	**326**	(698)
Exchange differences	**(8,033)**	(5,981)
Items that will not subsequently be reclassified to the income statement:		
Property revaluation:		
– fair value changes taken to equity	**4,510**	5,687
– income taxes	**(731)**	(949)
Remeasurement of defined benefit:		
– before income taxes	**(704)**	2,281
– income taxes	**41**	(374)
Other comprehensive income/(expense) for the year, net of tax	**15,223**	(37,874)
Total comprehensive income for the year, net of tax	**107,400**	91,181
Total comprehensive income for the year attributable to:		
– shareholders of the parent company	**94,181**	81,689
– non-controlling interests	**13,219**	9,492
	107,400	91,181

Consolidated balance sheet at 31 December 2014

	Note	2014 HK$m	2013 HK$m
ASSETS			
Cash and sight balances at central banks	10	**156,475**	158,879
Items in the course of collection from other banks		**21,122**	16,346
Hong Kong Government certificates of indebtedness	11	**214,654**	195,554
Trading assets	12	**407,026**	311,400
Derivatives	13	**389,934**	388,727
Financial assets designated at fair value	14	**98,195**	90,146
Reverse repurchase agreements – non-trading	15	**218,901**	150,584
Placings with and advances to banks		**488,313**	564,521
Loans and advances to customers	16	**2,815,216**	2,619,245
Financial investments	19	**1,456,493**	1,379,771
Amounts due from Group companies		**191,694**	161,975
Interests in associates and joint ventures	22	**116,654**	107,852
Goodwill and intangible assets	23	**45,078**	41,882
Property, plant and equipment	24	**104,679**	101,240
Deferred tax assets	7	**1,436**	2,294
Other assets	26	**150,876**	148,939
Total assets		**6,876,746**	6,439,355
LIABILITIES			
Hong Kong currency notes in circulation	11	**214,654**	195,554
Items in the course of transmission to other banks		**31,331**	34,240
Repurchase agreements – non-trading	15	**28,379**	6,312
Deposits by banks		**226,713**	231,358
Customer accounts	27	**4,479,992**	4,253,698
Trading liabilities	28	**215,812**	195,032
Derivatives	13	**367,128**	365,052
Financial liabilities designated at fair value	29	**48,834**	41,715
Debt securities in issue	30	**45,297**	52,334
Retirement benefit liabilities	6c	**5,606**	4,856
Amounts due to Group companies		**135,814**	91,797
Other liabilities and provisions	31	**87,731**	88,809
Liabilities under insurance contracts	32	**310,182**	276,180
Current tax liabilities	7	**2,927**	3,722
Deferred tax liabilities	7	**18,586**	16,051
Subordinated liabilities	34	**12,832**	13,107
Preference shares	35	**36,582**	47,314
Total liabilities		**6,268,400**	5,917,131
EQUITY			
Share capital	36	**96,052**	85,319
Other equity instruments	37	**14,737**	–
Other reserves		**107,985**	89,564
Retained profits		**324,811**	290,926
Proposed fourth interim dividend	9	**14,250**	15,000
Total shareholders' equity		**557,835**	480,809
Non-controlling interests		**50,511**	41,415
Total equity		**608,346**	522,224
Total equity and liabilities		**6,876,746**	6,439,355

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

Secretary
Paul A Stafford

Consolidated statement of changes in equity for the year ended 31 December 2014

	2014										
				Other reserves							
	Share capital HK$m	Other Equity Instruments HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	85,319	–	305,926	46,336	3,280	197	9,619	30,132	480,809	41,415	522,224
Profit for the year	–	–	86,428	–	–	–	–	–	86,428	5,749	92,177
Other comprehensive income (net of tax)	–	–	(930)	3,540	13,255	(363)	(7,747)	(2)	7,753	7,470	15,223
Available-for-sale investments	–	–	–	–	12,932	–	–	–	12,932	7,252	20,184
Cash flow hedges	–	–	–	–	–	(363)	–	–	(363)	(7)	(370)
Property revaluation	–	–	(220)	3,540	–	–	–	–	3,320	459	3,779
Actuarial losses on defined benefit plans	–	–	(715)	–	–	–	–	–	(715)	52	(663)
Share of other comprehensive income of associates and joint ventures	–	–	5	–	323	–	–	(2)	326	–	326
Exchange differences	–	–	–	–	–	–	(7,747)	–	(7,747)	(286)	(8,033)
Total comprehensive income for the year	–	–	85,498	3,540	13,255	(363)	(7,747)	(2)	94,181	13,219	107,400
Shares issued	10,733	–	–	–	–	–	–	–	10,733	–	10,733
Other equity instruments issued[6]	–	14,737	–	–	–	–	–	–	14,737	–	14,737
Dividends paid	–	–	(42,750)	–	–	–	–	–	(42,750)	(3,981)	(46,731)
Movement in respect of share-based payment arrangements	–	–	(141)	–	–	–	–	261	120	5	125
Other movements	–	–	6	–	(1)	–	–	–	5	(147)	(142)
Transfers[8]	–	–	(9,478)	(1,395)	3	–	–	10,870	–	–	–
At 31 December	96,052	14,737	339,061	48,481	16,537	(166)	1,872	41,261	557,835	50,511	608,346

Consolidated statement of changes in equity for the year ended 31 December 2014 *(continued)*

	2013									
			Other reserves							
	Share capital HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total share-holders' equity HK$m	Non-controlling interests HK$m	Total equity HK$m
At 1 January	58,969	244,640	43,451	40,580	210	15,193	34,356	437,399	35,679	473,078
Profit for the year	–	119,009	–	–	–	–	–	119,009	10,046	129,055
Other comprehensive income (net of tax)	–	1,451	4,272	(37,293)	(13)	(5,574)	(163)	(37,320)	(554)	(37,874)
Available-for-sale investments	–	–	–	(36,744)	–	–	–	(36,744)	(1,079)	(37,823)
Cash flow hedges	–	–	–	–	(13)	–	–	(13)	(4)	(17)
Property revaluation	–	(202)	4,272	–	–	–	–	4,070	668	4,738
Actuarial gains on defined benefit plans	–	1,661	–	–	–	–	–	1,661	246	1,907
Share of other comprehensive income of associates and joint ventures	–	(9)	–	(526)	–	–	(163)	(698)	–	(698)
Exchange differences	–	1	–	(23)	–	(5,574)	–	(5,596)	(385)	(5,981)
Total comprehensive income for the year	–	120,460	4,272	(37,293)	(13)	(5,574)	(163)	81,689	9,492	91,181
Shares issued	26,350	–	–	–	–	–	–	26,350	–	26,350
Dividends paid	–	(47,000)	–	–	–	–	–	(47,000)	(3,836)	(50,836)
Movement in respect of share-based payment arrangements	–	(355)	–	–	–	–	240	(115)	11	(104)
Other movements[7]	–	7	–	(7)	–	–	(17,514)	(17,514)	69	(17,445)
Transfers[8]	–	(11,826)	(1,387)	–	–	–	13,213	–	–	–
At 31 December	85,319	305,926	46,336	3,280	197	9,619	30,132	480,809	41,415	522,224

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

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

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

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

5 *The other reserves mainly comprise the share-based payment reserve account, purchase premium arising from transfer of business within the HSBC Group and other non-distributable reserves. The share-based payment reserve account is used to record the amount relating to share options granted to employees of the group directly by HSBC Holdings plc.*

6 *During 2014, the Bank issued new capital instruments that are included in the group's capital base as Basel III-compliant additional tier 1 capital under the Banking (Capital) Rules.*

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

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

Financial Statements (continued)

Consolidated statement of cash flows for the year ended 31 December 2014

	Note	2014 HK$m	2013 HK$m
Operating activities			
Cash generated from operations	*40*	**61,780**	158,886
Interest received on financial investments		**14,891**	13,222
Dividends received on financial investments		**1,466**	1,087
Dividends received from associates		**4,765**	4,468
Taxation paid		**(17,546)**	(16,182)
Net cash inflow from operating activities		**65,356**	161,481
Investing activities			
Purchase of financial investments		**(403,722)**	(350,187)
Proceeds from sale or redemption of financial investments		**385,353**	267,382
Purchase of property, plant and equipment		**(2,864)**	(8,419)
Proceeds from sale of property, plant and equipment and assets held for sale		**180**	1,003
Purchase of other intangible assets		**(1,546)**	(1,502)
Net cash outflow in respect of the purchase of interests in business portfolios	*41c*	**–**	(1,792)
Net cash inflow/(outflow) from the sale of interests in business portfolios	*41d*	**2,882**	(2,670)
Proceeds from the sale of interests in associates		**–**	2,840
Net cash outflow from investing activities		**(19,717)**	(93,345)
Net cash inflow before financing		**45,639**	68,136
Financing			
Issue of ordinary share capital		**10,733**	26,350
Issue of other equity instruments		**14,737**	–
Issue of subordinated liabilities		**12,409**	–
Redemption of preference shares		**(10,733)**	(36,042)
Repayment of subordinated liabilities		**(6,010)**	(338)
Ordinary dividends paid	*9*	**(42,750)**	(47,000)
Dividends paid to non-controlling interests		**(3,981)**	(3,836)
Interest paid on preference shares		**(1,108)**	(2,294)
Interest paid on subordinated liabilities		**(1,056)**	(829)
Net cash outflow from financing		**(27,759)**	(63,989)
Increase in cash and cash equivalents	*41a*	**17,880**	4,147

Bank balance sheet at 31 December 2014

	Note	2014 HK$m	2013 HK$m
ASSETS			
Cash and sight balances at central banks	*10*	**120,468**	112,585
Items in the course of collection from other banks		**15,888**	10,922
Hong Kong Government certificates of indebtedness	*11*	**214,654**	195,554
Trading assets	*12*	**298,365**	235,599
Derivatives	*13*	**374,876**	377,183
Financial assets designated at fair value	*14*	**1,257**	1,561
Reverse repurchase agreements – non-trading	*15*	**116,113**	86,601
Placings with and advances to banks		**206,309**	250,918
Loans and advances to customers	*16*	**1,590,711**	1,483,910
Financial investments	*19*	**721,983**	758,583
Amounts due from Group companies		**404,136**	366,889
Investments in subsidiaries	*21*	**70,849**	63,272
Interests in associates and joint ventures	*22*	**39,830**	40,410
Goodwill and intangible assets	*23*	**4,307**	4,530
Property, plant and equipment	*24*	**76,884**	80,144
Deferred tax assets	*7*	**664**	999
Other assets	*26*	**94,617**	98,400
Total assets		**4,351,911**	4,168,060
LIABILITIES			
Hong Kong currency notes in circulation	*11*	**214,654**	195,554
Items in the course of transmission to other banks		**22,512**	24,774
Repurchase agreements – non-trading	*15*	**21,033**	5,951
Deposits by banks		**174,385**	192,025
Customer accounts	*27*	**2,814,510**	2,723,322
Trading liabilities	*28*	**98,549**	82,623
Derivatives	*13*	**353,645**	354,695
Financial liabilities designated at fair value	*29*	**9,180**	4,759
Debt securities in issue	*30*	**32,089**	30,062
Retirement benefit liabilities	*6*	**3,663**	2,689
Amounts due to Group companies		**187,935**	156,144
Other liabilities and provisions	*31*	**47,777**	51,265
Current tax liabilities	*7*	**1,840**	2,029
Deferred tax liabilities	*7*	**6,435**	6,503
Subordinated liabilities	*34*	**9,337**	9,346
Preference shares	*35*	**36,474**	47,205
Total liabilities		**4,034,018**	3,888,946
EQUITY			
Share capital	*36*	**96,052**	85,319
Other equity instruments	*37*	**14,737**	–
Other reserves		**7,253**	10,337
Retained profits		**185,601**	168,458
Proposed fourth interim dividend	*9*	**14,250**	15,000
Total equity		**317,893**	279,114
Total equity and liabilities		**4,351,911**	4,168,060

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

Secretary
Paul A Stafford

Bank statement of changes in equity for the year ended 31 December 2014

	2014								
				Other reserves					
	Share capital HK$m	Other equity instruments HK$m	Retained profits and proposed dividend HK$m	Property revaluation reserve[1] HK$m	Available-for-sale investment reserve[2] HK$m	Cash flow hedge reserve[3] HK$m	Foreign exchange Reserve[4] HK$m	Other[5] HK$m	Total equity HK$m
At 1 January	**85,319**	**–**	**183,458**	**28,256**	**4,562**	**188**	**(7,127)**	**(15,542)**	**279,114**
Profit for the year	**–**	**–**	**59,480**	**–**	**–**	**–**	**–**	**–**	**59,480**
Other comprehensive income (net of tax)	**–**	**–**	**(946)**	**3,269**	**(1,987)**	**(294)**	**(1,698)**	**–**	**(1,656)**
Available-for-sale investments	**–**	**–**	**–**	**–**	**(1,987)**	**–**	**–**	**–**	**(1,987)**
Cash flow hedges	**–**	**–**	**–**	**–**	**–**	**(294)**	**–**	**–**	**(294)**
Property revaluation	**–**	**–**	**(121)**	**3,269**	**–**	**–**	**–**	**–**	**3,148**
Actuarial losses on defined benefit plans	**–**	**–**	**(825)**	**–**	**–**	**–**	**–**	**–**	**(825)**
Exchange differences	**–**	**–**	**–**	**–**	**–**	**–**	**(1,698)**	**–**	**(1,698)**
Total comprehensive income	**–**	**–**	**58,534**	**3,269**	**(1,987)**	**(294)**	**(1,698)**	**–**	**57,824**
Shares issued	**10,733**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**10,733**
Other equity instruments issued[6]	**–**	**14,737**	**–**	**–**	**–**	**–**	**–**	**–**	**14,737**
Dividends paid	**–**	**–**	**(42,750)**	**–**	**–**	**–**	**–**	**–**	**(42,750)**
Movement in respect of share-based payment arrangements	**–**	**–**	**(123)**	**–**	**–**	**–**	**–**	**218**	**95**
Other movements	**–**	**–**	**5**	**(1,865)**	**–**	**–**	**–**	**–**	**(1,860)**
Transfers	**–**	**–**	**727**	**(727)**	**–**	**–**	**–**	**–**	**–**
At 31 December	**96,052**	**14,737**	**199,851**	**28,933**	**2,575**	**(106)**	**(8,825)**	**(15,324)**	**317,893**

Bank statement of changes in equity for the year ended 31 December 2014 *(continued)*

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

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

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

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

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

5 *The other reserves mainly comprise the share-based payment reserve account, purchase premium arising from transfer of business within the HSBC Group and other non-distributable reserves. The share-based payment reserve account is used to record the amount relating to share options granted to employees of the group directly by HSBC Holdings plc.*

6 *During 2014, the Bank issued new capital instruments that are included in the group's capital base as Basel III-compliant additional tier 1 capital under the Banking (Capital) Rules.*

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

Notes on the Financial Statements

1 Basis of preparation

a Compliance with Hong Kong Financial Reporting Standards

Hong Kong Financial Reporting Standards ('HKFRSs') comprise 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 of the group and the separate financial statements of the Bank have been prepared in accordance with HKFRSs and accounting principles generally accepted in Hong Kong. These financial statements also comply with the requirements of the predecessor Hong Kong Companies Ordinance (Cap. 32) which are applicable to the preparation of financial statements. This is in accordance with the transitional and savings arrangements for Part 9 of the new Hong Kong Companies Ordinance (Cap. 622), 'Accounts and Audit' ('new Companies Ordinance'), 'Accounts and Audit', which are set out in sections 76 to 87 of Schedule 11 to that Ordinance.

Standards adopted during the year ended 31 December 2014

On 1 January 2014, the group adopted 'Offsetting Financial Assets and Financial Liabilities (Amendments to HKAS 32)', which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in HKAS 32 'Financial Instruments: Presentation'. The amendments were applied retrospectively and did not have a material effect on the group's financial statements.

During 2014, 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.

New Companies Ordinance

The new Companies Ordinance came into operation on 3 March 2014. As a result, the concept of authorised share capital no longer exists and the Bank's ordinary and preference shares no longer have par or nominal values with effect from 3 March 2014. There was no impact on the Bank's share capital or the number of shares in issue as a result of this transition.

b Presentation of information

Disclosures under HKFRS 4 'Insurance Contracts' and HKFRS 7 'Financial Instruments: Disclosures' concerning the nature and extent of risks relating to insurance contracts and financial instruments have been included in the audited sections of the 'Risk Report' on pages 23 to 66.

Capital disclosures under HKAS 1 'Presentation of Financial Statements' have been included in the audited sections of 'Capital' on pages 67 to 75.

In accordance with the group's policy to provide disclosures that help stakeholders understand the group's performance, financial position and changes thereto, the information provided in the notes on the Financial Statements, the Risk Report and the Capital section goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements. In particular, the group provides additional disclosures having regard to the recommendation of the Enhanced Disclosure Task Force ('EDTF') report 'Enhancing the Risk Disclosures of Banks' issued in October 2012. The report aims to help financial institutions identify areas that users had highlighted a need for better and more transparent information about banks' risks, and how these risks relate to performance measurement and reporting.

1 Basis of preparation *(continued)*

c Changes in presentation

In the second half of 2013, Global Banking and Markets changed the way it managed repo and reverse repo transactions. From 1 January 2014, non-trading reverse repos and repos are presented as separate lines in the balance sheet to align disclosure with market practice and provide more meaningful information in relation to loans and advances. Previously, non-trading reverse repos were included within 'Placings with and advances to banks' and 'Loans and advances to customers'; and non-trading repos were included within 'Deposits by banks' and 'Customers accounts'.

The group has also changed the balance sheet line item, 'Cash and short-term funds' to 'Cash and sight balances at central banks'. Short term funds included 'Treasury and other eligible bills' and 'Placings with banks with remaining maturity of one month or less', which are now included within 'Financial investments' and 'Placings with and advances to banks' respectively.

'Placings with and advances to banks' is a new line which combines 'Placings with banks with remaining maturity of one month or less' (previously included under 'Cash and short term funds') and 'Placings with banks maturing after one month'. 'Certificates of deposit' are now included within 'Financial investments' rather than being shown separately on the face of the balance sheet.

Comparative figures have been re-presented accordingly and the affected lines are shown below. There are no other effects of this change in presentation.

31 December 2013 consolidated balance sheet items

Assets	As previously disclosed HK$m	Adjustments HK$m	As re-presented HK$m
Cash and short-term funds	1,132,719	(1,132,719)	–
Cash and sight balances at central banks	–	158,879	158,879
Reverse repurchase agreements – non-trading	–	150,584	150,584
Placings with banks maturing after one month	216,970	(216,970)	–
Placings with and advances to banks	–	564,521	564,521
Certificates of deposit	88,207	(88,207)	–
Loans and advances to customers	2,669,238	(49,993)	2,619,245
Financial investments	765,866	613,905	1,379,771
		–	
Liabilities			
Repurchase agreements – non-trading	–	6,312	6,312
Deposits by banks	236,616	(5,258)	231,358
Customer accounts	4,254,752	(1,054)	4,253,698
		–	

d Consolidation

The consolidated financial statements comprise the financial statements of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') made up to 31 December 2014. The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The group is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities of the entity. For the group to have power over an entity, it must have the practical ability to exercise those rights. In situations where potential voting rights exist, these are taken into account if the group has the practical ability to exercise those rights.

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

1 Basis of preparation *(continued)*

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

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

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

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

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements also include the attributable share of the results and reserves of associates and joint ventures based on accounts prepared at dates not earlier than three months prior to 31 December 2014.

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e Future accounting developments

At 31 December 2014, 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 2014. In addition to the projects to complete financial instrument accounting discussed below, the HKICPA is working on projects on insurance and lease accounting which could represent significant changes to accounting requirements in the future.

In July 2014, the HKICPA issued HKFRS 15 'Revenue from Contracts with Customers'. The standard is effective for annual periods beginning on or after 1 January 2017 with early adoption permitted. HKFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognising revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The group is currently assessing the impact of this standard but it is not practicable to quantify the effect as at the date of the publication of these financial statements.

In September 2014, the HKICPA issued HKFRS 9 'Financial Instruments', which is the comprehensive standard to replace HKAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

Classification and measurement

The classification and measurement of financial assets will depend on the entity's business model for their management and their contractual cash flow characteristics and result in financial assets being classified and measured at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss. In many instances, the classification and measurement outcomes will be similar to HKAS 39, although some differences will arise. For example, since HKFRS 9 does not apply embedded derivative accounting to financial assets, equity securities will be measured at fair value through profit or loss or, in limited circumstances, at fair value through OCI. The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in population of financial assets measured at amortised cost or fair value compared with HKAS 39. The classification of financial liabilities is essentially unchanged, except that, for certain liabilities measured at fair value, gains or losses relating to changes in the entity's own credit risk are to be included in OCI.

1 Basis of preparation *(continued)*

Impairment

The impairment requirements apply to financial assets measured at amortised cost, FVOCI, lease receivables, certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12 month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL').

The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period by considering the probability of default occurring over the remaining life of the financial instrument, rather than by considering an increase in ECL.

The assessment of credit risk, as well as the estimation of ECL, are required to be unbiased, probability-weighted and should incorporate all available information which is relevant to the assessment, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under HKAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with HKAS 39.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link between it and risk management strategy and permitting the former to be applied to a greater variety of hedging instruments and risks. The standard does not explicitly address macro hedge accounting strategies, which are being considered in a separate project. To remove the risk of any conflict between existing macro hedge accounting practice and the new general hedge accounting requirements, HKFRS 9 includes an accounting policy choice to remain with HKAS 39 hedge accounting.

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods. Hedge accounting is generally applied prospectively from that date.

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. The group intends to revise the presentation of fair value gains and losses relating to the entity's own credit risk on certain liabilities. If this presentation was applied at 31 December 2014, the effect would be to increase or decrease profit before tax with the opposite effect to be reported on other comprehensive income based on the change in fair value attributable to changes in the group's credit risk for the year, with no effect on net assets. Further information on change in fair value attributable to changes in credit risk, including the group's credit risk, is disclosed in note 29.

The group is currently assessing the impact that the rest of HKFRS 9 will have on the financial statements through a groupwide project which has been in place since 2012, but due to the complexity of the classification and measurement, impairment, and hedge accounting requirements and their inter-relationships, it is not possible at this stage to quantify the potential effect.

New Companies Ordinance

Part 9 'Accounts and Audit' of the new Companies Ordinance will be effective for annual periods beginning on or after 3 March 2014. It will primarily affect the presentation and disclosure of information in the group's financial statements. The group is in the process of making an assessment of the impact on the consolidated financial statements. Currently we do not expect the changes in the new Companies Ordinance to have a material impact on the consolidated financial statements of the group.

2 Critical accounting estimates and judgements in applying accounting policies

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

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

Loan impairment

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

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

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

Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded principal 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 issued. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. 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. Valuation techniques may incorporate assumptions about factors that other market participants would use in their valuations, including:

- the likelihood and expected timing of future cash flows on the instrument. Judgement may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Judgement is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate;
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. 'Projection' utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent on more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may affect the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, the group uses a discounting curve that reflects the overnight interest rate ('OIS discounting').

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

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

The group's accounting policy for valuation of financial instruments is included in note 3(i) and is discussed further in note 49 'Fair value of financial instruments carried at fair value'.

Interests in associates

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

Under the equity accounting method, investments in associates are initially stated at cost, and are adjusted thereafter for the post-acquisition change in the group's share of the net assets of the associate. An investment in an associate is tested for impairment when there is an indication that the investment may be impaired. At 31 December 2014, the fair value of the group's investment in Bank of Communications Co., Ltd. ('BoCom') had been below the carrying amount for approximately 32 months, apart from a short period in 2013. The conclusion of the impairment test, based on the assessment of the value in use, was that the investment is not impaired. The measurement of value in use involves significant judgements in estimating the present values of cash flows expected to arise from continuing to hold the investment. Note 22 of the Financial Statements includes detailed information on the group's investment in BoCom. It provides a description of the key assumptions used in estimating value in use, the sensitivity of the value in use calculation to different assumptions and a sensitivity analysis that shows the changes in key assumptions that would reduce the excess of value in use over the carrying amount ('headroom') to nil.

Liabilities under investment contracts

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

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

Insurance contracts

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 23(b). The assumptions are reassessed at each reporting date and changes in the estimates which affect the value of PVIF are reflected in the income statement.

Insurance liabilities

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

3 Summary of significant accounting policies

a *Interest income and expense*

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

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

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.

3 Summary of significant accounting policies *(continued)*

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

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

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

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

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c *Operating segments*

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

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

3 Summary of significant accounting policies *(continued)*

d *Loans and advances to banks and customers*

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

Loans and advances are reclassified to 'Assets held for sale' when they meet the criteria presented in note 3(ad); however, their measurement continues to be measured in accordance with this policy.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. On drawdown, the loan is classified as held for trading. Where the group intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. On inception of the loan, the loan to be held is recorded at its fair value and subsequently measured at amortised cost. For certain transactions, such as leveraged finance and syndicated lending activities, the cash advanced may not be 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, the difference is charged to the income statement in other operating income. The write-down will be recovered over the life of the loan, through the recognition of interest income, unless the loan becomes impaired.

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e *Impairment of loans and advances*

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

Individually assessed loans and advances

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio, and the importance of the individual loan relationship, and how this is managed.

Loans that meet the above criteria will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify a collective assessment.

3 **Summary of significant accounting policies** *(continued)*

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual basis. These loans are assessed individually at each balance sheet date to identify whether objective evidence of impairment exists based on the following criteria:

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

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

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or pari passu with, the group and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

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

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

3 Summary of significant accounting policies *(continued)*

Collectively assessed loans and advances

Impairment is assessed collectively to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment or for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for a collective impairment assessment. These credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. This assessment captures 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. When information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed individually.

The collective impairment allowance is determined after taking into account:

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

The period between a loss occurring and its identification is estimated by local management for each identified portfolio based on economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. The estimated period between a loss occurring and its identification may vary over time as these factors change.

Homogeneous groups of loans and advances

Statistical methods are used to determine collective impairment losses for homogeneous groups of loans not considered individually significant. Losses in these groups of loans are recorded individually when individual loans are removed from the group and written off. The methods that are used to calculate collective allowances are:

- When appropriate empirical information is available, the group utilises roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date and which the group is not able to identify individually. Individual loans are grouped using ranges of past due days; statistical analysis is then used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics as described above. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring and its discovery, for example through a missed payment, (known as the emergence period) and the period of time between discovery and write-off (known as the outcome period). 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, or a discounted cash flow model. Where a basic formulaic approach is undertaken, management estimates that typically it takes between six and twelve months between a loss occurring and its identification.

3 Summary of significant accounting policies *(continued)*

The inherent loss within each portfolio is assessed on the basis of statistical models using historical data observations, which are updated periodically to reflect recent portfolio and economic trends. When the most recent trends arising from changes in economic, regulatory or behavioural conditions are not fully reflected in the statistical models, they are taken into account by adjusting the impairment allowances derived from the statistical models to reflect these changes as at the balance sheet date. Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Write-off of loans and advances

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

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets' if the carrying amounts of the assets are recovered principally through sale, the assets are available-for-sale in their present condition and their sale is highly probable. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance amounts) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included within 'Other operating income' in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised as a gain in 'Other operating income' in the income statement, together with any realised gains or losses on disposal. Debt securities or equities acquired in debt-to-debt/equity swaps are included in 'Financial investments' and are classified as available-for-sale.

Renegotiated loans

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

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

3 Summary of significant accounting policies *(continued)*

f *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, placings with and by banks, debt securities, structured deposits, equity shares, own debt issued and short positions in securities which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as held for trading. Financial assets and financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell the financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, the fair values are remeasured and gains and losses from changes therein are recognised in the income statement within 'Net trading income'.

g *Financial instruments designated at fair value*

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

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

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

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

- applies to a groups of financial instruments that are managed and their performance evaluated, on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that groups of financial instruments is reported to management on that basis. For example, certain financial assets are held to meet liabilities under non-linked insurance contracts, the group has documented risk management and investment strategies designed to manage and monitor market risk of those assets on net basis, after considering non-linked liabilities. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations; and

- relates to financial instruments containing one or more non-closely related embedded derivatives.

Designated financial assets are recognised at fair value when the group enters into contracts with counterparties, which is generally on trade date, and are normally derecognised when sold. Subsequent changes in fair values are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

3 Summary of significant accounting policies *(continued)*

h *Financial investments*

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

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 until they are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

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

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

3 Summary of significant accounting policies *(continued)*

Available-for-sale equity securities

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

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

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if, there is objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised directly in other comprehensive income. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value. If there is no longer objective evidence that the debt security is impaired, the impairment loss is also reversed through the income statement;
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on an equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost, less cumulative impairment to date, of the equity security.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends and is able 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, less any impairment losses.

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i *Valuation of financial instruments*

All financial instruments are recognised initially at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received). However, sometimes the fair value will 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 day 1, being the difference between the transaction price and the fair value. When significant unobservable parameters are used, the entire day 1 gain or loss is deferred and is recognised in the income statement over the life of the transaction until the transaction matures, is closed out, the valuation inputs become observable, or when the group enters into an offsetting transaction.

The fair value of financial instruments is generally measured on an individual basis. However, in cases where the group manages a group of financial assets and liabilities according to its net market or credit risk exposure, the group measures the fair value of the group of financial instruments on a net basis but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the HKFRS offsetting criteria as described in note 45.

3 Summary of significant accounting policies *(continued)*

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

When securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in 'Repurchase agreements - non-trading' or 'Trading liabilities' for the consideration received. Securities purchased under commitments to re-sell are not recognised on the balance sheet and the right to receive back the initial consideration paid is recorded in 'Reverse repurchase agreements - non-trading' or 'Trading assets' as appropriate.

Securities lending and borrowing transactions are generally secured against cash or non-cash collateral. Securities lent or borrowed do not normally result in derecognition or recognition on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

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

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k *Derivative financial instruments and hedge accounting*

Derivatives are initially recognised, and are subsequently remeasured, at fair value. Fair values of derivatives are obtained either from quoted market prices or by using valuation techniques. Derivative assets and liabilities arising from different transactions are only offset for accounting purposes if the offsetting criteria are met.

Embedded derivatives are treated as separate derivatives ('bifurcated') when their economic characteristics and risks are not clearly and closely related to those of the host non-derivative contract, their contractual terms would otherwise meet the definition of a stand-alone derivative and the combined contract is not held for trading or designated at fair value. The bifurcated 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.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income' except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value' together with the gains and losses on the economically hedged items. Where the derivatives are managed with debt securities in issue, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt.

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

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 requires documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items.

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 that contain the hedged risk. If a hedging relationship no longer meets the criteria for hedge accounting, the hedge accounting is discontinued: the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised.

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 similarly to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; the residual change in fair value 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, or part 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 both prospectively and retrospectively, on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed and the method adopted by an entity to assess hedge effectiveness will depend on its 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, with the effectiveness range being defined as 80% to 125%. Hedge ineffectiveness is recognised in the income statement in ‘Net trading income’.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are economic hedges entered into as part of documented interest rate management strategies for which hedge accounting is not applied. Changes in fair value of non-qualifying hedges do not alter the cash flows expected as part of the documented management strategies for both the non-qualifying hedge instruments and the related assets and liabilities.

3 Summary of significant accounting policies *(continued)*

l *Derecognition of financial assets and liabilities*

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

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

m *Offsetting financial assets and financial liabilities*

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

n *Subsidiaries, associates and joint ventures*

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

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

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

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

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

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, for example when any voting rights relate to administrative tasks only, and key activities are directed by contractual agreement. Structured entities often have restricted activities and a narrow and well-defined objective. Examples of structured entities include investment funds, securitisation vehicles and asset backed financings. Involvement with consolidated and unconsolidated structured entities is disclosed in note 51.

The group is considered to sponsor another entity if, in addition to ongoing involvement with the entity, it had a key role in establishing that entity or in bringing together the relevant counterparties so that the transaction, which is the purpose of the entity, could occur. The group is generally not considered a sponsor if the only involvement with the entity is merely administrative in nature.

3 Summary of significant accounting policies *(continued)*

o *Goodwill and intangible assets*

(i) Goodwill arises on the acquisition of subsidiaries, when the aggregate of the fair value of the consideration transferred, the amount of any non-controlling interest and the fair value of any previously held equity interest in the acquiree exceed the amount of the identifiable assets and liabilities acquired. If the amount of the identifiable assets and liabilities acquired is greater, the difference is recognised immediately in the income statement. Goodwill arises on the acquisition of interests in joint ventures and associates when the cost of investment exceeds the group's share of the net fair value of the associate's or joint venture's identifiable assets and liabilities.

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

Goodwill is allocated to cash-generating units ('CGU') for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the CGU may be impaired, by comparing the recoverable amount of a CGU with the carrying amount of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of its fair value less cost to sell, and its value in use. Value in use is the present value of the expected future cash flows from a CGU. If the recoverable amount of the CGU is less than the carrying value, an impairment loss is charged to the income statement. Any write-off in excess of the carrying value of goodwill is limited to the fair value of the individual assets and liabilities of the CGU. Goodwill is stated at cost less accumulated impairment losses, if any.

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

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

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

(ii) Intangible assets include the present value of in-force long-term insurance business, operating rights, computer software and, when acquired in a business combination, trade names, customer relationships and core deposit relationships. Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually.

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

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

The accounting policy on the present value of in-force long-term insurance business is set out in note 3(x).

3 Summary of significant accounting policies *(continued)*

p *Property, plant and equipment*

(i) Land and buildings

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

Revaluations are performed by professional qualified valuers, on a market basis, with sufficient regularity to ensure that the net carrying amount does not differ materially from the fair value. Surpluses arising on revaluation are credited firstly to the income statement, to the extent of any deficits arising on revaluation previously charged to the income statement in respect of the same land and buildings, and are thereafter taken to the 'Property revaluation reserve'. Deficits arising on revaluation are first set off against any previous revaluation surpluses included in the 'Property revaluation reserve' in respect of the same land and buildings, and are thereafter recognised in the income statement.

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

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

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

(ii) Investment properties

The group holds certain properties as investments to earn rentals, or for capital appreciation, or both. Investment properties are stated at fair value with changes in fair value being recognised in 'Other operating income'. Fair values are determined by independent professional valuers based on the highest and best use of the property, primarily using the capitalisation of net incomes with due allowance for outgoings and reversionary income potential. Property interests which are held under operating leases to earn rentals, or for capital appreciation, or both, are classified and accounted for as investment properties on a property-by-property basis. Such property interests are accounted for as if they were held under finance leases (see note 3(q)).

(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.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

(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.

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q *Finance and operating leases*

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

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

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

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

(v) Leasehold land is included under 'Other assets' in the balance sheet if such land is considered to be held under operating leases and is stated at cost less amortisation and impairment losses. Amortisation is calculated to write off the cost of the land on a straight-line basis over the terms of the leases.

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r *Income tax*

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

(ii) Current tax is the expected tax payable on the taxable income for the year, calculated using tax rates enacted or substantively enacted at the period end date, and any adjustment to tax payable in respect of previous years. The group provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

3 Summary of significant accounting policies *(continued)*

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

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

Deferred tax relating to actuarial gains and losses arising from post-employment benefit plans which are recognised in the statement of comprehensive income is also credited or charged to the statement of comprehensive income. Deferred tax relating to share-based payment transactions is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense.

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

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s *Pension and other post-employment benefits*

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

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

The costs recognised for funding defined benefit plans are determined using the projected unit credit method, with annual actuarial valuations performed on each plan. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit liability and is presented in operating expenses. Service cost comprises current service cost, past service cost, and gain or loss on settlement.

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

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

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

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

t *Share-based payments*

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

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

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

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

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

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

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u *Foreign currencies*

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

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

The results of branches, subsidiaries and associates not reporting in Hong Kong dollars are translated into Hong Kong dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period-end are accounted for in a separate foreign exchange reserve in the consolidated financial statements.

Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary's financial statements. In the consolidated financial statements, these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto previously recognised in reserves are recognised in the income statement.

3 Summary of significant accounting policies *(continued)*

v *Provisions*

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

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

w *Financial guarantee contracts*

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

x *Insurance contracts*

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

Insurance contracts are accounted for as follows:

Premiums

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

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

Present value of in-force long-term insurance business

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

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

3 Summary of significant accounting policies *(continued)*

Insurance 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.

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.

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

Liabilities under insurance contracts

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

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.

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

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y *Investment contracts*

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

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

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

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z *Dividends*

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

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aa *Debt securities in issue and subordinated liabilities*

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the consideration received, net of directly attributable transaction costs incurred. Debt securities issued for trading purposes or designated at fair value are reported under the appropriate balance sheet captions. Other debt securities in issue and subordinated liabilities are measured at amortised cost using the effective interest rate method and are reported under 'Debt securities in issue' or 'Subordinated liabilities'.

3 Summary of significant accounting policies *(continued)*

ab *Cash and cash equivalents*

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

ac *Share capital and other equity instruments*

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

ad *Assets held for sale*

Assets and liabilities of disposal groups and non-current assets are classified as held for sale ('HFS') when their carrying amounts will be recovered principally through sale rather than through continuing use. HFS assets are generally measured at the lower of their carrying amount and fair value less cost to sell.

Immediately before the initial classification as held for sale, the carrying amounts of the relevant assets and liabilities are measured in accordance with applicable HKFRSs. On subsequent remeasurement of a disposal group, fair value less costs to sell of the disposal group is determined after each HFS asset is individually measured under applicable HKFRSs.

Notes on the Financial Statements (continued)

4 Operating profit

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

a *Interest income*

	2014 HK$m	2013 HK$m
Interest income on listed securities	**15,802**	6,539
Interest income on unlisted securities	**13,812**	19,946
Other interest income	**106,820**	98,969
	136,434	125,454
Less: interest income classified as 'Net trading income' (note 4(d))	**(9,617)**	(8,352)
Less: interest income classified as 'Net income from financial instruments designated at fair value'(note 4(e))	**(35)**	(63)
	126,782	117,039

Included in the above is interest income accrued on impaired financial assets of HK$215m (2013: HK$128m).

b *Interest expense*

	2014 HK$m	2013 HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**505**	525
Interest expense on preference shares	**976**	1,591
Other interest expense	**34,641**	32,068
	36,122	34,184
Less: interest expense classified as 'Net trading income' (note 4(d))	**(4,449)**	(4,493)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**–**	(17)
	31,673	29,674

c *Net fee income*

	2014 HK$m	2013 HK$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	**15,273**	15,596
– fee expense	**(1,821)**	(1,833)
	13,452	13,763
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**8,626**	8,607
– fee expense	**(944)**	(981)
	7,682	7,626

4 Operating profit *(continued)*

d *Net trading income*

	2014 HK$m	2013 HK$m
Dealing profits	**13,674**	15,104
– Foreign exchange	**10,761**	15,317
– Interest rate	**887**	217
– Debt securities	**1,513**	(1,462)
– Equities and other trading	**513**	1,032
Loss from hedging activities	**(6)**	(37)
Fair value hedges		
– Net gain/(loss) on hedged items attributable to the hedged risk	**408**	(1,977)
– Net gain/(loss) on hedging instruments	**(419)**	1,938
Cash flow hedges		
– Net hedging gain	**5**	2
Interest on trading assets and liabilities	**5,168**	3,859
– Interest income (note 4(a))	**9,617**	8,352
– Interest expense (note 4(b))	**(4,449)**	(4,493)
Dividend income from trading securities	**1,384**	974
– Listed investments	**1,359**	815
– Unlisted investments	**25**	159
Ping An contingent forward sale contract	**–**	(3,323)
	20,220	16,577

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

	2014 HK$m	2013 HK$m
Income on assets designated at fair value which back insurance and investment contracts	**5,025**	3,589
Increase in fair value of liabilities to customers under investment contracts	**(807)**	(1,050)
	4,218	2,539
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**(205)**	(110)
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	**35**	63
– Interest expense (note 4(b))	**–**	(17)
	4,048	2,475

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 2014, the group recognised a HK$35m loss on changes in the fair value of these instruments arising from changes in own credit risk (2013:HK$18m loss).*

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

f *Gains less losses from financial investments*

	2014 HK$m	2013 HK$m
Gains on disposal of available-for-sale securities	**4,608**	470
Impairment of available-for-sale equity investments	**(2,219)**	(28)
	2,389	442

Gains on disposal of available-for-sale securities in 2014 included the disposal of our investment in Bank of Shanghai and the intercompany sale of private equity funds..

In 2014, we recorded an impairment of HK$2,103m on our investment in Industrial Bank.

There were no gains or losses on the disposal of held-to-maturity investments in the year (2013: nil).

g *Dividend income*

	2014 HK$m	2013 HK$m
Listed investments	**1,204**	1,008
Unlisted investments	**170**	167
	1,374	1,175

h *Net gain/(loss) on reclassification of associates*

	2014 HK$m	2013 HK$m
Gain on reclassification of Industrial Bank	–	8,454
Loss on reclassification of Yantai Bank	–	(297)
Loss on reclassification of Techcom Bank	**(251)**	–
	(251)	8,157

i *Other operating income*

	2014 HK$m	2013 HK$m
Movement in present value of in-force insurance business	**3,581**	4,735
Gains on investment properties	**670**	1,389
Gain on disposal of property, plant and equipment and assets held for sale	**61**	299
Gain on disposal of subsidiaries, associates and business portfolios	**104**	758
Rental income from investment properties	**422**	312
Other	**3,915**	3,925
	8,753	11,418

Other includes net gains on loans and receivables of HK$197m (2013: HK$388m). There were no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2013: nil).

4 Operating profit *(continued)*

j *Loan impairment charges and other credit risk provisions*

	2014 HK$m	2013 HK$m
Individually assessed impairment charges:		
– New allowances	**4,202**	2,433
– Releases	**(1,420)**	(1,426)
– Recoveries	**(156)**	(198)
	2,626	809
Collectively assessed impairment charges	**2,272**	2,602
Other credit risk provisions	**27**	121
Loan impairment charges and other credit risk provisions	**4,925**	3,532

There were no impairment charge against available-for-sale debt securities included in other credit risk provisions (2013: nil). There were no impairment losses or provisions relating to held-to-maturity investments (2013: nil).

k *General and administrative expenses*

	2014 HK$m	2013 HK$m
Premises and equipment		
– Rental expenses	**3,546**	3,428
– Amortisation of prepaid operating lease payments	**18**	18
– Other premises and equipment expenses	**4,143**	3,953
	7,707	7,399
Marketing and advertising expenses	**3,983**	3,565
Other administrative expenses	**16,588**	15,163
	28,278	26,127

Included in operating expenses were direct operating expenses of HK$24m (2013: HK$25m) 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$4m (2013: HK$1m).

Included in operating expenses are minimum lease payments under operating leases of HK$3,553m (2013: HK$3,404m).

l *Auditors' remuneration*

Auditors' remuneration amounted to HK$73m (2013: HK$74m), of which HK$30m (2013: 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*

	2014 HK$m	2013 HK$m
Net interest income	**9,439**	8,702
Net fee income	**2,083**	1,864
Net trading loss	**(512)**	(349)
Net income from financial instruments designated at fair value	**4,159**	2,426
Net insurance premium income (note 5(b))	**57,307**	53,663
Movement in present value of in-force business	**3,581**	4,735
Other operating income	**173**	1,052
	76,230	72,093
Net insurance claims and benefits paid and movement in liabilities to policyholders (note 5(c))	**(60,182)**	(56,592)
Net operating income	**16,048**	15,501

b *Net insurance premium income*

	Non-linked insurance HK$m	Linked insurance HK$m	Total HK$m
2014			
Gross insurance premium income	**50,882**	**8,271**	**59,153**
Reinsurers' share of gross insurance premium income	**(1,831)**	**(15)**	**(1,846)**
Net insurance premium income	**49,051**	**8,256**	**57,307**
2013			
Gross insurance premium income	43,376	12,088	55,464
Reinsurers' share of gross insurance premium income	(1,783)	(18)	(1,801)
Net insurance premium income	41,593	12,070	53,663

5 Insurance income *(continued)*

c *Net insurance claims and benefits paid and movement in liabilities to policyholders*

	Non-linked insurance HK$m	Linked insurance HK$m	Total HK$m
2014			
Gross claims and benefits paid and movement in liabilities to policyholders	**53,104**	**8,339**	**61,443**
Claims, benefits and surrenders paid	**23,761**	**2,921**	**26,682**
Movement in provision	**29,343**	**5,418**	**34,761**
Reinsurers' share of claims and benefits paid and movement in liabilities to policyholders	**(1,611)**	**350**	**(1,261)**
Reinsurers' share of claims, benefits and surrenders paid	**(204)**	**(644)**	**(848)**
Reinsurers' share of movement in provision	**(1,407)**	**994**	**(413)**
Net insurance claims and benefits paid and movement in liabilities to policyholders	**51,493**	**8,689**	**60,182**
2013			
Gross claims and benefits paid and movement in liabilities to policyholders	46,731	10,530	57,261
Claims, benefits and surrenders paid	20,370	4,898	25,268
Movement in provision	26,361	5,632	31,993
Reinsurers' share of claims and benefits paid and movement in liabilities to policyholders	(1,683)	1,014	(669)
Reinsurers' share of claims, benefits and surrenders paid	(201)	(3,267)	(3,468)
Reinsurers' share of movement in provision	(1,482)	4,281	2,799
Net insurance claims and benefits paid and movement in liabilities to policyholders	45,048	11,544	56,592

Notes on the Financial Statements (continued)

6 Employee compensation and benefits

a *Employee compensation and benefits*

	2014 HK$m	2013 HK$m
Wages and salaries	**35,476**	33,761
Social security costs	**1,046**	970
Retirement benefit costs		
– Defined contribution plans	**1,350**	1,115
– Defined benefit plans (note 6(c)(i))	**1,022**	1,092
	38,894	36,938

b *Directors' emoluments*

The aggregate emoluments of the Directors of the Bank disclosed pursuant to section 78 of Schedule 11 to the Hong Kong Companies Ordinance (Cap. 622), which requires compliance with section 161 of the predecessor Hong Kong Companies Ordinance (Cap. 32), were HK$101m (2013: HK$71m). This comprises fees of HK$9m (2013: HK$9m) and other emoluments of HK$92m (2013: HK$62m) which includes pension benefits of HK$1m (2013: HK$1m).

c *Retirement benefit pension plans*

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

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

	2014 HK$m	2013 HK$m
Defined benefit pension plan		
Current service cost	**903**	1,023
Net interest cost on the net defined benefit liability/asset	**120**	74
Past service cost and gains on settlements	**(6)**	(10)
Administrative costs and taxes paid by plan	**5**	5
Total expense	**1,022**	1,092

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

	The group		The Bank	
	2014 HK$m	2013 HK$m	2014 HK$m	2013 HK$m
At 1 January	**(6,937)**	(9,218)	**(4,276)**	(5,573)
Actuarial gains/(losses) recognised in other comprehensive income	**(704)**	2,281	**(907)**	1,297
At 31 December	**(7,641)**	(6,937)	**(5,183)**	(4,276)

The group operates 85 (2013: 86) retirement benefit plans, with a total cost of HK$2,372m (2013: HK$2,207m), of which HK$619m (2013: HK$605m) relates to overseas plans and HK$13m (2013: HK$14m) to a plan sponsored by HSBC Asia Holdings BV.

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

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

6 Employee compensation and benefits *(continued)*

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

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

The Principal Plan mainly invests in bonds with a smaller portion in equities and each investment manager has been assigned a benchmark applicable to their respective asset class. The target asset allocations for the portfolio are as follows: Bonds 65% and Equity 35%.

Defined benefit pension plans

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

The group

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability				
At 1 January 2014	**14,505**	**(19,207)**	**(1)**	**(4,703)**
Current service cost	–	(903)	–	(903)
Past service cost and gains from settlements[1]	–	6	–	6
Service cost	–	(897)	–	(897)
Net interest income/(cost) on the net defined benefit liability	345	(465)	–	(120)
Remeasurement effects recognised in other comprehensive income	319	(1,023)	–	(704)
– Return on plan assets (excluding interest income)	319	–	–	319
– Actuarial losses from changes in demographic assumptions	–	(16)	–	(16)
– Actuarial losses from changes in financial assumptions	–	(634)	–	(634)
– Actuarial losses from experience	–	(373)	–	(373)
Exchange differences and other movements	(31)	68	–	37
Contributions by the group	835	–	–	835
Contributions by employees	2	(2)	–	–
Benefits paid	(1,105)	1,170	–	65
At 31 December 2014	**14,870**	**(20,356)**	**(1)**	**(5,487)**
Retirement benefit liabilities recognised on the balance sheet				(5,606)
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				119
Present value of defined benefit obligation relating to:				
– Actives		(20,115)		
– Deferreds		(4)		
– Pensioners		(237)		

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

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The group

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

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

6 Employee compensation and benefits *(continued)*

The Bank

	Fair value of plan assets HK$m	Present value of defined benefit obligations HK$m	Effect of the asset ceiling HK$m	Net defined benefit liability HK$m
Net defined benefit liability				
At 1 January 2014	**9,210**	**(11,828)**	**(1)**	**(2,619)**
Current service cost	**–**	**(587)**	**–**	**(587)**
Net interest income/(cost) on the net defined benefit liability	**235**	**(308)**	**–**	**(73)**
Remeasurement effects recognised in other comprehensive income	**313**	**(1,220)**	**–**	**(907)**
– Return on plan assets (excluding interest income)	**313**	**–**	**–**	**313**
– Actuarial losses from changes in demographic assumptions	**–**	**(8)**	**–**	**(8)**
– Actuarial losses from changes in financial assumptions	**–**	**(750)**	**–**	**(750)**
– Actuarial losses from experience	**–**	**(462)**	**–**	**(462)**
Exchange differences and other movements	**254**	**(231)**	**–**	**23**
Contributions by the bank	**510**	**–**	**–**	**510**
Contributions by employees	**1**	**(1)**	**–**	**–**
Benefits paid	**(584)**	**632**	**–**	**48**
At 31 December 2014	**9,939**	**(13,543)**	**(1)**	**(3,605)**
Retirement benefit liabilities recognised on the balance sheet				**(3,663)**
Retirement benefit assets recognised on the balance sheet (within 'Other assets')				**58**
Present value of defined benefit obligation relating to:				
– Actives		**(13,479)**		
– Deferreds		**(4)**		
– Pensioners		**(60)**		

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The Bank

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

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

The group expects to make HK$744m of contributions to defined benefit pension plans during 2015. Contributions to be made by the Bank are expected to be HK$436m.

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

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

	2015 HK$m	2016 HK$m	2017 HK$m	2018 HK$m	2019 HK$m	2020-2024 HK$m
HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	**596**	**712**	**807**	**865**	**987**	**5,133**

6 Employee compensation and benefits *(continued)*

(v) Fair value of plan assets by asset classes

The group

	2014			2013		
	Value HK$m	**Quoted market price in active market HK$m**	**Thereof HSBC HK$m**	Value HK$m	Quoted market price in active market HK$m	Thereof HSBC HK$m
Fair value of plan assets	**14,870**	**14,870**	**257**	14,505	14,505	156
– Equities	**5,251**	**5,251**	**81**	4,750	4,750	109
– Bonds	**8,328**	**8,328**	**–**	8,573	8,573	–
– Derivatives	**1**	**1**	**–**	(1)	(1)	–
– Other[1]	**1,290**	**1,290**	**176**	1,183	1,183	47

The Bank

	2014			2013		
	Value HK$m	**Quoted market price in active market HK$m**	**Thereof HSBC HK$m**	Value HK$m	Quoted market price in active market HK$m	Thereof HSBC HK$m
Fair value of plan assets	**9,939**	**9,939**	**196**	9,210	9,210	62
– Equities	**3,464**	**3,464**	**20**	2,369	2,369	54
– Bonds	**6,069**	**6,069**	**–**	6,279	6,279	–
– Other[1]	**406**	**406**	**176**	562	562	8

1 *Other mainly consists of cash and deposits.*

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

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

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

The present value of the Principal Plan's obligation was a final lump sum salary of HK$11,534m (2013: HK$10,284m). The principal actuarial assumptions used to calculate the group's obligations for the Principal Plan for each year, and used as the basis for measuring the expenses in relation to the Principal Plan, were as follows:

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

Principal actuarial assumptions for the Principal Plan

	2014 **% p.a.**	2013 % p.a.
Discount rate	**1.75**	2.15
Rate of pay increase	**4.0**	4.0
Mortality table	HKLT2011[1]	HKLT2011[1]

1 *HKLT2011- Hong Kong Life Tables 2011.*

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

(vii) Actuarial assumption sensitivities

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

The effect of changes in key assumptions on the Principal Plan

	HSBC Group Hong Kong Local Staff Retirement Benefit Scheme	
	2014 **HK$m**	2013 HK$m
Discount rate		
– Change in pension obligation at year end from a 25bps increase	**(234)**	(195)
– Change in pension obligation at year end from a 25bps decrease	**242**	201
– Change in 2014/2013 pension cost from a 25bps increase	**(11)**	(8)
– Change in 2014/2013 pension cost from a 25bps decrease	**11**	8
Rate of pay increase		
– Change in pension obligation at year end from a 25bps increase	**227**	207
– Change in pension obligation at year end from a 25bps decrease	**(221)**	(202)
– Change in 2014/2013 pension cost from a 25bps increase	**10**	14
– Change in 2014/2013 pension cost from a 25bps decrease	**(10)**	(14)

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% (2013: 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 2014. Deferred taxation is provided for in accordance with the group's accounting policy in note 3(r).

The charge for taxation in the income statement comprises:

	2014 **HK$m**	2013 HK$m
Current income tax		
– Hong Kong profits tax – on current year profit	**9,039**	8,643
– Hong Kong profits tax – adjustments in respect of prior years	**(177)**	(164)
– Overseas taxation – on current year profit	**8,542**	8,964
– Overseas taxation – adjustments in respect of prior years	**154**	(806)
	17,558	16,637
Deferred tax		
– Origination and reversal of temporary differences	**1,462**	(1,385)
– Effect of changes in tax rates	**19**	(1)
– Adjustments in respect of prior years	**(27)**	450
	1,454	(936)
	19,012	15,701

7 Tax expense *(continued)*

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

(i) Deferred tax assets

The group

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2014							
At 1 January	**154**	**–**	**852**	**669**	**(743)**	**1,362**	**2,294**
Exchange and other adjustments	**(49)**	**–**	**(245)**	**(8)**	**490**	**(142)**	**46**
Credit/(charge) to income statement	**1**	**–**	**6**	**(432)**	**4**	**(87)**	**(508)**
Charge to reserves	**–**	**–**	**–**	**–**	**(26)**	**(370)**	**(396)**
At 31 December	**106**	**–**	**613**	**229**	**(275)**	**763**	**1,436**
2013							
At 1 January	109	–	1,093	894	(800)	1,333	2,629
Exchange and other adjustments	35	–	(324)	(284)	142	(50)	(481)
Credit/(charge) to income statement	10	–	83	59	3	(298)	(143)
Credit/(charge) to reserves	–	–	–	–	(88)	377	289
At 31 December	154	–	852	669	(743)	1,362	2,294

The Bank

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2014							
At 1 January	**36**	**–**	**357**	**487**	**(686)**	**805**	**999**
Exchange and other adjustments	**(32)**	**–**	**(64)**	**(317)**	**480**	**13**	**80**
Credit/(charge) to income statement	**(6)**	**–**	**9**	**(148)**	**2**	**(91)**	**(234)**
Charge to reserves	**–**	**–**	**–**	**–**	**(16)**	**(165)**	**(181)**
At 31 December	**(2)**	**–**	**302**	**22**	**(220)**	**562**	**664**
2013							
At 1 January	5	–	380	586	(730)	1,092	1,333
Exchange and other adjustments	24	–	(18)	(180)	91	(106)	(189)
Credit/(charge) to income statement	7	–	(5)	81	2	(401)	(316)
Credit/(charge) to reserves	–	–	–	–	(49)	220	171
At 31 December	36	–	357	487	(686)	805	999

Notes on the Financial Statements (continued)

7 Tax expense *(continued)*

(ii) Deferred tax liabilities

The group

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2014							
At 1 January	**568**	**4,796**	**(314)**	**(43)**	**10,549**	**495**	**16,051**
Exchange and other adjustments	**(36)**	**(1)**	**(177)**	**2**	**441**	**(145)**	**84**
Charge/(credit) to income statement	**204**	**595**	**25**	**(14)**	**(242)**	**378**	**946**
Charge to reserves	**–**	**–**	**–**	**–**	**705**	**800**	**1,505**
At 31 December	**736**	**5,390**	**(466)**	**(55)**	**11,453**	**1,528**	**18,586**
2013							
At 1 January	402	4,041	(16)	(262)	9,804	2,954	16,923
Exchange and other adjustments	47	(11)	(290)	(188)	65	14	(363)
Charge/(credit) to income statement	119	766	(8)	407	(181)	(2,182)	(1,079)
Charge/(credit) to reserves	–	–	–	–	861	(291)	570
At 31 December	568	4,796	(314)	(43)	10,549	495	16,051

The Bank

	Accelerated capital allowances HK$m	Insurance technical provisions HK$m	Expense provisions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Other HK$m	Total HK$m
2014							
At 1 January	**461**	**–**	**(1)**	**(208)**	**6,084**	**167**	**6,503**
Exchange and other adjustments	**(34)**	**–**	**(25)**	**(314)**	**(190)**	**29**	**(534)**
Charge/(credit) to income statement	**125**	**–**	**–**	**12**	**(119)**	**(224)**	**(206)**
Charge to reserves	**–**	**–**	**–**	**–**	**610**	**62**	**672**
At 31 December	**552**	**–**	**(26)**	**(510)**	**6,385**	**34**	**6,435**
2013							
At 1 January	323	–	(8)	(230)	5,805	304	6,194
Exchange and other adjustments	23	–	1	(139)	16	(52)	(151)
(Credit)/charge to income statement	115	–	6	161	(114)	(198)	(30)
Charge to reserves	–	–	–	–	377	113	490
At 31 December	461	–	(1)	(208)	6,084	167	6,503

7 Tax expense *(continued)*

(iii) Net deferred tax liabilities

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Deferred tax liabilities recognised on the balance sheet	**18,586**	16,051	**6,435**	6,503
Deferred tax assets recognised on the balance sheet	**(1,436)**	(2,294)	**(664)**	(999)
	17,150	13,757	**5,771**	5,504

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK$2,617m (2013: HK$2,951m). Of this amount, HK$1,890m (2013: HK$1,955m) has no expiry date and the remaining will expire within 10 years.

Deferred tax of HK$732m (2013: HK$156m) has been provided in respect of distributable reserves or post-acquisition reserves of associates that, on distribution or sale, would attract withholding tax.

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

c *Provisions for taxation*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Current tax liabilities	**2,927**	3,722	**1,840**	2,029
Deferred tax liabilities	**18,586**	16,051	**6,435**	6,503
	21,513	19,773	**8,275**	8,532

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

	2014	2013
	HK$m	HK$m
Profit before tax	**111,189**	144,756
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**21,184**	26,788
Adjustments in respect of prior years	**(50)**	(520)
Deferred tax temporary differences previously not recognised	**(15)**	(19)
Effects of profits in associates and joint ventures	**(2,586)**	(2,380)
Non taxable income and gains	**(2,980)**	(9,068)
Permanent disallowables	**1,653**	1,757
Change in tax rates	**19**	(1)
Local taxes and overseas withholding taxes	**1,267**	1,248
Others	**520**	(2,104)
	19,012	15,701

Notes on the Financial Statements (continued)

8 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$59,480m (2013: HK$108,678m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2014		2013	
	HK$ per share	**HK$m**	HK$ per share	HK$m
Ordinary dividends paid				
– fourth interim dividend in respect of the previous financial year approved and paid during the year	**0.44**	**15,000**	0.85	20,000
– first interim dividend paid	**0.27**	**9,250**	0.38	9,000
– second interim dividend paid	**0.24**	**9,250**	0.38	9,000
– third interim dividend paid	**0.24**	**9,250**	0.38	9,000
	1.19	**42,750**	1.99	47,000

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2014 of HK$14,250m (HK$0.37 per ordinary share).

10 Cash and sight balances at central banks

	The group		The Bank	
	2014 HK$m	2013 HK$m	**2014 HK$m**	2013 HK$m
Cash in hand	**16,223**	17,982	**8,958**	9,625
Sight balances at central banks	**140,252**	140,897	**111,510**	102,960
	156,475	158,879	**120,468**	112,585

At 31 December 2014, the total amount placed with central banks by the group, included within cash and sight balances at central banks, reverse repurchase agreements - non-trading, and placings with and advances to banks, amounted to HK$277,377m (2013: HK$321,433m). Placings with central banks made by the Bank amounted to HK$155,761m (2013: HK$169,767m).

11 Hong Kong Government certificates of indebtedness

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.

12 Trading assets

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**231,734**	150,145	**166,447**	111,588
Equity shares	**41,180**	31,640	**41,032**	31,530
Treasury and other eligible bills	**102,028**	109,174	**68,147**	82,003
Other	**32,084**	20,441	**22,739**	10,478
	407,026	311,400	**298,365**	235,599
Trading assets				
– which may be repledged or resold by counterparties	**4,718**	2,421	**4,718**	2,421
– not subject to repledge or resale by counterparties	**402,308**	308,979	**293,647**	233,178
	407,026	311,400	**298,365**	235,599

The amount of listed treasury and other eligible bills amounted to HK$8,421m at both group and Bank level as at 31 December 2014 (2013: HK$1,296m). ‘Other’ trading assets primarily includes settlement accounts with banks and customers.

a *Debt securities*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**25,104**	16,908	**15,275**	13,125
– listed outside Hong Kong	**134,650**	31,681	**97,881**	31,512
	159,754	48,589	**113,156**	44,637
Unlisted	**71,980**	101,556	**53,291**	66,951
	231,734	150,145	**166,447**	111,588
Issued by public bodies				
– central governments and central banks	**163,680**	111,721	**111,882**	81,818
– other public sector entities	**8,551**	4,620	**8,551**	4,294
	172,231	116,341	**120,433**	86,112
Issued by				
– banks	**26,745**	15,343	**22,743**	11,239
– corporate entities	**32,758**	18,461	**23,271**	14,237
	231,734	150,145	**166,447**	111,588

During 2014, certain exchanges have been regarded as recognised exchanges, causing more securities to be classified as listed.

b *Equity shares*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**22,807**	13,149	**22,767**	13,120
– listed outside Hong Kong	**17,600**	14,686	**17,600**	14,686
	40,407	27,835	**40,367**	27,806
Unlisted	**773**	3,805	**665**	3,724
	41,180	31,640	**41,032**	31,530
Issued by				
– banks	**10,346**	3,945	**10,346**	3,945
– corporate entities	**30,834**	27,695	**30,686**	27,585
	41,180	31,640	**41,032**	31,530

During 2014, certain exchanges have been regarded as recognised exchanges, causing more securities to be classified as listed.

13 Derivatives

Derivatives are financial instruments that derive their value from the price of underlying items 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 49.

Derivative assets and liabilities are only offset and reported net in the balance sheet when there is a legally enforceable right to offset and the cash flows are intended to be settled on a net basis. Changes in the values of derivatives are recognised in accordance with the group's accounting policy as described in note 3(k).

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio risk arising from client business, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments) are held for trading. Within the held for trading classification are two types of derivative instruments: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second 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. When entering into derivative transactions, the group employs the same credit risk management framework to assess and approve potential credit exposures that it uses for traditional lending.

a *Trading derivatives*

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities include market-making and risk management. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume. Risk management activity is undertaken to manage the risk arising from client transactions, with the principal purpose of retaining client margin.

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. Trading derivatives also include derivatives managed in conjunction with financial instruments designated at fair value.

13 Derivatives *(continued)*

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

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

The group

	2014			2013		
	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	**14,880,218**	**221,590**	**203,420**	11,953,908	196,420	183,644
– spot, forward and future	**10,060,892**	**112,297**	**104,108**	7,847,361	99,121	96,534
– swaps	**3,422,916**	**96,769**	**86,955**	3,303,017	93,128	83,819
– options purchased	**684,251**	**11,693**	**416**	398,079	3,185	261
– options written	**712,159**	**831**	**11,941**	405,451	986	3,030
Interest rate contracts	**18,254,624**	**164,071**	**161,746**	18,258,980	162,048	158,252
– forward and future	**448,799**	**41**	**39**	383,180	59	40
– swaps	**17,593,936**	**160,827**	**158,539**	17,669,570	159,024	155,739
– options purchased	**77,354**	**1,677**	**205**	66,425	1,354	12
– options written	**70,790**	**71**	**2,137**	87,884	80	1,583
– other	**63,745**	**1,455**	**826**	51,921	1,531	878
Equity derivatives	**1,084,221**	**37,562**	**38,247**	1,227,483	50,308	51,597
Credit derivatives	**259,298**	**1,644**	**1,659**	232,812	1,904	1,906
Commodity and other	**134,482**	**5,737**	**6,211**	140,496	2,511	2,131
Total held for trading	**34,612,843**	**430,604**	**411,283**	31,813,679	413,191	397,530
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**–**	**–**	**–**	546	4	–
Interest rate contracts	**8,140**	**86**	**6**	5,061	18	41
	8,140	**86**	**6**	5,607	22	41
Cash flow hedging derivatives						
Exchange rate contracts	**45,047**	**5,055**	**595**	48,904	9,115	97
Interest rate contracts	**54,040**	**74**	**122**	19,402	45	68
	99,087	**5,129**	**717**	68,306	9,160	165
Fair value hedging derivatives						
Interest rate contracts	**150,960**	**297**	**1,304**	140,952	963	1,925
Gross total derivatives	**34,871,030**	**436,116**	**413,310**	32,028,544	423,336	399,661
Netting	**–**	**(46,182)**	**(46,182)**	–	(34,609)	(34,609)
Total	**34,871,030**	**389,934**	**367,128**	32,028,544	388,727	365,052

Notes on the Financial Statements (continued)

13 Derivatives *(continued)*

The Bank

	2014			2013		
	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	**13,488,148**	**207,658**	**191,881**	10,677,757	188,003	177,012
– spot, forward and future	**9,053,650**	**102,754**	**96,773**	6,789,558	92,340	90,711
– swaps	**3,350,950**	**95,410**	**85,744**	3,342,242	91,965	83,444
– options purchased	**527,138**	**8,633**	**395**	269,883	2,784	262
– options written	**556,410**	**861**	**8,969**	276,074	914	2,595
Interest rate contracts	**17,746,898**	**163,078**	**160,768**	17,857,951	159,413	155,688
– forward and future	**447,376**	**39**	**74**	387,455	59	38
– swaps	**17,057,069**	**159,652**	**157,661**	17,267,281	156,386	153,203
– options purchased	**79,489**	**1,676**	**84**	65,139	1,359	102
– options written	**71,008**	**71**	**2,140**	85,565	80	1,515
– other	**91,956**	**1,640**	**809**	52,511	1,529	830
Equity derivatives	**1,104,132**	**38,301**	**38,268**	1,251,970	51,010	51,673
Credit derivatives	**261,283**	**1,646**	**1,660**	232,812	1,904	1,906
Commodity and other	**122,921**	**5,525**	**6,121**	131,786	2,629	2,011
Total held for trading	**32,723,382**	**416,208**	**398,698**	30,152,276	402,959	388,290
Trading derivatives managed in conjunction with financial instruments designated at fair value						
Exchange rate contracts	**–**	**–**	**–**	546	4	–
Interest rate contracts	**4,032**	**68**	**–**	5,061	18	30
	4,032	**68**	**–**	5,607	22	30
Cash flow hedging derivatives						
Exchange rate contracts	**40,715**	**4,564**	**585**	45,441	8,448	92
Interest rate contracts	**30,964**	**60**	**19**	8,930	26	24
	71,679	**4,624**	**604**	54,371	8,474	116
Fair value hedging derivatives						
Interest rate contracts	**95,329**	**158**	**525**	75,280	337	868
Gross total derivatives	**32,894,422**	**421,058**	**399,827**	30,287,534	411,792	389,304
Netting	**–**	**(46,182)**	**(46,182)**	–	(34,609)	(34,609)
Total	**32,894,422**	**374,876**	**353,645**	30,287,534	377,183	354,695

b *Hedging derivatives*

The group uses derivatives (principally interest rate and currency swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall costs to the group of accessing debt capital markets, and to 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.

13 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

	2014	2013
	HK$m	HK$m
Gains/(losses):		
On hedging instruments	**(419)**	1,938
On the hedged items attributable to hedged risk	**408**	(1,977)
	(11)	(39)

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and currency swaps that are used to protect against exposures to variability in future interest and principal cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their 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 in other comprehensive income, and accumulated in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Amount transferred to the income statement in respect of cash flow hedges include a loss of HK$99m (2013: HK$239m gain) taken to "Net interest income" and a gain of HK$4,401m (2013: HK$5,381m gain) taken to "Net trading income". The group does not have any qualifying cash flow hedges that involve non-financial assets or non-financial liabilities (2013: none).

The gains and losses on ineffective portions of such derivatives are recognised immediately in "Net trading income". During the year to 31 December 2014, an insignificant amount was recognised due to hedge ineffectiveness and termination of forecast transactions (2013: insignificant amount).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2014 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 2014			
Cash inflows from assets	**38,841**	**72,498**	**48,135**
Cash outflows from liabilities	**(9,043)**	**(19,424)**	**(18,445)**
Net cash inflows	**29,798**	**53,074**	**29,690**
At 31 December 2013			
Cash inflows from assets	21,698	38,271	18,252
Cash outflows from liabilities	(5,813)	(14,957)	(14,680)
Net cash inflows	15,885	23,314	3,572

13 Derivatives *(continued)*

c *Unobservable inception profits*

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

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

The group

	2014	2013
	HK$m	HK$m
Balance at 1 January	**74**	124
Deferrals on new transactions	**331**	211
Reduction due to amortisation	**(103)**	(109)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(194)**	(142)
Exchange differences and others	**(1)**	(10)
Balance at 31 December	**107**	74

The Bank

	2014	2013
	HK$m	HK$m
Balance at 1 January	**69**	110
Deferrals on new transactions	**298**	180
Reduction due to amortisation	**(93)**	(84)
Reduction due to redemption/sale/transfer/improved observability/risk hedged	**(180)**	(133)
Exchange differences and others	**(1)**	(4)
Balance at 31 December	**93**	69

14 Financial assets designated at fair value

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**17,238**	19,871	**1,257**	1,561
Equity shares	**80,957**	70,246	**–**	–
Other	**–**	29	**–**	–
	98,195	90,146	**1,257**	1,561

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

a *Debt securities*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,388**	1,707	**437**	555
– listed outside Hong Kong	**7,485**	4,855	**820**	1,006
	9,873	6,562	**1,257**	1,561
Unlisted	**7,365**	13,309	**–**	–
	17,238	19,871	**1,257**	1,561
Issued by public bodies				
– central governments and central banks	**1,194**	2,160	**–**	555
– other public sector entities	**784**	1,243	**–**	–
	1,978	3,403	**–**	555
Issued by other bodies				
– banks	**6,272**	7,846	**–**	–
– corporate entities	**8,988**	8,622	**1,257**	1,006
	17,238	19,871	**1,257**	1,561

b *Equity shares*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**8,788**	7,723	**–**	–
– listed outside Hong Kong	**37,274**	31,106	**–**	–
	46,062	38,829	**–**	–
Unlisted	**34,895**	31,417	**–**	–
	80,957	70,246	**–**	–
Issued by				
– banks	**3,910**	3,815	**–**	–
– corporate entities	**77,047**	66,431	**–**	–
	80,957	70,246	**–**	–

15 Non-trading reverse repurchase and repurchase agreements

Non-trading reverse repos and repos with customers and banks are set out below:

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Banks	**176,945**	100,591	**103,056**	67,260
Customers	**41,956**	49,993	**13,057**	19,341
	218,901	150,584	**116,113**	86,601
Liabilities				
Banks	**26,751**	5,258	**19,753**	5,258
Customers	**1,628**	1,054	**1,280**	693
	28,379	6,312	**21,033**	5,951

16 Loans and advances to customers

a *Loans and advances to customers*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Gross loans and advances to customers	**2,825,736**	2,628,746	**1,596,583**	1,489,116
Impairment allowances (note 17(a))	**(10,520)**	(9,501)	**(5,872)**	(5,206)
	2,815,216	2,619,245	**1,590,711**	1,483,910

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

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

The group

2014	**Hong Kong HK$m**	**Rest of Asia-Pacific HK$m**	**Total HK$m**
Residential mortgages[1]	**439,451**	**283,042**	**722,493**
Credit card advances	**54,943**	**24,863**	**79,806**
Other personal	**122,613**	**79,670**	**202,283**
Total personal	**617,007**	**387,575**	**1,004,582**
Commercial, industrial and international trade	**416,759**	**440,967**	**857,726**
Commercial real estate	**201,103**	**75,631**	**276,734**
Other property-related lending	**203,850**	**62,810**	**266,660**
Government	**6,613**	**2,654**	**9,267**
Other commercial	**150,314**	**151,930**	**302,244**
Total corporate and commercial	**978,639**	**733,992**	**1,712,631**
Non-bank financial institutions	**61,264**	**42,747**	**104,011**
Settlement accounts	**3,887**	**625**	**4,512**
Total financial	**65,151**	**43,372**	**108,523**
Gross loans and advances to customers	**1,660,797**	**1,164,939**	**2,825,736**
Individually assessed impairment allowances	**(2,411)**	**(3,888)**	**(6,299)**
Collectively assessed impairment allowances	**(2,103)**	**(2,118)**	**(4,221)**
Net loans and advances to customers	**1,656,283**	**1,158,933**	**2,815,216**
2013			
Residential mortgages[1]	416,857	296,860	713,717
Credit card advances	49,843	29,824	79,667
Other personal	103,593	68,558	172,151
Total personal	570,293	395,242	965,535
Commercial, industrial and international trade	423,536	432,984	856,520
Commercial real estate	196,621	71,348	267,969
Other property-related lending	151,554	58,937	210,491
Government	5,728	2,190	7,918
Other commercial	112,939	131,788	244,727
Total corporate and commercial	890,378	697,247	1,587,625
Non-bank financial institutions	41,578	31,460	73,038
Settlement accounts	1,989	559	2,548
Total financial	43,567	32,019	75,586
Gross loans and advances to customers	1,504,238	1,124,508	2,628,746
Individually assessed impairment allowances	(1,349)	(3,658)	(5,007)
Collectively assessed impairment allowances	(2,131)	(2,363)	(4,494)
Net loans and advances to customers	1,500,758	1,118,487	2,619,245

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$26,671m (2013: HK$25,040m).*

16 Loans and advances to customers *(continued)*

The Bank

2014	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
Residential mortgages[1]	**269,301**	**105,145**	**374,446**
Credit card advances	**30,662**	**10,439**	**41,101**
Other personal	**98,265**	**49,079**	**147,344**
Total personal	**398,228**	**164,663**	**562,891**
Commercial, industrial and international trade	**285,161**	**198,976**	**484,137**
Commercial real estate	**128,110**	**28,394**	**156,504**
Other property-related lending	**83,835**	**29,907**	**113,742**
Government	**6,209**	**1,948**	**8,157**
Other commercial	**113,182**	**85,763**	**198,945**
Total corporate and commercial	**616,497**	**344,988**	**961,485**
Non-bank financial institutions	**54,211**	**17,747**	**71,958**
Settlement accounts	**–**	**249**	**249**
Total financial	**54,211**	**17,996**	**72,207**
Gross loans and advances to customers	**1,068,936**	**527,647**	**1,596,583**
Individually assessed impairment allowances	**(1,896)**	**(1,577)**	**(3,473)**
Collectively assessed impairment allowances	**(1,383)**	**(1,016)**	**(2,399)**
Net loans and advances to customers	**1,065,657**	**525,054**	**1,590,711**
2013			
Residential mortgages[1]	254,465	113,548	368,013
Credit card advances	28,343	11,446	39,789
Other personal	82,949	48,393	131,342
Total personal	365,757	173,387	539,144
Commercial, industrial and international trade	298,895	195,114	494,009
Commercial real estate	130,123	29,710	159,833
Other property-related lending	64,171	23,652	87,823
Government	5,462	1,460	6,922
Other commercial	81,482	68,743	150,225
Total corporate and commercial	580,133	318,679	898,812
Non-bank financial institutions	35,730	15,181	50,911
Settlement accounts	–	249	249
Total financial	35,730	15,430	51,160
Gross loans and advances to customers	981,620	507,496	1,489,116
Individually assessed impairment allowances	(808)	(1,774)	(2,582)
Collectively assessed impairment allowances	(1,521)	(1,103)	(2,624)
Net loans and advances to customers	979,291	504,619	1,483,910

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

1 *Residential mortgages include Hong Kong Government Home Ownership Scheme loans of HK$10,961m (2013: HK$10,588m).*

Notes on the Financial Statements (continued)

16 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

	2014			2013		
	Present value of the minimum lease payments HK$m	**Unearned future finance income HK$m**	**Total minimum lease payments HK$m**	Present value of the minimum lease payments HK$m	Unearned future finance income HK$m	Total minimum lease payments HK$m
Amounts receivable						
– Within one year	**2,756**	**689**	**3,445**	2,982	697	3,679
– After one year but within five years	**8,743**	**2,012**	**10,755**	9,184	2,107	11,291
– After five years	**16,663**	**2,545**	**19,208**	14,893	2,236	17,129
	28,162	**5,246**	**33,408**	27,059	5,040	32,099
Impairment allowances	**(43)**			(39)		
Net investment in finance leases and hire purchase contracts	**28,119**			27,020		

The Bank

	2014			2013		
	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	**1,578**	**369**	**1,947**	1,643	344	1,987
– After one year but within five years	**4,347**	**1,145**	**5,492**	4,218	1,042	5,260
– After five years	**12,673**	**2,102**	**14,775**	11,700	1,878	13,578
	18,598	**3,616**	**22,214**	17,561	3,264	20,825
Impairment allowances	**(7)**			(6)		
Net investment in finance leases and hire purchase contracts	**18,591**			17,555		

17 Impairment allowances against loans and advances to customers

a *Impairment allowances against loans and advances to customers*

The group

2014	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**5,007**	**4,494**	**9,501**
Amounts written off	**(1,366)**	**(3,356)**	**(4,722)**
Recoveries of loans and advances written off in previous years	**156**	**1,029**	**1,185**
Net charge to income statement (note 4(j))	**2,626**	**2,272**	**4,898**
Unwinding of discount of loan impairment	**(136)**	**(79)**	**(215)**
Exchange and other adjustments	**12**	**(139)**	**(127)**
At 31 December (note 16(a))	**6,299**	**4,221**	**10,520**
2013			
At 1 January	5,245	4,526	9,771
Amounts written off	(856)	(3,495)	(4,351)
Recoveries of loans and advances written off in previous years	198	1,089	1,287
Net charge to income statement (note 4(j))	809	2,602	3,411
Unwinding of discount of loan impairment	(51)	(77)	(128)
Exchange and other adjustments	(338)	(151)	(489)
At 31 December (note 16(a))	5,007	4,494	9,501

The Bank

2014	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**2,582**	**2,624**	**5,206**
Amounts written off	**(365)**	**(1,746)**	**(2,111)**
Recoveries of loans and advances written off in previous years	**39**	**458**	**497**
Net charge to income statement	**1,268**	**1,141**	**2,409**
Unwinding of discount of loan impairment	**(97)**	**(44)**	**(141)**
Exchange and other adjustments	**46**	**(34)**	**12**
At 31 December (note 16(a))	**3,473**	**2,399**	**5,872**
2013			
At 1 January	2,897	2,652	5,549
Amounts written off	(454)	(1,664)	(2,118)
Recoveries of loans and advances written off in previous years	67	479	546
Net charge to income statement	357	1,225	1,582
Unwinding of discount of loan impairment	(37)	(35)	(72)
Exchange and other adjustments	(248)	(33)	(281)
At 31 December (note 16(a))	2,582	2,624	5,206

Notes on the Financial Statements (continued)

17 Impairment allowances against loans and advances to customers *(continued)*

b *Impairment allowances on loans and advances to customers*

Impaired loans and advances to customers are those loans and advances where objective evidence exists that full repayment of principal or interest is considered unlikely. Individually assessed allowances are made after taking into account the value of collateral in respect of such loans and advances.

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

The group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2014			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**5,297**	**9,218**	**14,515**
Collectively assessed	**1,655,500**	**1,155,721**	**2,811,221**
– Impaired loans and advances	**602**	**770**	**1,372**
– Non-impaired loans and advances	**1,654,898**	**1,154,951**	**2,809,849**
Total gross loans and advances to customers	**1,660,797**	**1,164,939**	**2,825,736**
Impairment allowances	**(4,514)**	**(6,006)**	**(10,520)**
– Individually assessed	**(2,411)**	**(3,888)**	**(6,299)**
– Collectively assessed	**(2,103)**	**(2,118)**	**(4,221)**
Net loans and advances	**1,656,283**	**1,158,933**	**2,815,216**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**1,767**	**3,373**	**5,140**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.3%**	**0.8%**	**0.5%**
Total allowances as a percentage of total gross loans and advances	**0.3%**	**0.5%**	**0.4%**
At 31 December 2013			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	2,928	8,867	11,795
Collectively assessed	1,501,310	1,115,641	2,616,951
– Impaired loans and advances	524	816	1,340
– Non-impaired loans and advances	1,500,786	1,114,825	2,615,611
Total gross loans and advances to customers	1,504,238	1,124,508	2,628,746
Impairment allowances	(3,480)	(6,021)	(9,501)
– Individually assessed	(1,349)	(3,658)	(5,007)
– Collectively assessed	(2,131)	(2,363)	(4,494)
Net loans and advances	1,500,758	1,118,487	2,619,245
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,433	3,619	5,052
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.2%	0.8%	0.4%
Total allowances as a percentage of total gross loans and advances	0.2%	0.5%	0.4%

17 Impairment allowances against loans and advances to customers *(continued)*

The Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2014			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	**4,158**	**4,281**	**8,439**
Collectively assessed	**1,064,778**	**523,366**	**1,588,144**
– Impaired loans and advances	**450**	**290**	**740**
– Non-impaired loans and advances	**1,064,328**	**523,076**	**1,587,404**
Total gross loans and advances to customers	**1,068,936**	**527,647**	**1,596,583**
Impairment allowances	**(3,279)**	**(2,593)**	**(5,872)**
– Individually assessed	**(1,896)**	**(1,577)**	**(3,473)**
– Collectively assessed	**(1,383)**	**(1,016)**	**(2,399)**
Net loans and advances	**1,065,657**	**525,054**	**1,590,711**
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	**1,202**	**1,214**	**2,416**
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	**0.4%**	**0.8%**	**0.5%**
Total allowances as a percentage of total gross loans and advances	**0.3%**	**0.5%**	**0.4%**
At 31 December 2013			
Gross loans and advances to customers			
Individually assessed impaired gross loans and advances	1,965	4,468	6,433
Collectively assessed	979,655	503,028	1,482,683
– Impaired loans and advances	370	315	685
– Non-impaired loans and advances	979,285	502,713	1,481,998
Total gross loans and advances to customers	981,620	507,496	1,489,116
Impairment allowances	(2,329)	(2,877)	(5,206)
– Individually assessed	(808)	(1,774)	(2,582)
– Collectively assessed	(1,521)	(1,103)	(2,624)
Net loans and advances	979,291	504,619	1,438,910
Fair value of collateral which has been taken into account in respect of individually assessed impaired loans and advances to customers	1,058	1,093	2,151
Individually assessed impaired gross loans and advances as a percentage of gross loans and advances to customers	0.2%	0.9%	0.4%
Total allowances as a percentage of total gross loans and advances	0.2%	0.6%	0.3%

Notes on the Financial Statements (continued)

17 Impairment allowances against loans and advances to customers *(continued)*

For individually assessed customer loans and advances where the industry sector comprises not less than 10% of the group's total gross loans and advances to customers, the analysis of gross impaired loans and advances and allowances by major industry sectors based on categories and definitions used by the HSBC Group is as follows:

The group

	Total gross loans and advances HK$m	Gross impaired advances HK$m	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Net new impairment allowances HK$m	Advances written-off in year HK$m
At 31 December 2014						
Residential mortgages	**722,493**	**2,030**	**(288)**	**(70)**	**70**	**131**
Commercial, industrial and international trade	**857,726**	**6,951**	**(3,820)**	**(2,182)**	**1,583**	**664**
Other commercial	**302,244**	**3,756**	**(1,470)**	**(211)**	**800**	**57**
At 31 December 2013						
Residential mortgages	713,717	2,121	(363)	(77)	(12)	58
Commercial, industrial and international trade	856,520	6,264	(3,194)	(2,050)	1,061	567
Other commercial	244,727	1,345	(522)	(372)	182	125

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 2014						
Residential mortgages	**374,446**	**613**	**(60)**	**(21)**	**17**	**54**
Commercial, industrial and international trade	**484,137**	**3,643**	**(1,839)**	**(1,299)**	**350**	**189**
Other commercial	**198,945**	**3,006**	**(1,108)**	**(144)**	**648**	**43**
At 31 December 2013						
Residential mortgages	368,013	607	(98)	(22)	6	10
Commercial, industrial and international trade	494,009	3,757	(1,814)	(1,267)	622	327
Other commercial	150,225	980	(351)	(262)	86	85

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.

17 Impairment allowances against loans and advances to customers *(continued)*

c *Overdue and rescheduled loans and advances to customers*

The group

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
At 31 December 2014						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	**624**	**0.0**	**2,023**	**0.2**	**2,647**	**0.1**
– more than six months but less than one year	**452**	**0.0**	**764**	**0.1**	**1,216**	**0.0**
– more than one year	**2,024**	**0.1**	**2,185**	**0.2**	**4,209**	**0.2**
	3,100	**0.1**	**4,972**	**0.5**	**8,072**	**0.3**
Individually assessed impairment allowances made in respect of amounts overdue	**(1,235)**		**(2,265)**		**(3,500)**	
Fair value of collateral held in respect of amounts overdue	**1,144**		**1,805**		**2,949**	
Rescheduled loans and advances to customers	**431**	**0.0**	**2,298**	**0.2**	**2,729**	**0.1**
At 31 December 2013						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	402	0.0	1,836	0.2	2,238	0.1
– more than six months but less than one year	223	0.0	1,300	0.1	1,523	0.1
– more than one year	1,956	0.1	2,449	0.2	4,405	0.2
	2,581	0.1	5,585	0.5	8,166	0.4
Individually assessed impairment allowances made in respect of amounts overdue	(1,132)		(2,698)		(3,830)	
Fair value of collateral held in respect of amounts overdue	914		2,429		3,343	
Rescheduled loans and advances to customers	464	0.0	1,928	0.2	2,392	0.1

Notes on the Financial Statements (continued)

17 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 2014						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	**372**	**0.0**	**436**	**0.1**	**808**	**0.0**
– more than six months but less than one year	**363**	**0.0**	**265**	**0.1**	**628**	**0.0**
– more than one year	**1,491**	**0.1**	**1,088**	**0.2**	**2,579**	**0.2**
	2,226	**0.1**	**1,789**	**0.4**	**4,015**	**0.2**
Individually assessed impairment allowances made in respect of amounts overdue	**(795)**		**(774)**		**(1,569)**	
Fair value of collateral held in respect of amounts overdue	**810**		**369**		**1,179**	
Rescheduled loans and advances to customers	**341**	**0.0**	**1,216**	**0.1**	**1,557**	**0.1**
At 31 December 2013						
Gross amounts which have been overdue with respect to either principal or interest for:						
– more than three months but less than six months	297	0.0	602	0.1	899	0.1
– more than six months but less than one year	176	0.0	430	0.1	606	0.0
– more than one year	1,433	0.1	968	0.2	2,401	0.2
	1,906	0.1	2,000	0.4	3,906	0.3
Individually assessed impairment allowances made in respect of amounts overdue	(671)		(966)		(1,637)	
Fair value of collateral held in respect of amounts overdue	742		512		1,254	
Rescheduled loans and advances to customers	340	0.0	647	0.1	987	0.1

Rescheduled loans and advances to customers are those loans and advances which have been restructured or renegotiated because of deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule. Rescheduled loans and advances to customers are stated net of any loans and advances which have subsequently become overdue for more than three months and which are included in the overdue amounts shown above.

18 Impairment and rescheduled amounts relating to placings with and advances to banks and other assets

There were no significant impaired or rescheduled placings with and advances to banks nor overdue or rescheduled other assets as at 31 December 2014 and 31 December 2013. Information relating to overdue balances can be found in Risk Report.

19 Financial investments

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Treasury and other eligible bills				
– available-for-sale	**544,536**	525,698	**410,012**	425,711
Debt securities, excluding certificates of deposit				
– held-to-maturity	**169,277**	167,242	**–**	–
– available-for-sale	**595,378**	563,828	**304,925**	319,849
Certificates of deposit				
– held-to-maturity	**13,349**	12,223	**–**	–
– available-for-sale	**84,822**	75,984	**3,041**	10,012
Equity shares				
– available-for-sale	**49,131**	34,796	**4,005**	3,011
	1,456,493	1,379,771	**721,983**	758,583
Financial investments				
– which may be repledged or resold by counterparties	**2,091**	1,641	**1,585**	1,545
– not subject to repledge or resale by counterparties	**1,454,402**	1,378,130	**720,398**	757,038
	1,456,493	1,379,771	**721,983**	758,583

Treasury and other eligible bills are largely unlisted.

a *Held-to-maturity debt securities, including certificates of deposit*

The group

	Book value		Fair value	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**7,961**	4,715	**8,348**	4,850
– listed outside Hong Kong	**38,870**	43,172	**41,755**	43,848
	46,831	47,887	**50,103**	48,698
Unlisted	**135,795**	131,578	**140,632**	131,417
	182,626	179,465	**190,735**	180,115
Issued by public bodies				
– central governments and central banks	**5,336**	4,653	**6,039**	4,753
– other public sector entities	**17,115**	21,917	**18,067**	22,714
	22,451	26,570	**24,106**	27,467
Issued by				
– banks	**77,303**	71,770	**80,468**	72,827
– corporate entities	**82,872**	81,125	**86,161**	79,821
	182,626	179,465	**190,735**	180,115

During 2014, certain exchanges have been regarded as recognised exchanges, causing more securities to be classified as listed.

Notes on the Financial Statements (continued)

19 Financial Investments *(continued)*

b *Available-for-sale debt securities, including certificates of deposit*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**20,774**	16,779	**5,750**	4,791
– listed outside Hong Kong	**428,835**	215,434	**235,596**	171,915
	449,609	232,213	**241,346**	176,706
Unlisted	**230,591**	407,599	**66,620**	153,155
	680,200	639,812	**307,966**	329,861
Issued by public bodies				
– central governments and central banks	**463,659**	415,728	**209,827**	215,121
– other public sector entities	**58,388**	71,762	**40,635**	47,721
	522,047	487,490	**250,462**	262,842
Issued by				
– banks	**108,692**	117,705	**51,826**	57,965
– corporate entities	**49,461**	34,617	**5,678**	9,054
	680,200	639,812	**307,966**	329,861

During 2014, certain exchanges have been regarded as recognised exchanges, causing more securities to be classified as listed.

c *Available-for-sale equity shares*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**360**	446	**–**	–
– listed outside Hong Kong	**42,736**	26,959	**–**	59
	43,096	27,405	**–**	59
Unlisted	**6,035**	7,391	**4,005**	2,952
	49,131	34,796	**4,005**	3,011
Issued by				
– banks	**44,167**	27,528	**610**	17
– corporate entities	**4,964**	7,268	**3,395**	2,994
	49,131	34,796	**4,005**	3,011

20 Assets transferred, assets charged as security for liabilities, and collateral accepted as security for assets

Transferred financial assets not qualifying for derecognition or full derecognition and associated financial liabilities

The group

	2014		2013	
	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	**18,194**	**18,100**	10,287	11,146
Securities lending agreements	**5,165**	**34**	3,431	2,088
	23,359	**18,134**	13,718	13,234

The Bank

	2014		2013	
	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	**14,625**	**14,689**	10,986	11,786
Securities lending agreements	**4,659**	**34**	3,335	2,088
	19,284	**14,723**	14,321	13,874

Financial assets pledged to secure liabilities

	The group		The Bank	
	2014 HK$m	2013 HK$m	**2014 HK$m**	2013 HK$m
Assets pledged to secure liabilities				
Financial assets[1] pledged to secure liabilities	**119,845**	106,077	**86,729**	79,490
Collateral accepted as security for assets				
Fair value of the collateral permitted to sell or repledge in the absence of default[2]	**320,998**	224,360	**263,491**	200,803
Fair value of collateral actually sold or repledged	**68,146**	35,486	**37,483**	37,725

1 *Financial assets comprise treasury bills, debt securities, equities and deposits.*

2 *These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.*

The table above shows assets where a charge has been granted to secure liabilities on a legal and contractual basis.

These transactions are conducted under terms that are usual and customary to collateralised transactions including, where relevant, standard securities lending and repurchase agreements.

The financial assets shown above include amounts transferred that do not qualify for derecognition, notably debt securities held by counterparties as collateral under repurchase agreements and equity securities lent under securities lending agreements. As the substance of these transactions is secured borrowings, the asset collateral continues to be recognised in full and the related liability reflecting the Group's obligation to repurchase the transferred assets for a fixed price at a future date is recognised on the balance sheet. As a result of these transactions, the Group is unable to use, sell or pledge the transferred assets for the duration of the transaction. The Group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

Notes on the Financial Statements (continued)

21 Investments in subsidiaries

	The Bank	
	2014	2013
	HK$m	HK$m
Investments in subsidiaries:		
Unlisted investments	**63,004**	62,407
Listed investment	**7,845**	865
	70,849	63,272

The principal subsidiaries of the Bank are:

	Place of incorporation	**Principal activity**	**Class of share / registered or charter capital**	**The group's interest in issued share capital / registered or charter capital**
Hang Seng Bank Limited	Hong Kong	Banking	Ordinary	62.14%
HSBC Bank (China) Company Limited	PRC[1]	Banking	Registered Capital	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	Ordinary	100%
HSBC Bank Australia Limited[2]	Australia	Banking	Ordinary	100%
HSBC Bank (Taiwan) Limited[2]	Taiwan	Banking	Ordinary	100%
HSBC Insurance (Asia) Limited[2]	Hong Kong	Insurance	Ordinary	100%
HSBC Life (International) Limited[2]	Bermuda	Retirement benefits and life insurance	Ordinary	100%
HSBC Bank (Vietnam) Ltd.	Vietnam	Banking	Charter Capital	100%

1 *People's Republic of China*
2 *Held indirectly*

All the above subsidiaries are included in the group's consolidated financial statements. All these subsidiaries make their financial statements up to 31 December.

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

The proportion of voting rights held is the same as the proportion of ownership interest held.

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

During the year, the Bank extended a perpetual subordinated loan to a subsidiary which is recognised as an equity investment for accounting purposes.

Subsidiary with material non-controlling interest

	2014	2013
Hang Seng Bank Limited		
Ownership interest and voting rights held by non-controlling interests	**37.86%**	37.86%
	HK$m	HK$m
Profit attributable to non-controlling interests	**5,730**	10,100
Accumulated non-controlling interests of the subsidiary	**50,057**	40,807
Dividends paid to non-controlling interests	**3,981**	3,836
Summarised financial information (before intra-group eliminations):		
– Assets	**1,263,990**	1,143,730
– Liabilities	**1,124,797**	1,035,952
– Net operating income before loan impairment	**28,570**	37,589
– Profit for the year	**15,131**	26,678
– Other comprehensive income	**19,804**	(1,120)
– Total comprehensive income	**34,935**	25,558

22 Interests in associates and joint ventures

	The group 2014 HK$m	2013 HK$m
Share of net assets	**112,283**	103,435
Goodwill	**4,236**	4,720
Intangible assets	**194**	688
Deferred tax on intangible assets	**(48)**	(172)
Impairment	**(11)**	(819)
	116,654	107,852

At 31 December 2014, the group's interests in associates amounted to HK$116,134m (2013: HK$107,384m).

	The Bank 2014 HK$m	2013 HK$m
Listed investments	**39,824**	39,824
Unlisted investments	**6**	586
	39,830	40,410

Associate

(i) Principal associate

	Place of incorporation	Principal activity	Class of share	The group's interest in issued share capital
Bank of Communications Co., Ltd.	People's Republic of China	Banking	Ordinary	19.03%

Bank of Communications Co., Ltd. is listed on recognised stock exchanges. The fair value represents valuation based on quoted market price of the shares held (Level 1 in the fair value hierarchy) and amounted to HK$101,918m at 31 December 2014 (2013: HK$77,181m).

Bank of Communications Co., Limited ('BoCom')

The group's investment in BoCom was equity accounted with effect from August 2004. The group's significant influence in BoCom was established as a result of representation on the Board of Directors and, in accordance with the Technical Cooperation and Exchange Programme, the group is assisting in the maintenance of financial and operating policies and a number of staff has been seconded to assist in this process.

Impairment testing

At 31 December 2014, the fair value of the group's investment in BoCom had been below the carrying amount for approximately 32 months, apart from a short period in 2013. As a result, the group performed an impairment test on the carrying amount of the investment in BoCom. The test confirmed that there was no impairment at 31 December 2014. The recoverable amount was HK$121.7bn (2013: HK$108.9bn), an excess of HK$7.9bn over the carrying amount ('headroom') at 31 December 2014 (2013: HK$4.3bn). The increase in headroom is due to the improved capital position of BoCom.

	At 31 December 2014			At 31 December 2013		
	VIU HK$bn	**Carrying amount HK$bn**	**Fair value HK$bn**	VIU HK$bn	Carrying amount HK$bn	Fair value HK$bn
Bank of Communications Co., Limited	**121.7**	**113.8**	**101.9**	108.9	104.6	77.2

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

Basis of recoverable amount

The impairment test was performed by comparing the recoverable amount of BoCom, determined by a value in use ('VIU') calculation, with its carrying amount. The VIU calculation used discounted cash flow projections based on management's estimates of earnings. Cash flows beyond the short to medium-term were then extrapolated in perpetuity using a long-term growth rate. An imputed capital maintenance charge ('CMC') is calculated to reflect expected regulatory capital requirements, and is deducted from forecast cash flows. The principal inputs to the CMC calculation include estimates of asset growth, the ratio of risk-weighted assets to total assets, and the expected regulatory capital requirements. Management judgement is required in estimating the future cash flows of BoCom.

Key assumptions in VIU calculation

Long-term growth rate: the growth rate is 5% (2013: 5%) for periods after 2018 and does not exceed forecast GDP growth in China.

Discount rate: the discount rate of 13% (2013: 13%) is derived from a range of values obtained by applying a Capital Asset Pricing Model ('CAPM') calculation for BoCom, using market data. Management supplements this by comparing the rates derived from the CAPM with discount rates available from external sources, and the group's discount rate for evaluating investments in mainland China. The discount rate used is within the range of 11.4% to 14.2% (2013: 10.5% to 15.0%) indicated by the CAPM and external sources.

Loan impairment charge as a percentage of customer advances: the ratio used ranges from 0.73% to 1% (2013: 0.64% to 1%) in the short to medium-term. The long-term ratio is assumed to revert to a historical rate of 0.65% (2013: 0.64%). The rates are within the short to medium-term range forecasts of 0.51% and 1.08% (2013: 0.55% and 1.20%) disclosed by external analysts.

Risk-weighted assets as a percentage of total assets: the ratio used ranges from 70% to 72% in the short to medium-term. The long-term ratio reverts to a rate of 70% (2013: 68.7%).

Cost-income ratio: the ratio used ranges from 40.0% to 42.4% (2013: 39.7% to 43.2%) in the short to medium-term. The ratios were within the short to medium-term range forecasts of 37.2% to 44.5% (2013: 38.0% to 44.2%) disclosed by external analysts.

Sensitivity analyses were performed on each key assumption to ascertain the impact of reasonably possible changes in assumptions. The following change to each key assumption used on its own in the VIU calculation would reduce the headroom to nil.

Key assumption	Changes to key assumption to reduce headroom to nil
• Long-term growth rate	• Decrease by 43 basis points
• Discount rate	• Increase by 53 basis points
• Loan impairment charge as a percentage of customer advances	• Increase by 8 basis points
• Risk-weighted assets as a percentage of total assets	• Increase by 3.3%
• Cost-income ratio	• Increase by 1.6%

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

The following table further illustrates the impact on VIU of reasonably possible changes to key assumptions. This reflects the sensitivity of VIU to each key assumption on its own and it is possible that more than one favourable and/or unfavourable change may occur at the same time.

As at 31 December 2014

HK$bn Carrying amount: 113.8	**Favourable change**		**Current model**	**Unfavourable change**	
Long-term growth rate	**+50bp**	**+100bp**	**5.00%**	**-50bp**	**-100bp**
VIU	**132.0**	**143.9**	**121.7**	**112.5**	**104.3**
Increase/(decrease) in VIU	**10.3**	**22.2**		**(9.2)**	**(17.4)**
Discount rate	**-50bp**	**-100bp**	**13.00%**	**+50bp**	**+100bp**
VIU	**130.2**	**140.1**	**121.7**	**114.2**	**107.6**
Increase/(decrease) in VIU	**8.5**	**18.4**		**(7.5)**	**(14.1)**
Loan impairment charge as a percentage of customer advances	**0.65% throughout**		**2014 – 2018: 0.73% to 1.00% 2019 onwards: 0.65%**	**1.00% from 2014 to 2018 2019 onwards: 0.65%**	
VIU	**125.5**		**121.7**	**115.8**	
Increase/(decrease) in VIU	**3.8**			**(5.9)**	
Risk-weighted assets as a percentage of total assets	**-100bp**	**-200bp**	**2014 – 2018: 70% to 72% 2019 onwards: 70%**	**+100bp**	**+200bp**
VIU	**123.9**	**126.4**	**121.7**	**119.2**	**116.8**
Increase/(decrease) in VIU	**2.2**	**4.7**		**(2.5)**	**(4.9)**
Cost-income ratio	**-50bp**	**-100bp**	**2014 – 2018: 40.0% to 42.4% 2019 onwards: 42.4%**	**+50bp**	**+100bp**
VIU	**124.1**	**126.7**	**121.7**	**119.2**	**116.8**
Increase/(decrease) in VIU	**2.4**	**5.0**		**(2.5)**	**(4.9)**

As at 31 December 2013

HK$bn Carrying amount: 104.6	Favourable change		Current model	Unfavourable change	
Long-term growth rate	+50bp	+100bp	5.00%	-50bp	-100bp
VIU	119.3	131.3	108.9	99.7	91.5
Increase/(decrease) in VIU	10.4	22.4		(9.2)	(17.4)
Discount rate	-50bp	-100bp	13.00%	+50bp	+100bp
VIU	120.7	134.4	108.9	98.7	89.8
Increase/(decrease) in VIU	11.8	25.5		(10.2)	(19.1)
Loan impairment charge as a percentage of customer advances	0.64% throughout		2013 – 2018: 0.64% to 1.00% 2019 onwards: 0.64%	1.00% from 2014 to 2018 2019 onwards: 0.64%	
VIU	114.5		108.9	103.9	
Increase/(decrease) in VIU	5.6			(5.0)	
Risk-weighted assets as a percentage of total assets	-100bp	-200bp	68.7% throughout	+100bp	+200bp
VIU	111.4	114.0	108.9	106.2	103.6
Increase/(decrease) in VIU	2.5	5.1		(2.7)	(5.3)
Cost-income ratio	-50bp	-100bp	2013 – 2018: 39.7% to 43.2% 2019 onwards: 43.2%	+50bp	+100bp
VIU	111.2	113.8	108.9	106.4	103.9
Increase/(decrease) in VIU	2.3	4.9		(2.5)	(5.0)

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

Selected financial information of BoCom

The statutory accounting reference date of BoCom is 31 December. For the year ended 31 December 2014, the group included the associate's results on the basis of financial statements made up for the 12 months to 30 September 2014, but taking into account the financial effect of significant transactions or events in the period from 1 October 2014 to 31 December 2014.

	At 30 September 2014 HK$m	At 30 September 2013 HK$m
Selected balance sheet information of BoCom		
Cash and balances at central banks	**1,165,846**	1,102,661
Loans and advances to banks and other financial institutions	**620,206**	682,714
Loans and advances to customers	**4,248,285**	4,002,207
Other financial assets	**1,387,509**	1,283,423
Other assets	**353,438**	270,034
Total assets	**7,775,284**	7,341,039
Deposits by banks and other financial institutions	**1,628,358**	1,325,248
Customer accounts	**5,148,337**	5,176,342
Other financial liabilities	**223,852**	159,446
Other liabilities	**196,712**	152,405
Total liabilities	**7,197,259**	6,813,441
Total equity	**578,025**	527,598
Total equity attributable to:		
– shareholders	**575,424**	525,195
– non-controlling interests	**2,601**	2,403
Reconciliation of BoCom's net assets to carrying amount in the group's consolidated financial statements		
The group's share of net assets	**109,529**	99,969
Add: Goodwill	**4,122**	4,191
Add: Intangible assets	**145**	476
Carrying amount	**113,796**	104,636

	For the 12 months ended 30 September	
	2014 HK$m	2013 HK$m
Selected income statement information of BoCom		
Net interest income	**170,833**	161,092
Net fee and commission income	**37,157**	31,101
Loan impairment charges	**(27,209)**	(21,807)
Depreciation and amortisation	**(7,136)**	(6,277)
Tax expense	**(24,055)**	(21,895)
Profit for the year	**82,405**	78,541
Other comprehensive income/ (loss)	**1,681**	(2,909)
Total comprehensive income	**84,086**	75,632
Dividends received from BoCom	**4,629**	4,264

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

(ii) Other associates

Summarised aggregate financial information in respect of associates not individually material

	2014 HK$m	2013 HK$m
Carrying value	**2,338**	2,748
The group's share of:		
– Assets	**2,704**	13,524
– Liabilities	**366**	11,229
– Profit or loss from continuing operations	**311**	659
– Other comprehensive income	**–**	9
– Total comprehensive income	**311**	668
Other expense related to investment in an associate:		
– Impairment of an associate	**11**	819

At 31 December 2014, the group's share of associates' contingent liabilities incurred relating to the group's interest in associates was HK$359,524m (2013: HK$361,129m).

The group's investment in Vietnam Technological & Commercial Joint Stock Bank ('TechCom Bank') was equity-accounted since October 2007 due to the group's representation on the Board of Directors and involvement in the Technical Support and Assistance Agreement. The terms of the group's nominated directors expired in April 2014 and the Technical Support and Assistance Agreement expired at the end of June 2014. As a result of these and other factors, the group considers that it is no longer in a position to exercise significant influence over TechCom Bank and ceased to account for the investment as an associate from the end of June 2014. Thereafter, the holding in TechCom Bank of 19.41% is classified as an available-for-sale financial investment. The loss arising from this reclassification was HK$251m.

Notes on the Financial Statements (continued)

23 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	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**6,379**	6,362	**1,152**	1,181
Present value of in-force long-term insurance business	**32,389**	28,916	**–**	–
Other intangible assets	**6,310**	6,604	**3,155**	3,349
	45,078	41,882	**4,307**	4,530

a *Goodwill*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Cost at 1 January	**6,362**	7,237	**1,181**	1,180
Exchange and other movements	**17**	(875)	**(29)**	1
Net book value at 31 December	**6,379**	6,362	**1,152**	1,181

Segmental analysis of goodwill

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Commercial Banking	**24**	24	**24**	24
Hong Kong – Global Banking and Markets	**750**	750	**498**	498
Hong Kong – Private Banking	**82**	82	**82**	82
Rest of Asia-Pacific – Retail Banking and Wealth Management	**1,302**	1,180	**76**	80
Rest of Asia-Pacific – Commercial Banking	**3,337**	3,408	**–**	–
Rest of Asia-Pacific – Global Banking and Markets	**884**	918	**472**	497
Total goodwill in the CGUs listed	**6,379**	6,362	**1,152**	1,181

23 Goodwill and intangible assets *(continued)*

During 2014 there was no impairment of goodwill (2013: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs'), determined at 1 July 2014 based on a value in use calculation, with the carrying amount of the CGUs. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current Gross Domestic Product for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of business units making up the CGUs. The discount rate used is based on the cost of capital HSBC allocates to investments in the countries in which the CGU operates.

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

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the nominal long-term growth rate. The discount rates used in the impairment test in 2014 were in the range of 11% to 14% across different CGUs. The nominal long-term growth rates used in the impairment test in 2014 for Hong Kong and Rest of Asia-Pacific were 6.7% and 7.9% respectively.

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:

	2014	2013
Risk free rate	**1.86%**	2.31%
Risk discount rate	**7.42%**	7.41%
Expenses inflation	**3.00%**	3.00%

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

	The group	
	2014	2013
	HK$m	HK$m
At 1 January	**28,916**	24,425
Value of new business written during the year	**5,317**	5,075
Movements arising from in-force business:		
– expected return	**(1,781)**	(1,358)
– experience variances	**(60)**	(33)
– changes in operating assumptions	**(731)**	1,499
Investment return variances	**(88)**	(75)
Changes in investment assumptions	**891**	(387)
Other adjustments	**33**	14
Changes in PVIF	**3,581**	4,735
Exchange differences and other	**(108)**	(244)
At 31 December	**32,389**	28,916

23 Goodwill and intangible assets *(continued)*

c *Other intangible assets*

The group

	2014			
	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other[1] HK$m**	**Total HK$m**
Cost				
At 1 January	**12,645**	**1,606**	**2,288**	**16,539**
Additions	**1,546**	**–**	**–**	**1,546**
Disposals/amounts written-off	**(161)**	**–**	**(63)**	**(224)**
Exchange and other movements	**(66)**	**(91)**	**(122)**	**(279)**
At 31 December	**13,964**	**1,515**	**2,103**	**17,582**
Accumulated amortisation and impairment				
At 1 January	**8,818**	**1,033**	**84**	**9,935**
Amortisation charge for the year	**1,483**	**120**	**11**	**1,614**
Impairment	**36**	**–**	**21**	**57**
Disposals/amounts written-off	**(156)**	**–**	**(63)**	**(219)**
Exchange and other movements	**(50)**	**(65)**	**–**	**(115)**
At 31 December	**10,131**	**1,088**	**53**	**11,272**
Net book value at 31 December	**3,833**	**427**	**2,050**	**6,310**

	2013			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost				
At 1 January	11,521	1,842	2,367	15,730
Additions	1,502	–	–	1,502
Disposals/amounts written-off	(295)	–	(13)	(308)
Exchange and other movements	(83)	(236)	(66)	(385)
At 31 December	12,645	1,606	2,288	16,539
Accumulated amortisation and impairment				
At 1 January	7,653	1,039	66	8,758
Amortisation charge for the year	1,440	128	15	1,583
Impairment	71	–	21	92
Disposals/amounts written-off	(287)	–	(14)	(301)
Exchange and other movements	(59)	(134)	(4)	(197)
At 31 December	8,818	1,033	84	9,935
Net book value at 31 December	3,827	573	2,204	6,604

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

23 Goodwill and intangible assets *(continued)*

The Bank

	2014			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other HK$m	Total HK$m
Cost				
At 1 January	**10,020**	**1,145**	**79**	**11,244**
Additions	**1,196**	**–**	**–**	**1,196**
Disposals/amounts written-off	**(99)**	**–**	**–**	**(99)**
Exchange and other movements	**(12)**	**(83)**	**(2)**	**(97)**
At 31 December	**11,105**	**1,062**	**77**	**12,244**
Accumulated amortisation and impairment				
At 1 January	**7,113**	**737**	**45**	**7,895**
Amortisation charge for the year	**1,222**	**93**	**8**	**1,323**
Impairment	**36**	**–**	**2**	**38**
Disposals/amounts written-off	**(99)**	**–**	**–**	**(99)**
Exchange and other movements	**(8)**	**(58)**	**(2)**	**(68)**
At 31 December	**8,264**	**772**	**53**	**9,089**
Net book value at 31 December	**2,841**	**290**	**24**	**3,155**

	2013			
	Computer software HK$m	Customer/ merchant relationships HK$m	Other HK$m	Total HK$m
Cost				
At 1 January	9,049	1,286	78	10,413
Additions	1,140	–	–	1,140
Disposals/amounts written-off	(173)	–	–	(173)
Exchange and other movements	4	(141)	1	(136)
At 31 December	10,020	1,145	79	11,244
Accumulated amortisation and impairment				
At 1 January	6,079	719	30	6,828
Amortisation charge for the year	1,169	99	8	1,276
Impairment	32	–	6	38
Disposals/amounts written-off	(172)	–	–	(172)
Exchange and other movements	5	(81)	1	(75)
At 31 December	7,113	737	45	7,895
Net book value at 31 December	2,907	408	34	3,349

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

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

23 Goodwill and intangible assets *(continued)*

An impairment test was carried out in respect of the operating licenses in Taiwan as at 1 July 2014. The result confirmed that there was no impairment. The impairment test was performed by comparing the recoverable amount of the relevant cash generating units ('CGUs'), determined by a value in use calculation, with the carrying amounts of the CGUs. The calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a long-term growth rate applicable to the banking industry in Taiwan. The discount rate used is based on the cost of capital the group allocates to Taiwan.

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the long-term growth rate. The discount rate used during 2014 was 10% to 12% across different CGUs. The long-term growth rate used during 2014 was 3%.

24 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 2014	**85,306**	**11,392**	**22,686**	**76,945**	**473**	**14,465**
Exchange and other adjustments	**(366)**	**1**	**(290)**	**(4,938)**	**(481)**	**(93)**
Additions	**376**	**–**	**2,488**	**375**	**–**	**1,630**
Disposals	**(14)**	**–**	**(1,057)**	**(1)**	**–**	**(520)**
Elimination of accumulated depreciation on revalued land and buildings	**(2,300)**	**–**	**–**	**(2,634)**	**–**	**–**
Surplus on revaluation	**4,511**	**670**	**–**	**3,775**	**99**	**–**
Reclassifications	**(760)**	**721**	**(1)**	**(476)**	**463**	**–**
At 31 December 2014	**86,753**	**12,784**	**23,826**	**73,046**	**554**	**15,482**
Accumulated depreciation						
At 1 January 2014	**91**	**–**	**18,053**	**164**	**–**	**11,575**
Exchange and other adjustments	**(2)**	**–**	**(225)**	**(2)**	**–**	**(67)**
Charge for the year	**2,294**	**–**	**1,813**	**2,547**	**–**	**1,135**
Disposals	**(1)**	**–**	**(1,030)**	**(1)**	**–**	**(513)**
Elimination of accumulated depreciation on revalued land and buildings	**(2,300)**	**–**	**–**	**(2,634)**	**–**	**–**
Reclassifications	**(8)**	**–**	**(1)**	**(6)**	**–**	**–**
At 31 December 2014	**74**	**–**	**18,610**	**68**	**–**	**12,130**
Net book value at 31 December 2014	**86,679**	**12,784**	**5,216**	**72,978**	**554**	**3,352**
Total at 31 December 2014			**104,679**			**76,884**

24 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 2013	80,104	5,282	22,228	50,895	197	13,872
Exchange and other adjustments	(188)	–	(402)	(156)	–	(202)
Additions	1,743	4,868	1,808	25,060	251	1,300
Disposals	(11)	–	(975)	–	–	(530)
Elimination of accumulated depreciation on revalued land and buildings	(2,048)	–	–	(1,238)	–	–
Surplus on revaluation	5,687	1,389	–	2,370	25	–
Reclassifications	19	(147)	27	14	–	25
At 31 December 2013	85,306	11,392	22,686	76,945	473	14,465
Accumulated depreciation						
At 1 January 2013	60	–	17,375	57	–	11,055
Exchange and other adjustments	(4)	–	(303)	(4)	–	(156)
Charge for the year	2,084	–	1,904	1,349	–	1,174
Disposals	–	–	(944)	–	–	(519)
Elimination of accumulated depreciation on revalued land and buildings	(2,048)	–	–	(1,238)	–	–
Reclassifications	(1)	–	21	–	–	21
At 31 December 2013	91	–	18,053	164	–	11,575
Net book value at 31 December 2013	85,215	11,392	4,633	76,781	473	2,890
Total at 31 December 2013			101,240			80,144

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	
	2014 HK$m	2013 HK$m	**2014 HK$m**	2013 HK$m
Cost less accumulated depreciation	**19,387**	19,998	**34,544**	38,477

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

	The group		The Bank	
	2014 HK$m	2013 HK$m	**2014 HK$m**	2013 HK$m
Land and buildings carried at valuation	**86,743**	85,296	**73,046**	76,945
Other land and buildings stated at cost	**10**	10	**–**	–
Land and buildings before deduction of accumulated depreciation	**86,753**	85,306	**73,046**	76,945

Notes on the Financial Statements (continued)

24 Property, plant and equipment *(continued)*

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

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Long leaseholds (over fifty years)	**37,356**	36,988	**33,234**	33,028
Medium-term leaseholds (between ten and fifty years)	**50,698**	48,407	**36,495**	35,265
Short leaseholds (less than ten years)	**39**	63	**39**	63
	88,093	85,458	**69,768**	68,356
Outside Hong Kong:				
Freehold	**4,625**	4,522	**3,474**	3,451
Long leaseholds (over fifty years)	**145**	158	**127**	129
Medium-term leaseholds (between ten and fifty years)	**6,580**	6,444	**143**	5,293
Short leaseholds (less than ten years)	**20**	25	**20**	25
	11,370	11,149	**3,764**	8,898
	99,463	96,607	**73,532**	77,254
Analysed as follows:				
Land and buildings	**86,679**	85,215	**72,978**	76,781
Investment properties	**12,784**	11,392	**554**	473
	99,463	96,607	**73,532**	77,254

The group's land and buildings and investment properties were revalued in November 2014 and updated for any material changes at 31 December 2014. The basis of valuation for land and buildings and investment properties was open market value, depreciated replacement cost or surrender value as noted in note 3(p). The resultant values would mainly be categorised as Level 3 in the fair value hierarchy. In determining the open market value of investment properties, expected future cash flows have been discounted to their present values. The net book value of 'Land and buildings' includes HK$12,368m (2013: HK$11,731m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$5,181m (2013: HK$7,076m). Amounts of HK$3,292m (2013: HK$4,073m) and HK$671m (2013: HK$1,389m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$3,292m (2013: HK$4,073m) is stated after deduction of non-controlling interests of HK$552m (2013: HK$796m) and deferred tax of HK$666m (2013: HK$818m). The amount credited to the income statement comprises the surplus of HK$670m (2013: HK$1,389m) on revaluation of investment properties, and HK$1m (2013: nil) relating to the reversal of previous revaluation deficits that arose when the value of certain land and buildings fell below depreciated historical cost.

Land and buildings and investment properties in Hong Kong, Macau and mainland China, representing 96% 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 4% by value of the group's properties, were valued by different independent professionally qualified valuers.

24 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$422m (2013: HK$312m) was recognised as rental income in the income statement in respect of operating leases.

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

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**411**	303	**18**	20
After one but within five years	**147**	190	**12**	7
Over five years	**–**	1	**–**	–
	558	494	**30**	27

25 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	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
In Hong Kong:				
Medium-term leaseholds (between ten and fifty years)	**277**	295	**71**	73

The above amounts were included within 'Prepayments and accrued income' in 'Other assets' (note 26).

26 Other assets

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Current tax assets	**2,418**	2,034	**2,041**	1,723
Assets held for sale	**148**	4,476	**100**	4,330
Prepayments and accrued income	**3,821**	3,578	**2,077**	1,721
Accrued interest receivable	**18,370**	15,898	**6,452**	5,794
Acceptances and endorsements	**31,200**	34,239	**16,625**	19,845
Other	**94,919**	88,714	**67,322**	64,987
	150,876	148,939	**94,617**	98,400

Other assets include HK$82,000m (2013: HK$82,190m) of financial assets, the majority of which are measured at amortised cost.

Asset held for sale at 31 December 2013 mainly represented our investment in Bank of Shanghai.

27 Customer accounts

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**919,343**	862,138	**556,327**	526,698
Savings accounts	**2,379,651**	2,246,618	**1,669,924**	1,571,836
Other deposit accounts	**1,180,998**	1,144,942	**588,259**	624,788
	4,479,992	4,253,698	**2,814,510**	2,723,322

28 Trading liabilities

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**3,470**	4,261	**–**	198
Other debt securities in issue	**19,418**	18,104	**16,022**	16,922
Short positions in securities	**66,063**	53,889	**38,120**	29,228
Deposits by banks	**6,301**	6,558	**6,212**	4,918
Customer accounts	**120,560**	112,220	**38,195**	31,357
	215,812	195,032	**98,549**	82,623

29 Financial liabilities designated at fair value

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**196**	222	**196**	222
Debt securities in issue	**11,973**	4,807	**8,984**	4,537
Liabilities to customers under investment contracts	**36,665**	36,686	**–**	–
	48,834	41,715	**9,180**	4,759

At 31 December 2014, the carrying amount of the above liabilities was HK$108m higher than the contractual amount at maturity (2013: HK$12m). At 31 December 2014, the accumulated loss in fair value attributable to changes in credit risk was HK$60m (2013: HK$29m).

30 Debt securities in issue

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**7,530**	16,319	**7,229**	11,782
Other debt securities	**37,767**	36,015	**24,860**	18,280
	45,297	52,334	**32,089**	30,062

31 Other liabilities and provisions

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**26,435**	26,021	**14,643**	15,144
Provisions for liabilities and charges (note 33)	**1,141**	1,723	**1,041**	1,260
Acceptances and endorsements	**31,200**	34,239	**16,625**	19,845
Share based payment liability to HSBC Holdings plc	**2,186**	2,303	**1,823**	1,900
Other liabilities	**26,769**	24,523	**13,645**	13,116
	87,731	88,809	**47,777**	51,265

Other liabilities include HK$78,498m (2013: HK$79,540m) of financial liabilities which are measured at amortised cost.

32 Liabilities under insurance contracts

	Gross	**Reinsurers' Share**[2]	**Net**
	HK$m	**HK$m**	**HK$m**
2014			
Non-linked insurance contracts[1]			
At 1 January	**236,911**	**(2,836)**	**234,075**
Benefits paid	**(23,761)**	**204**	**(23,557)**
Increase in liabilities to policyholders	**53,104**	**(1,611)**	**51,493**
Foreign exchange and other movements	**(511)**	**61**	**(450)**
At 31 December	**265,743**	**(4,182)**	**261,561**
Linked insurance contracts			
At 1 January	**39,269**	**(1,695)**	**37,574**
Benefits paid	**(2,921)**	**644**	**(2,277)**
Increase in liabilities to policyholders	**8,339**	**350**	**8,689**
Foreign exchange and other movements	**(248)**	**(740)**	**(988)**
At 31 December	**44,439**	**(1,441)**	**42,998**
Total liabilities to policyholders	**310,182**	**(5,623)**	**304,559**
2013			
Non-linked insurance contracts[1]			
At 1 January	210,973	(1,389)	209,584
Benefits paid	(20,370)	201	(20,169)
Increase in liabilities to policyholders	46,731	(1,683)	45,048
Foreign exchange and other movements	(423)	35	(388)
At 31 December	236,911	(2,836)	234,075
Linked insurance contracts			
At 1 January	33,948	(3,103)	30,845
Benefits paid	(4,898)	3,267	(1,631)
Increase in liabilities to policyholders	10,530	1,014	11,544
Foreign exchange and other movements	(311)	(2,873)	(3,184)
At 31 December	39,269	(1,695)	37,574
Total liabilities to policyholders	276,180	(4,531)	271,649

1 *Includes liabilities under non-life insurance contracts.*

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

33 Provisions for liabilities and charges

Provisions for liabilities and charges

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**1,723**	2,144	**1,260**	1,266
Additional provisions/increase in provisions	**218**	909	**109**	465
Provisions used	**(1,013)**	(325)	**(621)**	(269)
Amounts reversed	**(195)**	(720)	**(127)**	(322)
Exchange and other movements	**408**	(285)	**420**	120
At 31 December	**1,141**	1,723	**1,041**	1,260

Of which: provisions for restructuring costs

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**225**	287	**145**	256
Additional provisions/increase in provisions	**55**	133	**41**	52
Provisions used	**(108)**	(165)	**(73)**	(136)
Amounts reversed	**(67)**	(1)	**(28)**	(1)
Exchange and other movements	**8**	(29)	**(5)**	(26)
At 31 December	**113**	225	**80**	145

Included in the above are amounts of HK$842 million relating to ongoing regulatory investigations. There is inherent uncertainty as to the amounts at which such matters will be settled in future, which could be higher or lower than the amounts provided. Included in Amount due from Group companies is an amount of HK$653 million that is recoverable from another Group company relating to an ongoing regulatory investigation.

34 Subordinated liabilities

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

		2014	2013
		HK$m	HK$m
The Bank			
US$1,200m	Undated floating rate primary capital notes	**9,337**	9,346
		9,337	9,346
The group			
AUD200m	Floating rate subordinated notes due 2020, callable from 2015	**1,271**	1,386
MYR500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[1]	**1,108**	1,182
MYR500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[2]	**1,116**	1,193
		12,832	13,107

1 *The interest rate on the MYR500m 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.*

2 *The interest rate on the MYR500m 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.*

35 Preference shares

Authorised

At 31 December 2013, the authorised preference share capital of the Bank was US$13,450.5m comprising 3,750.5m cumulative redeemable preference shares of US$1 each, 7,500m non-cumulative irredeemable preference shares of US$1 each and 2,200m cumulative irredeemable preference shares of US$1 each.

As discussed in note 1(a), in Hong Kong, the concept of authorised share capital has been abolished with effect from 3 March 2014.

At a group level, there was INR870m (2013: INR870m) of authorised preference share capital comprising 8.7m compulsorily convertible preference shares of INR100 each in the share capital of a subsidiary.

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Issued and fully paid				
Redeemable preference shares	**8,143**	8,141	**8,143**	8,141
Irredeemable preference shares	**28,439**	39,173	**28,331**	39,064
	36,582	47,314	**36,474**	47,205

1,050m cumulative redeemable preference shares were issued in 2009, which have a mandatory redemption date of 2 January 2024 but may be redeemed at the Bank's option on or after 2 January 2019, subject to 30 days' notice in writing to shareholders and to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share together with the amount equal to any accrued but unpaid dividends. The total number of issued cumulative redeemable preference shares at 31 December 2014 was 1,050m (2013: 1,050m). No cumulative redeemable preference shares were issued during the year (2013: nil).

The non-cumulative irredeemable preference shares were issued at nominal value, and may be cancelled subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. In the event of cancellation, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of cancellation, subject to the Bank having sufficient distributable profits. 700m non-cumulative irredeemable preference shares were cancelled on 26 June 2014 at the issue price of US$1 each. The number of issued non-cumulative irredeemable preference shares at 31 December 2014 was 3,253m (2013: 3,953m). No non-cumulative irredeemable preference shares were issued during the year (2013: nil).

35 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. 685m cumulative irredeemable preference shares were cancelled on 26 June 2014 at the issue price of US$1 each. The number of issued cumulative irredeemable preference shares at 31 December 2014 was 400m (2013: 1,085m). No cumulative irredeemable preference shares were issued during the year (2013: nil).

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

8.7m compulsorily convertible preference shares ('CCPS') were issued by HSBC InvestDirect Securities (India) Private Limited ('HSBC InvestDirect') in 2009 at a nominal value of INR100 each. These shares may be converted into fully paid equity shares of HSBC InvestDirect at any time after one year from the date of allotment of the CCPS by written notice. The conversion shall be made at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion. The CCPS shall carry a fixed dividend of 0.001% of the face value per annum. After ten years following the allotment of the CCPS all outstanding CCPS shall be converted at par or premium as may be determined by the Board of HSBC InvestDirect at the time of the conversion.

HSBC InvestDirect did not convert any CCPS during 2014 (converted 2m CCPS into 5,882,352 equity shares of INR10 each at a premium of INR24 per share amounting to INR200m during 2013).

36 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2013 was HK$100,000m divided into 40,000m ordinary shares of HK$2.50 each.

As discussed in note 1(a), in Hong Kong, the concept of authorised share capital has been abolished with effect from 3 March 2014.

Issued and fully paid

	The group and the Bank	
	2014	2013
	HK$m	HK$m
Ordinary share capital	**96,052**	85,319

	The group and the Bank	
	2014	**2014**
Ordinary shares	**Number**	**HK$m**
At 1 January	**34,127,482,901**	**85,319**
Issued during the year	**4,293,500,000**	**10,733**
At 31 December	**38,420,982,901**	**96,052**

4,293.5m new ordinary shares were issued during 2014 (2013: 10,540m) at an issue price of HK$2.50 each for general corporate purposes and to further strengthen the capital base.

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.

37 Other equity instruments

Other equity instruments comprise additional tier 1 capital instruments.

Additional tier 1 capital instruments in issue which are accounted for in equity

		The group and the bank	
		2014	2013
		HK$m	HK$m
US$1,000m	Floating rate perpetual subordinated loan, callable from Dec 2019[1]	**7,756**	–
US$900m	Floating rate perpetual subordinated loan, callable from Dec 2019[1]	**6,981**	–
		14,737	–

1 *Interest rate at one year US dollar LIBOR plus 3.84%.*

During 2014, the Bank issued new capital instruments to its ultimate holding company that are included in the group's capital base as Basel III compliant additional tier 1 capital under the Banking (Capital) Rules. The net proceeds of the issuances will be used for general corporate purposes and to further strengthen the capital base.

The additional tier 1 capital instruments are perpetual subordinated loans on which coupon payments may be cancelled at the sole discretion of the Bank. The subordinated loans will be written down at the point of non-viability on the occurrence of a trigger event as defined in the Banking (Capital) Rules. They rank higher than ordinary shares in the event of a wind-up.

38 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

2014	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 sight balances at central banks	156,475	–	–	–	–	–	–	–	–	156,475
Items in the course of collection from other banks	–	21,122	–	–	–	–	–	–	–	21,122
Hong Kong Government certificates of indebtedness	214,654	–	–	–	–	–	–	–	–	214,654
Trading assets	–	–	–	–	–	–	–	407,026	–	407,026
Derivatives	–	–	–	–	–	–	–	384,508	5,426	389,934
Financial assets designated at fair value	–	224	404	2,458	10,230	3,922	80,957	–	–	98,195
Debt securities	–	224	404	2,458	10,230	3,922	–	–	–	17,238
Equity shares	–	–	–	–	–	–	80,957	–	–	80,957
Reverse repurchase agreements – non-trading	17,185	146,739	25,959	6,474	22,544	–	–	–	–	218,901
Placings with and advances to banks	89,234	216,293	107,527	37,885	27,129	10,245	–	–	–	488,313
Loans and advances to customers	149,788	343,242	333,097	533,851	776,135	689,623	(10,520)	–	–	2,815,216
Financial investments	93	161,254	315,078	405,194	358,914	166,412	49,548	–	–	1,456,493
Treasury and other eligible bills	93	117,183	253,137	174,123	–	–	–	–	–	544,536
Certificate of deposit	–	6,028	18,421	56,374	13,762	3,586	–	–	–	98,171
Debt securities held to maturity	–	359	1,436	7,157	64,770	95,555	–	–	–	169,277
Debt securities available-for-sale	–	37,684	42,084	167,540	280,382	67,271	417	–	–	595,378
Equity shares available-for-sale	–	–	–	–	–	–	49,131	–	–	49,131
Amounts due from Group companies	83,035	64,891	28,687	3,193	2,983	305	–	8,600	–	191,694
Interests in associates and joint ventures	–	–	–	–	–	–	116,654	–	–	116,654
Goodwill and intangible assets	–	–	–	–	–	–	45,078	–	–	45,078
Property, plant and equipment	–	–	–	–	–	–	104,679	–	–	104,679
Deferred tax assets	–	–	–	–	–	–	1,436	–	–	1,436
Other assets	11,915	23,568	28,906	15,534	7,357	2,443	61,153	–	–	150,876
Total assets	722,379	977,333	839,658	1,004,589	1,205,292	872,950	448,985	800,134	5,426	6,876,746

38 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
2014										
Liabilities										
Hong Kong currency notes in circulation	**214,654**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**214,654**
Items in the course of transmission to other banks	**–**	**31,331**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**31,331**
Repurchase agreements – non-trading	**2,497**	**25,882**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**28,379**
Deposits by banks	**168,504**	**50,624**	**2,131**	**1,291**	**4,023**	**140**	**–**	**–**	**–**	**226,713**
Customer accounts	**3,361,396**	**575,631**	**269,802**	**231,562**	**41,324**	**277**	**–**	**–**	**–**	**4,479,992**
Trading liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**215,812**	**–**	**215,812**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**365,107**	**2,021**	**367,128**
Financial liabilities designated at fair value	**190**	**–**	**–**	**195**	**11,632**	**251**	**36,566**	**–**	**–**	**48,834**
Debt securities in issue	**30**	**2,055**	**6,985**	**3,575**	**28,968**	**3,684**	**–**	**–**	**–**	**45,297**
Retirement benefit liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**5,606**	**–**	**–**	**5,606**
Amounts due to Group companies	**35,279**	**63,853**	**1,200**	**539**	**46**	**22,264**	**–**	**12,633**	**–**	**135,814**
Other liabilities and provisions	**6,150**	**28,171**	**27,073**	**16,003**	**3,511**	**544**	**6,279**	**–**	**–**	**87,731**
Liabilities under insurance contracts	**1,320**	**–**	**–**	**–**	**–**	**–**	**308,862**	**–**	**–**	**310,182**
Current tax liabilities	**179**	**69**	**202**	**2,469**	**8**	**–**	**–**	**–**	**–**	**2,927**
Deferred tax liabilities	**–**	**–**	**–**	**–**	**–**	**–**	**18,586**	**–**	**–**	**18,586**
Subordinated liabilities	**–**	**–**	**–**	**1,271**	**1,108**	**1,116**	**9,337**	**–**	**–**	**12,832**
Preference shares	**–**	**–**	**–**	**–**	**107**	**8,144**	**28,331**	**–**	**–**	**36,582**
Total liabilities	**3,790,199**	**777,616**	**307,393**	**256,905**	**90,727**	**36,420**	**413,567**	**593,552**	**2,021**	**6,268,400**

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

The Bank

2014	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 sight balances at central banks	**120,468**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**120,468**
Items in the course of collection from other banks	**–**	**15,888**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**15,888**
Hong Kong Government certificates of indebtedness	**214,654**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**214,654**
Trading assets	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**298,365**	**–**	**298,365**
Derivatives	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**370,094**	**4,782**	**374,876**
Financial assets designated at fair value	**–**	**–**	**–**	**233**	**1,024**	**–**	**–**	**–**	**–**	**1,257**
Debt securities	–	–	–	233	1,024	–	–	–	–	1,257
Equity shares	–	–	–	–	–	–	–	–	–	–
Reverse repurchase agreements – non-trading	**4,849**	**58,241**	**24,005**	**6,474**	**22,544**	**–**	**–**	**–**	**–**	**116,113**
Placings with and advances to banks	**63,998**	**62,942**	**43,882**	**12,426**	**21,654**	**1,407**	**–**	**-**	**–**	**206,309**
Loans and advances to customers	**104,059**	**215,426**	**180,693**	**275,296**	**462,517**	**358,592**	**(5,872)**	**–**	**–**	**1,590,711**
Financial investments	**93**	**104,919**	**212,170**	**211,835**	**170,623**	**18,286**	**4,057**	**–**	**–**	**721,983**
Treasury and other eligible bills	93	93,458	185,349	131,112	–	–	–	–	–	410,012
Certificates of deposit	–	1,351	1,119	196	375	–	–	–	–	3,041
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available-for-sale	–	10,110	25,702	80,527	170,248	18,286	52	–	–	304,925
Equity shares available-for-sale	–	–	–	–	–	–	4,005	–	–	4,005
Amounts due from Group companies	**74,982**	**168,433**	**73,390**	**28,194**	**24,277**	**12,169**	**–**	**22,691**	**–**	**404,136**
Investments in subsidiaries	**–**	**–**	**–**	**–**	**–**	**–**	**70,849**	**–**	**–**	**70,849**
Interests in associates and joint ventures	**–**	**–**	**–**	**–**	**–**	**–**	**39,830**	**–**	**–**	**39,830**
Goodwill and intangible assets	**–**	**–**	**–**	**–**	**–**	**–**	**4,307**	**–**	**–**	**4,307**
Property, plant and equipment	**–**	**–**	**–**	**–**	**–**	**–**	**76,884**	**–**	**–**	**76,884**
Deferred tax assets	**–**	**–**	**–**	**–**	**–**	**–**	**664**	**–**	**–**	**664**
Other assets	**1,847**	**10,006**	**20,778**	**4,978**	**1,767**	**365**	**54,876**	**–**	**–**	**94,617**
Total assets	**584,950**	**635,855**	**554,918**	**539,436**	**704,406**	**390,819**	**245,595**	**691,150**	**4,782**	**4,351,911**

38 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
2014										
Liabilities										
Hong Kong currency notes in circulation	214,654	–	–	–	–	–	–	–	–	214,654
Items in the course of transmission to other banks	–	22,512	–	–	–	–	–	–	–	22,512
Repurchase agreements – non-trading	658	20,375	–	–	–	–	–	–	–	21,033
Deposits by banks	124,378	44,233	2,055	1,107	2,472	140	–	–	–	174,385
Customer accounts	2,267,449	345,695	96,569	89,811	14,879	107	–	–	–	2,814,510
Trading liabilities	–	–	–	–	–	–	–	98,549	–	98,549
Derivatives	–	–	–	–	–	–	–	352,516	1,129	353,645
Financial liabilities designated at fair value	–	–	–	195	8,924	–	61	–	–	9,180
Debt securities in issue	30	909	6,267	1,929	21,194	1,760	–	–	–	32,089
Retirement benefit liabilities	–	–	–	–	–	–	3,663	–	–	3,663
Amounts due to Group companies	66,439	58,773	15,519	1,191	47	22,720	–	23,246	–	187,935
Other liabilities and provisions	2,150	15,788	16,557	6,432	2,249	367	4,234	–	–	47,777
Current tax liabilities	178	–	190	1,472	–	–	–	–	–	1,840
Deferred tax liabilities	–	–	–	–	–	–	6,435	–	–	6,435
Subordinated liabilities	–	–	–	–	–	–	9,337	–	–	9,337
Preference shares	–	–	–	–	–	8,143	28,331	–	–	36,474
Total liabilities	2,675,936	508,285	137,157	102,137	49,765	33,237	52,061	474,311	1,129	4,034,018

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

The group

2013	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and sight balances at central banks	158,879	–	–	–	–	–	–	–	–	158,879
Items in the course of collection from other banks	–	16,346	–	–	–	–	–	–	–	16,346
Hong Kong Government certificates of indebtedness	195,554	–	–	–	–	–	–	–	–	195,554
Trading assets	–	–	–	–	–	–	–	311,400	–	311,400
Derivatives	–	–	–	–	–	–	–	378,603	10,124	388,727
Financial assets designated at fair value	–	203	632	3,792	10,500	4,773	70,246	–	–	90,146
Debt securities	–	203	632	3,763	10,500	4,773	–	–	–	19,871
Equity shares	–	–	–	–	–	–	70,246	–	–	70,246
Other	–	–	–	29	–	–	–	–	–	29
Reverse repurchase agreements – non-trading	34,172	92,784	22,932	377	319	–	–	–	–	150,584
Placings with and advances to banks	128,948	237,497	136,062	30,773	21,639	9,602	–	–	–	564,521
Loans and advances to customers	138,355	325,338	309,941	484,179	714,044	656,889	(9,501)	–	–	2,619,245
Financial investments	–	178,597	301,060	412,096	314,164	138,182	35,672	–	–	1,379,771
Treasury and other eligible bills	–	143,354	217,209	165,135	–	–	–	–	–	525,698
Certificates of deposit	–	7,380	22,981	45,723	8,028	4,078	17	–	–	88,207
Debt securities held to maturity	–	1,497	5,976	14,600	56,487	88,682	–	–	–	167,242
Debt securities available-for-sale	–	26,366	54,894	186,638	249,649	45,422	859	–	–	563,828
Equity shares available-for-sale	–	–	–	–	–	–	34,796	–	–	34,796
Amounts due from Group companies	60,639	69,830	21,833	1,757	1,558	1,714	–	4,644	–	161,975
Interests in associates and joint ventures	–	–	–	–	–	–	107,852	–	–	107,852
Goodwill and intangible assets	–	–	–	–	–	–	41,882	–	–	41,882
Property, plant and equipment	–	–	–	–	–	–	101,240	–	–	101,240
Deferred tax assets	–	–	–	–	–	–	2,294	–	–	2,294
Other assets	8,428	24,763	25,563	20,223	5,539	4,070	60,353	–	–	148,939
Total assets	724,975	945,358	818,023	953,197	1,067,763	815,230	410,038	694,647	10,124	6,439,355

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

The group

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2013										
Liabilities										
Hong Kong currency notes in circulation	195,554	–	–	–	–	–	–	–	–	195,554
Items in the course of transmission to other banks	–	34,240	–	–	–	–	–	–	–	34,240
Repurchase agreements – non-trading	–	6,312	–	–	–	–	–	–	–	6,312
Deposits by banks	140,201	80,524	1,850	3,992	4,563	228	–	–	–	231,358
Customer accounts	3,166,759	574,572	268,174	208,687	35,411	95	–	–	–	4,253,698
Trading liabilities	–	–	–	–	–	–	–	195,032	–	195,032
Derivatives	–	–	–	–	–	–	–	362,963	2,089	365,052
Financial liabilities designated at fair value	164	–	–	–	4,752	269	36,530	–	–	41,715
Debt securities in issue	–	4,829	6,922	6,373	29,383	4,827	–	–	–	52,334
Retirement benefit liabilities	–	–	–	–	–	–	4,856	–	–	4,856
Amounts due to Group companies	51,477	10,256	2,014	1,346	9	15,891	–	10,804	–	91,797
Other liabilities and provisions	4,897	28,792	27,367	16,750	3,104	363	7,536	–	–	88,809
Liabilities under insurance contracts	1,310	–	–	–	–	–	274,870	–	–	276,180
Current tax liabilities	204	366	385	2,767	–	–	–	–	–	3,722
Deferred tax liabilities	–	–	–	–	–	–	16,051	–	–	16,051
Subordinated liabilities	–	–	–	–	2,568	1,193	9,346	–	–	13,107
Preference shares	–	–	–	–	–	8,141	39,173	–	–	47,314
Total liabilities	3,560,566	739,891	306,712	239,915	79,790	31,007	388,362	568,799	2,089	5,917,131

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

The Bank

2013	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and sight balances at central banks	112,586	–	–	–	–	–	–	–	–	112,586
Items in the course of collection from other banks	–	10,922	–	–	–	–	–	–	–	10,922
Hong Kong Government certificates of indebtedness	195,554	–	–	–	–	–	–	–	–	195,554
Trading assets	–	–	–	–	–	–	–	235,599	–	235,599
Derivatives	–	–	–	–	–	–	–	368,372	8,811	377,183
Financial assets designated at fair value	–	–	–	555	1,006	–	–	–	–	1,561
Debt securities	–	–	–	555	1,006	–	–	–	–	1,561
Equity shares	–	–	–	–	–	–	–	–	–	–
Other	–	–	–	–	–	–	–	–	–	–
Reverse repurchase agreements – non-trading	32,074	36,348	17,484	377	318	–	–	–	–	86,601
Placings with and advances to banks	99,008	72,409	45,992	17,244	15,098	1,166	–	–	–	250,917
Loans and advances to customers	94,738	200,800	151,865	271,965	421,195	348,553	(5,206)	–	–	1,483,910
Financial investments	–	123,650	194,047	263,759	155,119	18,605	3,403	–	–	758,583
Treasury and other eligible bills	–	112,491	169,908	143,312	–	–	–	–	–	425,711
Certificates of deposit	–	3,279	5,299	1,434	–	–	–	–	–	10,012
Debt securities held to maturity	–	–	–	–	–	–	–	–	–	–
Debt securities available-for-sale	–	7,880	18,840	119,013	155,119	18,605	392	–	–	319,849
Equity shares available-for-sale	–	–	–	–	–	–	3,011	–	–	3,011
Amounts due from Group companies	65,294	166,578	47,962	34,448	19,925	21,262	–	11,420	–	366,889
Investments in subsidiaries	–	–	–	–	–	–	63,272	–	–	63,272
Interests in associates and joint ventures	–	–	–	–	–	–	40,410	–	–	40,410
Goodwill and intangible assets	–	–	–	–	–	–	4,530	–	–	4,530
Property, plant and equipment	–	–	–	–	–	–	80,144	–	–	80,144
Deferred tax assets	–	–	–	–	–	–	999	–	–	999
Other assets	1,514	11,716	16,541	11,454	1,783	394	54,998	–	–	98,400
Total assets	600,768	622,423	473,891	599,802	614,444	389,980	242,550	615,391	8,811	4,168,060

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

The Bank

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2013										
Liabilities										
Hong Kong currency notes in circulation	195,554	–	–	–	–	–	–	–	–	195,554
Items in the course of transmission to other banks	–	24,774	–	–	–	–	–	–	–	24,774
Repurchase agreements – non-trading	–	5,951	–	–	–	–	–	–	–	5,951
Deposits by banks	112,683	70,409	1,800	3,894	3,011	228	–	–	–	192,025
Customer accounts	2,139,580	379,056	96,352	92,688	15,610	36	–	–	–	2,723,322
Trading liabilities	–	–	–	–	–	–	–	82,623	–	82,623
Derivatives	–	–	–	–	–	–	–	353,712	983	354,695
Financial liabilities designated at fair value	–	–	–	–	4,751	–	8	–	–	4,759
Debt securities in issue	–	4,216	2,979	1,268	19,758	1,841	–	–	–	30,062
Retirement benefit liabilities	–	–	–	–	–	–	2,689	–	–	2,689
Amounts due to Group companies	65,741	42,158	10,185	1,096	701	16,286	–	19,977	–	156,144
Other liabilities and provisions	2,918	16,347	16,525	8,270	2,072	155	4,978	–	–	51,265
Current tax liabilities	204	12	351	1,462	–	–	–	–	–	2,029
Deferred tax liabilities	–	–	–	–	–	–	6,503	–	–	6,503
Subordinated liabilities	–	–	–	–	–	–	9,346	–	–	9,346
Preference shares	–	–	–	–	–	8,141	39,064	–	–	47,205
Total liabilities	2,516,680	542,923	128,192	108,678	45,903	26,687	62,588	456,312	983	3,888,946

Notes on the Financial Statements (continued)

39 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 2014						
Hong Kong currency notes in circulation	214,654	–	–	–	–	214,654
Items in the course of transmission to other banks	–	31,331	–	–	–	31,331
Repurchase agreements -non-trading	2,498	25,916	–	–	–	28,414
Deposits by banks	168,511	52,777	1,302	4,060	159	226,809
Customer accounts	3,361,476	848,561	238,213	45,513	283	4,494,046
Trading liabilities	215,812	–	–	–	–	215,812
Derivatives	365,353	274	450	1,163	104	367,344
Financial liabilities designated at fair value	190	45	362	12,169	36,768	49,534
Debt securities in issue	30	9,293	4,162	30,507	3,967	47,959
Amounts due to Group companies	48,165	65,131	951	2,395	24,436	141,078
Other financial liabilities	5,905	48,917	13,527	1,906	480	70,735
Subordinated liabilities	–	162	1,601	2,794	14,141	18,698
Preference shares	–	475	389	3,457	43,565	47,886
	4,382,594	1,082,882	260,957	103,964	123,903	5,954,300
Loan commitments	1,407,919	464,200	11,361	12,700	62	1,896,242
Financial guarantee and credit risk related guarantee contracts	61,666	–	–	–	–	61,666
	5,852,179	1,547,082	272,318	116,664	123,965	7,912,208
At 31 December 2013						
Hong Kong currency notes in circulation	195,554	–	–	–	–	195,554
Items in the course of transmission to other banks	–	34,240	–	–	–	34,240
Repurchase agreements -non-trading	–	6,326	–	–	–	6,326
Deposits by banks	140,204	82,391	4,009	4,606	256	231,466
Customer accounts	3,167,882	845,213	212,681	39,244	181	4,265,201
Trading liabilities	195,032	–	–	–	–	195,032
Derivatives	362,908	242	666	1,536	108	365,460
Financial liabilities designated at fair value	164	22	83	5,073	36,848	42,190
Debt securities in issue	–	12,183	7,026	31,052	5,130	55,391
Amounts due to Group companies	62,341	12,309	1,543	1,492	16,568	94,253
Other financial liabilities	5,073	50,754	15,020	2,010	241	73,098
Subordinated liabilities	–	125	375	4,345	14,233	19,078
Preference shares	–	512	607	4,477	57,070	62,666
	4,129,158	1,044,317	242,010	93,835	130,635	5,639,955
Loan commitments	1,177,323	501,252	8,914	14,244	–	1,701,733
Financial guarantee and credit risk related guarantee contracts	83,647	–	–	–	–	83,647
	5,390,128	1,545,569	250,924	108,079	130,635	7,425,335

39 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 2014						
Hong Kong currency notes in circulation	**214,654**	**–**	**–**	**–**	**–**	**214,654**
Items in the course of transmission to other banks	**–**	**22,512**	**–**	**–**	**–**	**22,512**
Repurchase agreements -non-trading	**659**	**20,401**	**–**	**–**	**–**	**21,060**
Deposits by banks	**124,381**	**46,295**	**1,116**	**2,509**	**159**	**174,460**
Customer accounts	**2,267,510**	**443,184**	**91,256**	**16,126**	**107**	**2,818,183**
Trading liabilities	**98,549**	**–**	**–**	**–**	**–**	**98,549**
Derivatives	**352,779**	**140**	**325**	**566**	**53**	**353,863**
Financial liabilities designated at fair value	**–**	**17**	**279**	**9,118**	**–**	**9,414**
Debt securities in issue	**30**	**7,385**	**2,426**	**22,175**	**1,929**	**33,945**
Amounts due to Group companies	**89,725**	**74,434**	**1,601**	**2,392**	**24,893**	**193,045**
Other financial liabilities	**2,096**	**28,706**	**5,499**	**1,565**	**350**	**38,216**
Subordinated liabilities	**–**	**120**	**204**	**1,295**	**12,545**	**14,164**
Preference shares	**–**	**475**	**389**	**3,457**	**43,565**	**47,886**
	3,150,383	**643,669**	**103,095**	**59,203**	**83,601**	**4,039,951**
Loan commitments	**925,132**	**361,943**	**4,441**	**8,990**	**266**	**1,300,772**
Financial guarantee and credit risk related guarantee contracts	**40,589**	**–**	**–**	**–**	**–**	**40,589**
	4,116,104	**1,005,612**	**107,536**	**68,193**	**83,867**	**5,381,312**
At 31 December 2013						
Hong Kong currency notes in circulation	195,554	–	–	–	–	195,554
Items in the course of transmission to other banks	–	24,774	–	–	–	24,774
Repurchase agreements -non-trading	–	5,965	–	–	–	5,965
Deposits by banks	112,686	72,218	3,909	3,054	256	192,123
Customer accounts	2,139,622	476,108	94,222	17,375	114	2,727,441
Trading liabilities	82,623	–	–	–	–	82,623
Derivatives	353,651	74	354	995	42	355,116
Financial liabilities designated at fair value	–	18	72	5,017	–	5,107
Debt securities in issue	–	7,399	1,782	21,089	2,048	32,318
Amounts due to Group companies	85,789	52,380	1,287	2,184	16,962	158,602
Other financial liabilities	3,333	29,430	7,696	1,644	90	42,193
Subordinated liabilities	–	81	243	1,295	12,542	14,161
Preference shares	–	512	607	4,477	57,070	62,666
	2,973,258	668,959	110,172	57,130	89,124	3,898,643
Loan commitments	710,995	420,068	3,766	10,687	–	1,145,516
Financial guarantee and credit risk related guarantee contracts	41,783	–	–	–	–	41,783
	3,726,036	1,089,027	113,938	67,817	89,124	5,085,942

39 Analysis of cash flows payable under financial liabilities by remaining contractual maturities *(continued)*

The balances in the above tables will not agree directly with the balances in the consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan commitments and financial guarantee contracts are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows payable under hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under loan commitments and financial guarantee contracts are classified on the basis of the earliest date they can be called.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. In practice, however, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments and guarantee contracts expire without being drawn upon. The group's approach to managing liquidity risk is set out in the Risk Report.

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

	2014 HK$m	2013 HK$m
Operating profit	**95,514**	130,336
Net interest income	**(95,109)**	(87,365)
Dividend income	**(1,374)**	(1,175)
Depreciation and amortisation	**5,778**	5,663
Amortisation of prepaid operating lease payments	**18**	18
Loan impairment charges and other credit risk provisions	**4,925**	3,532
Loans and advances written off net of recoveries	**(3,537)**	(3,064)
Other provisions for liabilities and charges	**45**	120
Provisions used	**(1,013)**	(325)
Surplus arising on property revaluation	**(1)**	-
Gains on investment properties	**(670)**	(1,389)
Gain on disposal of property, plant and equipment and assets held for sale	**(61)**	(299)
Gain on disposal of subsidiaries, associates and business portfolios	**(104)**	(758)
Net (gain)/loss on reclassification of associates	**251**	(8,157)
Impairment on interests in associates and joint ventures	**11**	1,378
Gains less losses from financial investments	**(2,389)**	(34,512)
Share-based payments granted cost free	**1,442**	1,185
Movement in present value of in-force business	**(3,581)**	(4,735)
Interest received	**109,364**	103,050
Interest paid	**(28,598)**	(27,794)
Operating profit before changes in working capital	**80,911**	75,709
Change in treasury bills with original term to maturity of more than three months	**(24,883)**	(37,399)
Change in placings with and advances to banks	**15,290**	(18,554)
Change in certificates of deposit with original term to maturity of more than three months	**(10,446)**	4,920
Change in repos and reverse repos	**2,148**	(56,490)
Change in trading assets	**(89,784)**	187,015
Change in trading liabilities	**20,780**	13,521
Change in derivative assets	**(1,207)**	11,118
Change in derivative liabilities	**2,076**	(32,849)
Change in financial assets designated as fair value	**(8,049)**	(20,976)
Change in financial liabilities designated as fair value	**7,119**	(2,412)
Change in financial investments held for backing liabilities to long-term policyholders	**(23,657)**	(11,721)
Change in loans and advances to customers	**(199,817)**	(204,608)
Change in amounts due from Group companies	**(29,719)**	13,823
Change in other assets	**(22,540)**	(16,518)
Change in deposits by banks	**(4,645)**	(2,889)
Change in customer accounts	**226,294**	167,912
Change in amounts due to Group companies	**38,307**	(14,473)
Change in debt securities in issue	**(7,037)**	(22,313)
Change in liabilities under insurance contracts	**34,002**	32,385
Change in other liabilities	**43,418**	87,183
Exchange adjustments	**13,219**	6,502
Cash generated from operations	**61,780**	158,886

41 Analysis of cash and cash equivalents

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

	2014 HK$m	2013 HK$m
Balance at 1 January	**687,596**	707,186
Net cash inflow before the effect of foreign exchange movements	**17,880**	4,147
Effect of foreign exchange movements	**(25,806)**	(23,737)
Balance at 31 December	**679,670**	687,596

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

	2014 HK$m	2013 HK$m
Cash in hand and sight balances with central banks	**156,475**	158,879
Items in the course of collection from other banks	**21,122**	16,346
Reverse repurchase agreements – non-trading	**130,093**	81,697
Placings with and advances to banks	**319,758**	378,340
Treasury bills	**77,667**	80,419
Certificates of deposit	**4,133**	4,206
Other eligible bills	**1,753**	1,949
Less: items in the course of transmission to other banks	**(31,331)**	(34,240)
	679,670	687,596

c *Acquisition of subsidiaries and business portfolios*

There was no acquisition of subsidiaries and businesses in 2014.

	2013 Private banking businesses HK$m
Assets	
Placing with banks maturing after one month	2,548
Trading assets	86,886
Derivatives	1,222
Loans and advances to customers	79,401
Financial investments	3,225
Amounts due from Group companies	4,797
Goodwill and intangible assets	88
Property, plant and equipment	17
Other assets	51,615
Total assets excluding cash and cash equivalents	229,799
Liabilities	
Deposits by banks	392
Customer accounts	230,592
Derivatives	1,166
Retirement benefit liabilities	8
Amounts due to Group companies	12,274
Other liabilities and provisions	1,033
Current tax liabilities	56
Total liabilities	245,521
Aggregate net liabilities at date of acquisition, excluding cash and cash equivalents	15,722
Premium on purchase under common control	(17,514)
Purchase price	(1,792)
Satisfied by	
Cash and cash equivalents paid	(19,239)
Cash and cash equivalents bought	17,447
Cash consideration paid up to 31 December 2013	(1,792)
Cash still to be received/(paid) at 31 December 2013	–
Total cash consideration	(1,792)

Notes on the Financial Statements (continued)

41 Analysis of cash and cash equivalents *(continued)*

d *Disposal of subsidiaries and business portfolios*

	2014		
	Banking businesses HK$m	Other HK$m	Total HK$m
Assets			
Loans and advances to customers	2,179	611	2,790
Other assets	15	–	15
Total assets excluding cash and cash equivalents	2,194	611	2,805
Liabilities			
Other liabilities and provisions	38	–	38
Total liabilities	38	–	38
Aggregate net assets at date of disposal, excluding cash and cash equivalents	2,156	611	2,767
Gain on disposal including costs to sell	84	20	104
Add back: costs to sell	11	–	11
Selling price	2,251	631	2,882
Satisfied by			
Total cash consideration	2,251	631	2,882

41 Analysis of cash and cash equivalents *(continued)*

d *Disposal of subsidiaries and business (continued)*

	2013			
	Banking businesses HK$m	Insurance businesses HK$m	Other HK$m	Total HK$m
Assets				
Short-term funds	8,214	–	–	8,214
Placing with banks maturing after one month	3,674	–	–	3,674
Trading assets	1,648	–	–	1,648
Derivatives	333	–	–	333
Financial assets designated at fair value	–	309	–	309
Loans and advances to customers	5,918	–	–	5,918
Financial investments	1,702	670	–	2,372
Amounts due from Group companies	5,003	–	–	5,003
Interests in associates and joint ventures	–	231	–	231
Goodwill and intangible assets	1	541	–	542
Property, plant and equipment	9	–	–	9
Deferred tax assets	18	–	–	18
Other assets	175	1,636	671	2,482
Total assets excluding cash and cash equivalents	26,695	3,387	671	30,753
Liabilities				
Deposits by banks	4,615	–	–	4,615
Customer accounts	19,107	–	–	19,107
Trading liabilities	1,829	–	–	1,829
Derivatives	416	–	–	416
Financial liabilities designated at fair value	–	143	–	143
Amounts due to Group companies	2,619	–	–	2,619
Liabilities under insurance contracts	–	1,126	–	1,126
Current tax liabilities	42	–	–	42
Other liabilities	1,311	153	19	1,483
Total liabilities	29,939	1,422	19	31,380
Aggregate net assets/(liabilities) at date of disposal, excluding cash and cash equivalents	(3,244)	1,965	652	(627)
Gain/ (loss) on disposal including costs to sell	(2)	763	(3)	758
Add back: costs to sell	–	26	–	26
Selling price	(3,246)	2,754	649	157
Satisfied by				
Cash and cash equivalents received	1,576	2,886	662	5,124
Cash and cash equivalents sold	(4,822)	(132)	–	(4,954)
Cash consideration received/(paid) up to 31 December 2013	(3,246)	2,754	662	170
Cash still to be paid at 31 December 2013	–	–	(13)	(13)
Total cash consideration	(3,246)	2,754	649	157

Notes on the Financial Statements (continued)

42 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**246,332**	254,147	**174,049**	166,884
Other contingent liabilities	**1,795**	652	**1,722**	660
	248,127	254,799	**175,771**	167,544
Commitments				
Documentary credits and short-term trade-related transactions	**37,874**	37,693	**30,989**	27,539
Forward asset purchases and forward forward deposits placed	**1,717**	5,218	**442**	2,570
Undrawn formal standby facilities, credit lines and other commitments to lend	**1,856,651**	1,658,822	**1,269,341**	1,115,409
	1,896,242	1,701,733	**1,300,772**	1,145,518

The above table discloses the nominal principal amounts of commitments excluding capital commitments, guarantees and other contingent liabilities, which are mainly credit-related instruments including both financial and non-financial guarantees and commitments to extend credit. Contractual amounts represent the amounts at risk should contracts be fully drawn upon and clients default. The amount of the loan commitments shown above reflects, where relevant, the expected level of take-up of pre-approved facilities. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contractual amounts is not representative of future liquidity requirements.

b *Guarantees (including financial guarantee contracts)*

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

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Guarantees in favour of third parties				
Financial guarantees [1]	**54,827**	80,943	**36,631**	36,833
Other guarantees [2]	**173,960**	164,653	**124,062**	118,430
	228,787	245,596	**160,693**	155,263
Guarantees in favour of other HSBC Group entities	**17,545**	8,551	**13,356**	11,621
	246,332	254,147	**174,049**	166,884

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 *Other guarantees include re-insurance letters of credit related to particular transactions, trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment, performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees.*

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.

43 Capital commitments

	The group		The Bank	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**4,855**	2,440	**3,062**	1,952
Expenditure authorised by the Directors but not contracted for	**77**	376	**73**	368
	4,932	2,816	**3,135**	2,320

Capital commitments mainly relate to the commitment for purchase of premises.

44 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	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**2,893**	2,931	**1,334**	1,342
– five years or less but over one year	**4,345**	4,761	**2,475**	2,463
– over five years	**937**	820	**344**	555
	8,175	8,512	**4,153**	4,360
Equipment				
Amounts payable within				
– one year or less	**49**	64	**13**	8
– five years or less but over one year	**21**	42	**8**	13
	70	106	**21**	21

Notes on the Financial Statements (continued)

45 Offsetting of financial assets and financial liabilities

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

	Gross amounts of recognised financial assets HK$m	Gross amounts set off in the balance sheet HK$m	Amounts presented in the balance sheet HK$m	Amounts not set off in the balance sheet: Financial instruments[1] HK$m	Amounts not set off in the balance sheet: Cash collateral received HK$m	Net amount HK$m
At 31 December 2014						
Derivatives[2]	**436,116**	**(46,182)**	**389,934**	**296,580**	**25,204**	**68,150**
Reverse repurchase, securities borrowing and similar agreements classified as:						
– Trading assets	**283**	**–**	**283**	**201**	**–**	**82**
– Placings with banks	**244,831**	**–**	**244,831**	**219,583**	**12**	**25,236**
– Loans and advances to customers at amortised cost	**78,637**	**–**	**78,637**	**77,876**	**–**	**761**
Other loans and advances held at amortised cost						
– To customers	**15,044**	**(15,044)**	**–**	**–**	**–**	**–**
	774,911	**(61,226)**	**713,685**[3]	**594,240**	**25,216**	**94,229**
At 31 December 2013						
Derivatives[2]	423,336	(34,609)	388,727	286,782	34,721	67,224
Reverse repurchase, securities borrowing and similar agreements classified as:						
– Trading assets	8	–	8	–	–	8
– Placings with banks	179,748	–	179,748	158,775	95	20,878
– Loans and advances to customers at amortised cost	60,655	–	60,655	60,324	2	329
Other loans and advances held at amortised cost						
– To customers	15,039	(15,039)	–	–	–	–
	678,786	(49,648)	629,138[3]	505,881	34,818	88,439

1 *Inclues non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

3 *Amounts presented in the balance sheet includes HK187,985m (2013: HK$177,875m) which represent balances due from Group companies.*

45 Offsetting of financial assets and financial liabilities *(continued)*

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

	Gross amounts of recognised financial liabilities HK$m	Gross amounts set off in the balance sheet HK$m	Amounts presented in the balance sheet HK$m	Amounts not set off in the balance sheet: Financial instruments[1] HK$m	Amounts not set off in the balance sheet: Cash collateral pledged HK$m	Net amount HK$m
At 31 December 2014						
Derivatives[2]	**413,310**	**(46,182)**	**367,128**	**302,619**	**22,527**	**41,982**
Repurchase, securities lending and similar agreements classified as:						
– Trading liabilities	**494**	**–**	**494**	**470**	**–**	**24**
– Deposits by banks	**40,913**	**–**	**40,913**	**30,958**	**32**	**9,923**
– Customer accounts	**42,671**	**–**	**42,671**	**41,513**	**–**	**1,158**
Other deposits by banks at amortised cost	**–**	**–**	**–**	**–**	**–**	**–**
Other customer accounts at amortised cost	**15,044**	**(15,044)**	**–**	**–**	**–**	**–**
	512,432	**(61,226)**	**451,206[3]**	**375,560**	**22,559**	**53,087**
At 31 December 2013						
Derivatives[2]	399,661	(34,609)	365,052	289,076	24,779	51,197
Repurchase, securities lending and similar agreements classified as:						
– Trading liabilities	470	–	470	411	–	59
– Deposits by banks	7,741	–	7,741	5,703	–	2,038
– Customer accounts	24,695	–	24,695	23,474	–	1,221
Other deposits by banks at amortised cost	2	–	2	–	–	2
Other customer accounts at amortised cost	15,039	(15,039)	–	–	–	–
	447,608	(49,648)	397,960[3]	318,664	24,779	54,517

1 *Includes non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

3 *Amounts presented in the balance sheet includes HK$161,910m (2013: HK$122,327m) which represent balances due to Group companies.*

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

Derivatives and reverse repurchase/repurchase, stock borrowing/lending and other similar agreements included in amounts not set off in the balance sheet relate to transactions where:

- the counterparty has an offsetting exposure with the group and a master netting or similar arrangement is in place with a right of set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- cash and non-cash collateral received/pledged in respect of the transactions described above.

The group offsets certain loans and advances to customers and customer accounts when the offset criteria are met and the amounts presented above represent this subset of the total amounts recognised in the balance sheet. Of this subset, the loans and advances to customers and customer accounts included in amounts not set off in the balance sheet primarily relate to transactions where the counterparty has an offsetting exposure with the group and an agreement is in place with the right of offset but the offset criteria are otherwise not satisfied.

46 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.

46 Segmental analysis *(continued)*

Total assets

	2014		2013	
	HK$m	%	HK$m	%
Hong Kong	**4,630,716**	**67.3**	4,362,910	67.8
Rest of Asia-Pacific	**2,788,418**	**40.5**	2,611,188	40.5
Intra region	**(542,388)**	**(7.8)**	(534,743)	(8.3)
	6,876,746	**100.0**	6,439,355	100.0

Total liabilities

	2014		2013	
	HK$m	%	HK$m	%
Hong Kong	**4,325,607**	**69.0**	4,069,805	68.8
Rest of Asia-Pacific	**2,485,181**	**39.7**	2,382,069	40.3
Intra region	**(542,388)**	**(8.7)**	(534,743)	(9.1)
	6,268,400	**100.0**	5,917,131	100.0

Interests in associates and joint ventures

	2014		2013	
	HK$m	%	HK$m	%
Hong Kong	**2,316**	**2.0**	2,136	2.0
Rest of Asia-Pacific	**114,338**	**98.0**	105,716	98.0
	116,654	**100.0**	107,852	100.0

Credit commitments and contingencies (contract amounts)

	2014		2013	
	HK$m	%	HK$m	%
Hong Kong	**1,130,366**	**52.7**	975,565	49.9
Rest of Asia-Pacific	**1,014,003**	**47.3**	980,967	50.1
	2,144,369	**100.0**	1,956,532	100.0

Additions to property, plant and equipment and other intangible assets during the year

	2014		2013	
	HK$m	%	HK$m	%
Hong Kong	**3,512**	**79.6**	9,163	92.4
Rest of Asia-Pacific	**898**	**20.4**	758	7.6
	4,410	**100.0**	9,921	100.0

Notes on the Financial Statements (continued)

46 Segmental analysis *(continued)*

Consolidated income statement

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2014				
Interest income	57,751	72,841	(3,810)	126,782
Interest expense	(6,977)	(28,508)	3,812	(31,673)
Net interest income	50,774	44,333	2	95,109
Fee income	34,708	17,301	(1,347)	50,662
Fee expense	(4,712)	(2,675)	1,347	(6,040)
Net trading income	11,663	8,559	(2)	20,220
Net income from financial instruments designated at fair value	3,134	914	–	4,048
Gains less losses from financial investments	2,286	103	–	2,389
Dividend income	1,362	12	–	1,374
Net insurance premium income	50,226	7,081	–	57,307
Net loss on reclassification of associates	–	(251)	–	(251)
Other operating income	10,872	1,944	(4,063)	8,753
Total operating income	160,313	77,321	(4,063)	233,571
Net insurance claims and benefits paid and movement in liabilities to policyholders	(52,916)	(7,266)	–	(60,182)
Net operating income before loan impairment charges and other credit risk provisions	107,397	70,055	(4,063)	173,389
Loan impairment charges and other credit risk provisions	(2,478)	(2,447)	–	(4,925)
Net operating income	104,919	67,608	(4,063)	168,464
Operating expenses	(42,270)	(34,743)	4,063	(72,950)
Operating profit	62,649	32,865	–	95,514
Share of profit in associates and joint ventures	317	15,358	–	15,675
Profit before tax	62,966	48,223	–	111,189
Tax expense	(10,132)	(8,880)	–	(19,012)
Profit for the year	52,834	39,343	–	92,177
Profit attributable to shareholders	47,228	39,200	–	86,428
Profit attributable to non-controlling interests	5,606	143	–	5,749
Net operating income				
– external	95,906	69,459	–	165,365
– inter-company/inter-segment	9,013	(1,851)	(4,063)	3,099
Depreciation and amortisation included in operating expenses	(4,551)	(1,227)	–	(5,778)
Restructuring costs	(55)	(12)	–	(67)

46 Segmental analysis *(continued)*

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2013				
Interest income	52,190	67,956	(3,107)	117,039
Interest expense	(6,508)	(26,227)	3,061	(29,674)
Net interest income	45,682	41,729	(46)	87,365
Fee income	33,542	18,094	(1,449)	50,187
Fee expense	(4,748)	(2,965)	1,372	(6,341)
Net trading income	11,156	5,375	46	16,577
Net income from financial instruments designated at fair value	2,008	467	–	2,475
Gains less losses from financial investments	323	119	–	442
Dividend income	1,165	10	–	1,175
Net insurance premium income	47,173	6,490	–	53,663
Net gain on reclassification of associates	–	8,157	–	8,157
Gain on sale of Ping An	–	34,070	–	34,070
Other operating income	13,803	2,186	(4,571)	11,418
Total operating income	150,104	113,732	(4,648)	259,188
Net insurance claims and benefits paid and movement in liabilities to policyholders	(50,960)	(5,632)	–	(56,592)
Net operating income before loan impairment charges and other credit risk provisions	99,144	108,100	(4,648)	202,596
Loan impairment charges and other credit risk provisions	(1,032)	(2,500)	–	(3,532)
Net operating income	98,112	105,600	(4,648)	199,064
Operating expenses	(38,845)	(34,531)	4,648	(68,728)
Operating profit	59,267	71,069	–	130,336
Share of profit in associates and joint ventures	524	13,896	–	14,420
Profit before tax	59,791	84,965	–	144,756
Tax expense	(9,659)	(6,042)	–	(15,701)
Profit for the year	50,132	78,923	–	129,055
Profit attributable to shareholders	43,688	75,321	–	119,009
Profit attributable to non-controlling interests	6,444	3,602	–	10,046
Net operating income				
– external	89,322	106,563	–	195,885
– inter-company/inter-segment	8,790	(963)	(4,648)	3,179
Depreciation and amortisation included in operating expenses	(4,271)	(1,392)	–	(5,663)
Restructuring costs	(43)	(619)	–	(662)

Notes on the Financial Statements (continued)

46 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 2014							
External	**52,725**	**41,199**	**65,475**	**2,735**	**3,231**	**–**	**165,365**
Intercompany/intersegment	**11,815**	**(720)**	**(10,867)**	**1,190**	**8,225**	**(6,544)**	**3,099**
Year ended 31 December 2013							
External	52,213	38,304	62,749	362	42,257	–	195,885
Intercompany/intersegment	11,585	(137)	(8,646)	286	7,205	(7,114)	3,179

Information by country

	Net external operating income[1]		Non-current assets[2]	
	2014 HK$m	2013 HK$m	**2014 HK$m**	2013 HK$m
Hong Kong	**95,906**	89,322	**98,056**	94,525
Mainland China	**17,085**	52,948	**121,426**	112,024
Australia	**7,210**	7,347	**1,034**	1,212
India	**7,815**	7,697	**2,374**	2,152
Indonesia	**3,962**	4,617	**3,869**	4,012
Malaysia	**6,958**	7,025	**944**	1,002
Singapore	**9,493**	8,233	**1,429**	1,548
Taiwan	**3,597**	3,311	**2,174**	2,352
Other	**13,339**	15,385	**2,716**	3,232
Total	**165,365**	195,885	**234,022**	222,059

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.*

47 Related party transactions

a *Immediate and ultimate holding company*

The group is wholly owned by HSBC Asia Holdings BV. HSBC Asia Holdings BV is in turn wholly owned by HSBC Asia Holdings (UK) Limited, which is wholly owned by HSBC Holdings BV. HSBC Holdings BV is wholly owned by HSBC Finance (Netherlands), which is wholly owned by HSBC Holdings plc (incorporated in England).

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for the benefit of the group's employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

Transactions with the immediate holding company included the redemption of preference shares. These are classified as liabilities on the balance sheet. Information relating to preference shares can be found in note 35.

Transactions with the ultimate holding company included the issuance of subordinated liabilities. These are classified as liabilities on the balance sheet. There was also the issuance of other equity instruments. Information relating to other equity instruments can be found in note 37.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**976**	1,591	**569**	305
Other operating income	**–**	–	**318**	274
Other operating expenses	**13**	14	**2,331**	1,757

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.*

Balances at 31 December

The group

	Immediate holding company		Ultimate holding company	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Other assets	**–**	–	**30**	160
	–	–	**30**	160
Liabilities				
Other liabilities	**525**	657	**625**	415
Subordinated liabilities	**–**	–	**22,185**	15,788
Preference shares	**36,474**	47,205	**–**	–
	36,999	47,862	**22,810**	16,203
Guarantees	**–**	–	**–**	370

Notes on the Financial Statements (continued)

47 Related party transactions *(continued)*

The Bank

	Immediate holding company		Ultimate holding company	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Other assets	**–**	–	**28**	160
	–	–	**28**	160
Liabilities				
Other liabilities	**525**	657	**469**	237
Subordinated liabilities	**–**	–	**22,185**	15,788
Preference shares	**36,474**	47,205	**–**	–
	36,999	47,862	**22,654**	16,025

b *Share option and share award schemes*

The group participates in various share option and share plans operated by HSBC whereby share options or shares of HSBC are granted to employees of the group. As disclosed in note 48, the group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of share options is treated as a capital contribution and is recorded within 'Other reserves'. In respect of share awards, the group recognises a liability to the ultimate holding company over the vesting period. This liability is measured at the fair value of the shares at each reporting date, with changes since award date adjusted through the capital contribution account within 'Other reserves'. The balances of the capital contribution and the liability as at 31 December 2014 amounted to HK$3,139m and HK$2,186m respectively (2013: HK$2,877m and HK$2,303m respectively).

c *Pension funds*

At 31 December 2014, HK$11.2bn (2013: HK$13.7bn) 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$22m for the year (2013: HK$51m).

d *Subsidiaries and fellow subsidiaries*

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

The group shares the costs of certain IT projects with its fellow subsidiaries and also used certain processing services of fellow subsidiaries on a cost recovery basis. The Bank also acted as agent for the distribution of retail investment funds for fellow subsidiaries and paid professional fees for services provided by fellow subsidiaries. The commissions and fees in these transactions and services are priced on an 'arm's length' basis.

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

47 Related party transactions *(continued)*

Income and expenses for the year

	Fellow subsidiaries	
	2014	2013
	HK$m	HK$m
Interest income	**384**	481
Interest expense	**227**	281
Fee income	**2,404**	3,232
Fee expense	**870**	876
Other operating income	**2,756**	2,739
Other operating expenses[1]	**6,961**	5,942

1 *In 2014 payments were made of HK$1,002m (2013: HK$946m) for software costs which were capitalised as intangible assets in the balance sheet of the group.*

Balances at 31 December

The group

	Fellow subsidiaries	
	2014	2013
	HK$m	HK$m
Assets		
Trading assets	**8,600**	4,644
Other assets	**183,064**	157,171
	191,664	161,815
Liabilities		
Trading liabilities	**12,633**	10,804
Financial liabilities designated at fair value	**4**	1
Other liabilities	**99,842**	64,132
Preference shares	**108**	109
	112,587	75,046
Guarantees	**17,545**	8,551
Commitments	**2,185**	1,930

The Bank

	Subsidiaries		Fellow subsidiaries	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
Assets				
Trading assets	**14,257**	6,869	**8,434**	4,551
Financial investments	**7,497**	11,401	**–**	–
Other assets	**213,521**	208,056	**160,399**	135,852
	235,275	226,326	**168,833**	140,403
Liabilities				
Trading liabilities	**10,753**	9,244	**12,493**	10,733
Other liabilities	**98,415**	81,163	**43,095**	38,322
	109,168	90,407	**55,588**	49,055
Guarantees	**3,971**	4,399	**9,385**	7,222
Commitments	**42,563**	34,719	**1,866**	1,563

Notes on the Financial Statements (continued)

47 Related party transactions *(continued)*

Derivative balances

In addition, the group and the Bank had the following derivative asset and derivative liability balances with other HSBC Group entities:

	The group		The Bank	
	2014 HK$m	2013 HK$m	**2014 HK$m**	2013 HK$m
Derivative assets	**98,346**	88,350	**103,572**	92,296
Derivative liabilities	**106,704**	96,203	**107,967**	98,439

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 22. Transactions and balances during the year with associates and joint ventures were as follows:

The group

	2014		2013	
	Highest balance during the year HK$m	**Balance at 31 December HK$m**	Highest balance during the year HK$m	Balance at 31 December HK$m
Amounts due from associates				
– unsubordinated	**41,814**	**32,848**	41,397	35,348
Amounts due from joint ventures				
– subordinated	**–**	**–**	6	–
– unsubordinated	**1**	**–**	2	1
	41,815	**32,848**	41,405	35,349
Amounts due to associates	**5,038**	**1,259**	9,083	2,226
Amounts due to joint ventures	**–**	**–**	–	–
	5,038	**1,259**	9,083	2,226
Commitments	**11**	**1**	543	133

The Bank

	2014		2013	
	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	**20,958**	**14,139**	19,222	18,999
Amounts due from joint ventures				
– unsubordinated	**1**	**–**	2	1
	20,959	**14,139**	19,224	19,000
Amounts due to associates	**2,556**	**837**	1,929	1,929
Amounts due to joint ventures	**–**	**–**	–	–
	2,556	**837**	1,929	1,929
Commitments	**11**	**1**	251	10

47 Related party transactions *(continued)*

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 due 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.

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:

	2014	2013
	HK$m	HK$m
Salaries and other short term benefits	**209**	200
Retirement benefits		
– Defined contribution plans	**5**	5
– Defined benefit plans	**5**	3
Termination benefits	**–**	3
Share-based payments	**177**	102
	396	313

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:

	2014	2013
	HK$m	HK$m
During the year		
Highest average assets[1]	**34,385**	27,428
Highest average liabilities[1]	**41,527**	30,281
Contribution to the group's profit before tax	**1,056**	808
At the year end		
Guarantees	**4,809**	6,721
Commitments	**3,483**	2,622

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

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

The group adheres to Hong Kong Banking Ordinance Section 83 regarding lending to related parties; this includes unsecured lending to Key Management Personnel, their relatives and companies that may be directly or indirectly influenced or controlled by such individuals.

No impairment losses have been recorded against balances outstanding during the year with Key Management Personnel, and there are no specific impairment allowances on balances with Key Management Personnel at the year end.

Notes on the Financial Statements (continued)

47 Related party transactions *(continued)*

g *Loans to officers*

Officers are defined as the Board of Directors, Executive Committee members and the Secretary of the Bank and the Boards of Directors of the ultimate holding company, HSBC Holdings plc, and intermediate holding companies. Particulars of loans to officers disclosed pursuant to section 78 of Schedule 11 to the Hong Kong Companies Ordinance (Cap. 622), which requires compliance with section 161B of the predecessor Hong Kong Companies Ordinance (Cap. 32) are as follows:

	Aggregate amount of loans outstanding at 31 December		Maximum aggregate amount of loans outstanding during the year	
	2014	2013	**2014**	2013
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**171**	272	**184**	286
By subsidiaries	**10**	8	**11**	11
	181	280	**195**	297

48 Share-based payments

a *Income statement charge*

	2014	2013
	HK$m	HK$m
Restricted share awards	**1,398**	1,090
Savings-related share awards and option plans	**94**	160
	1,492	1,250
Equity-settled share-based payments	**1,442**	1,185
Cash-settled share-based payments	**50**	65

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.

48 Share-based payments *(continued)*

b *HSBC Share Award and Option Plans*

Award	Policy	Purpose
Restricted share awards (including Group Performance Share Plan)	• Vesting of awards generally subject to continued employment with HSBC. • Vesting often staggered over three years. GPSP awards vest after five years. • Certain shares subject to a retention requirement post-vesting. In the case of GPSP awards retention applies until cessation of employment. • Awards generally not subject to performance conditions. • Awards granted from 2010 onwards are subject to clawback provision prior to vesting.	• Rewards employee performance, potential and retention of key employees. • To defer variable pay.
Savings-related share award plan ('HSBC International Employee Share Purchase Plan')	• A new broad-based employee plan which was offered to eligible employees in Hong Kong in 2013. The plan was offered to six more countries within the group in 2014. • Eligible employees make contributions up to the local equivalent of £250 per month which are applied in the purchase of shares on a quarterly basis. For every three shares purchased, the employee is granted a matching award by HSBC of one share. • The matching award vests subject to continued employment with HSBC and retention of the purchased shares in the plan until the third anniversary of the start of the relevant plan year.	• To align the interests of all employees with the creation of shareholder value.
Savings-related share option plans	• Eligible employees save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or Euros), with the option to use the savings to acquire shares. The last grant of options under this plan was in 2012. • Exercisable within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively. • The exercise price is set at a 20% (2012: 20%) discount to the market value immediately preceding the date of invitation (except for the one-year options granted under the US sub-plan where a 15% discount is applied).	• To align the interests of all employees with the creation of shareholder value.
Executive Share Option Scheme ('ESOS') and Group Share Option Plan ('GSOP')	• Plan ceased in May 2005. • Exercisable between third and tenth anniversaries of the date of grant.	• Long-term incentive plan between 2000 and 2005 during which certain HSBC employees were awarded share options. • To align the interests of those higher performing employees with the creation of shareholder value.

Calculation of fair values

The fair values of share options at the date of grant of the options are calculated using a Black-Scholes model. The fair value of a share award is based on the share price at the date of the grant.

48 Share-based payments *(continued)*

c *Movement on HSBC share awards*

The group

	Restricted share awards	
	2014 Number (000s)	2013 Number (000s)
Outstanding at 1 January	**25,369**	36,040
Additions during the year	**19,177**	9,481
Released in the year	**(18,975)**	(20,672)
Transferred in the year	**3,654**	2,949
Lapsed in the year	**(764)**	(2,429)
Outstanding at 31 December	**28,461**	25,369
Weighted average fair value of awards granted (HK$)	**79.31**	77.99

d *HSBC Share Option Plans*

Significant weighted average assumptions used to estimate the fair value of options granted

	3-year Savings-Related Share Option Schemes	5-year Savings-Related Share Option Schemes
2014		
Risk-free interest rate[1] (%)	**1.4**	**1.9**
Expected life[2] (years)	**3**	**5**
Expected volatility[3] (%)	**20**	**20**
Share price at grant date (£)	**6.52**	**6.52**
2013		
Risk-free interest rate[1] (%)	0.9	1.7
Expected life[2] (years)	3	5
Expected volatility[3] (%)	20	20
Share price at grant date (£)	6.89	6.89

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 (2013: 4.5%) which vested in subsequent years.

48 Share-based payments *(continued)*

e *Movement on HSBC share option plans*

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$
2014						
Outstanding at 1 January	**7,258**	**7.22**	**5,469**	**3.88**	**23,889**	**43.27**
Granted during the year	**–**	**–**	**15**	**5.19**	**–**	**–**
Forfeited/expired in the year	**(7,219)**	**7.22**	**(335)**	**4.44**	**(621)**	**50.32**
Exercised during the year	**(2)**	**7.22**	**(3,079)**	**3.49**	**(16,767)**	**38.46**
Transferred in the year	**47**	**7.24**	**71**	**4.79**	**1**	**52.03**
Outstanding at 31 December	**84**	**7.29**	**2,141**	**4.38**	**6,502**	**54.97**
Exercisable at 31 December	**84**	**7.29**	**388**	**3.60**	**473**	**42.95**
At 31 December 2014						
Weighted average fair value of options granted during the year		**–**		**1.16**		**–**
Weighted average share price at the date the options were exercised		**6.13**		**6.40**		**82.95**
Weighted average remaining contractual life (years)		**0.30**		**0.67**		**0.71**
Exercise price range		**7.29**		**3.31 – 5.47**		**37.88 – 63.99**
2013						
Outstanding at 1 January	11,203	6.83	9,058	4.08	30,532	45.54
Granted during the year	–	–	18	5.47	–	–
Forfeited/expired in the year	(1,831)	6.18	(952)	4.25	(1,332)	50.17
Exercised during the year	(2,297)	6.16	(2,894)	4.44	(5,751)	53.95
Transferred in the year	183	7.25	239	4.16	440	46.59
Outstanding at 31 December	7,258	7.22	5,469	3.88	23,889	43.27
Exercisable at 31 December	7,258	7.22	109	5.57	103	66.82
At 31 December 2013						
Weighted average fair value of options granted during the year		–		1.20		–
Weighted average share price at the date the options were exercised		7.06		7.05		85.03
Weighted average remaining contractual life (years)		0.34		0.98		0.90
Exercise price range		7.22 – 7.54		3.31 – 5.94		37.88 – 92.59

1 *Weighted Average Exercise Price.*

During the year, no options were granted for schemes with option prices set in euros and US dollars.

49 Fair value of financial instruments carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described in note 2 and note 3. The fair value of financial instruments is generally measured on the basis of the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the HKFRS offsetting criteria as described in note 3(m).

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following table sets out the financial instruments carried at fair value.

Financial instruments carried at fair value and bases of valuation

The group

		Valuation techniques				
	Quoted market price Level 1 HK$m	Using observable inputs Level 2 HK$m	With significant unobservable inputs Level 3 HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2014						
Assets						
Trading assets[2]	**210,397**	**196,464**	**165**	**407,026**	**–**	**407,026**
Derivatives	**9,039**	**281,764**	**785**	**291,588**	**98,346**	**389,934**
Financial assets designated at fair value	**73,337**	**22,947**	**1,911**	**98,195**	**–**	**98,195**
Available-for-sale investments[1]	**736,254**	**530,901**	**6,712**	**1,273,867**	**–**	**1,273,867**
Liabilities						
Trading liabilities[2]	**63,614**	**140,045**	**12,153**	**215,812**	**–**	**215,812**
Derivatives	**10,766**	**248,550**	**1,108**	**260,424**	**106,704**	**367,128**
Financial liabilities designated at fair value	**–**	**48,834**	**–**	**48,834**	**–**	**48,834**
At 31 December 2013						
Assets						
Trading assets[2]	145,520	165,216	664	311,400	–	311,400
Derivatives	14,295	284,970	1,112	300,377	88,350	388,727
Financial assets designated at fair value	63,781	25,012	1,353	90,146	–	90,146
Available-for-sale investments[1]	739,792	449,296	11,218	1,200,306	–	1,200,306
Assets held for sale	–	–	4,295	4,295	–	4,295
Liabilities						
Trading liabilities[2]	53,138	124,065	17,829	195,032	–	195,032
Derivatives	15,125	252,279	1,445	268,849	96,203	365,052
Financial liabilities designated at fair value	–	41,715	–	41,715	–	41,715

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 19.*

2 *Amounts with HSBC Group entities are not reflected here.*

49 Fair value of financial instruments carried at fair value *(continued)*

The Bank

	Quoted market price Level 1 HK$m	Valuation techniques: Using observable inputs Level 2 HK$m	Valuation techniques: With significant unobservable inputs Level 3 HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2014						
Assets						
Trading assets[2]	**174,729**	**123,579**	**57**	**298,365**	**–**	**298,365**
Derivatives	**8,450**	**262,205**	**649**	**271,304**	**103,572**	**374,876**
Financial assets designated at fair value	**–**	**1,257**	**–**	**1,257**	**–**	**1,257**
Available-for-sale investments[1]	**543,146**	**173,944**	**4,893**	**721,983**	**–**	**721,983**
Liabilities						
Trading liabilities[2]	**35,671**	**59,669**	**3,209**	**98,549**	**–**	**98,549**
Derivatives	**10,513**	**234,116**	**1,049**	**245,678**	**107,967**	**353,645**
Financial liabilities designated at fair value	**–**	**9,180**	**–**	**9,180**	**–**	**9,180**
At 31 December 2013						
Assets						
Trading assets[2]	121,136	113,880	583	235,599	–	235,599
Derivatives	13,809	270,543	534	284,886	92,297	377,183
Financial assets designated at fair value	–	1,561	–	1,561	–	1,561
Available-for-sale investments[1]	582,340	169,370	6,873	758,583	–	758,583
Assets held for sale	–	–	4,295	4,295	–	4,295
Liabilities						
Trading liabilities[2]	28,348	49,140	5,135	82,623	–	82,623
Derivatives	15,010	240,233	1,013	256,256	98,439	354,695
Financial liabilities designated at fair value	–	4,759	–	4,759	–	4,759

1 *An analysis of available-for-sale investments across balance sheet lines can be found in note 19.*

2 *Amounts with HSBC Group entities are not reflected here.*

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

49 Fair value of financial instruments carried at fair value *(continued)*

Control framework

Fair values are subject to a control framework designed 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 valuation models, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an on-going basis.

Changes in fair value are generally subject to a profit and loss analysis process. This process disaggregates changes in fair value into three high level categories: (i) portfolio changes, such as new transactions or maturing transactions; (ii) market movements, such as changes in foreign exchange rates or equity prices; and (iii) other, such as changes in fair value adjustments.

To this end, the 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

Fair values are determined according to the following hierarchy:

(a) Level 1 – Valuation technique using quoted market price

Financial instruments with quoted prices for identical instruments in active markets that the group can access at the measurement date.

(b) Level 2 – Valuation technique using observable inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(c) Level 3 – Valuation technique with significant unobservable inputs

Financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities used. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of financial instrument is calculated as the product of the number of units and quoted price. In the event that the market for a financial instrument is not active, another valuation technique is used.

49 Fair value of financial instruments carried at fair value *(continued)*

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.

Financial liabilities measured at fair value

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

Fair value adjustments

Fair value adjustments are adopted when the group considers that there are additional factors that would be considered relevant by a market participant that are not incorporated within the valuation model. The group classifies fair value adjustments as either ‘risk-related’ or ‘model-related’. The majority of these adjustments relate to Global Banking and Markets.

Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.

49 Fair value of financial instruments carried at fair value *(continued)*

Risk-related adjustments

(i) Bid-offer

HKFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer costs would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of, or unwinding the position.

(ii) Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

(iii)Credit valuation adjustment

The credit valuation adjustment is an adjustment to the valuation of over-the-counter ('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. Further detail is provided below.

(iv)Debit valuation adjustment

The debit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the group may default, and that the group may not pay full market value of the transactions.

(v)Funding fair value adjustment

The funding fair value adjustment is calculated by applying future market funding spreads to the expected future funding exposure of any uncollateralised component of the OTC derivative portfolio. This includes the uncollateralised component of collateralised derivatives in addition to derivatives that are fully uncollateralised. The expected future funding exposure is calculated by a simulation methodology, where available. The expected future funding exposure is adjusted for events that may terminate the exposure such as the default of the group or the counterparty. The funding fair value adjustment and debit valuation adjustment are calculated independently.

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 when the fair value estimated by a valuation model is based on one or more significant unobservable inputs. The accounting for inception profit adjustments is discussed in note 3(i). An analysis of the movement in the deferred Day 1 profit or loss reserve is provided in note 13(c).

49 Fair value of financial instruments carried at fair value *(continued)*

Credit valuation adjustment/ debit valuation adjustment methodology

The group calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each group legal entity and, within each entity, for each counterparty to which the entity has exposure.

The group calculates the CVA by applying the probability of default ('PD') of the counterparty, conditional on the non-default of the group, to the expected positive exposure of the group to the counterparty and multiplying the result by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the PD of the group, conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the group, and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

For most products, the group uses a simulation methodology to calculate the expected positive exposure to a counterparty. This incorporates a range of potential exposures across the portfolio of transactions with the counterparty over the life of the portfolio. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default ('LGD') assumption of 60% is generally adopted for developed market exposures, and 75% for emerging market exposures. Alternative loss given default assumptions may be adopted where both the nature of the exposure and the available data support this.

For certain types of exotic derivatives, where the products are not currently supported by the simulation, or for derivative exposures in smaller trading locations, where the simulation tool is not yet available, the group adopts alternative methodologies. These may involve mapping to the results for similar products from the simulation tool or, where the mapping approach is not appropriate, using a simplified methodology, which generally follows the same principles as the simulation methodology. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than is used in the simulation methodology.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises when the underlying value of the derivative prior to any CVA is positively correlated to the probability of default by the counterparty. When there is significant wrong-way risk, a trade-specific approach is applied to reflect the wrong-way risk within the valuation.

With the exception of certain central clearing parties, the group includes all third-party counterparties in the CVA and DVA calculations and does not net these adjustments across the group entities. The group reviews and refines the CVA and DVA methodologies on an ongoing basis.

Valuation of uncollateralised derivatives

Historically, the group has valued uncollateralised derivatives by discounting expected future cash flows at a benchmark interest rate, typically Libor or its equivalent. In line with evolving industry practice, the group changed this approach in the second half of 2014. The group now views the overnight index swap ('OIS') curve as the base discounting curve for all derivatives, both collateralised and uncollateralised, and has adopted a 'funding fair value adjustment' to reflect the funding of uncollateralised derivative exposure at rates other than OIS. The impact of adopting the funding fair value adjustment was a reduction in trading revenues of HK$76m. This is an area in which a full industry consensus has not yet emerged. The group will continue to monitor industry evolution and refine the calculation methodology as necessary.

Notes on the Financial Statements (continued)

49 Fair value of financial instruments carried at fair value *(continued)*

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

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

The group

	Assets					Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2014	**11,218**	**664**	**1,353**	**1,112**	**4,295**	**17,829**	**1,445**
Total gains or losses recognised in profit or loss	**1,166**	**(3)**	**291**	**(124)**	**3,332**	**(1,473)**	**109**
– Trading income excluding net interest income	**–**	**(3)**	**–**	**(124)**	**–**	**(1,473)**	**109**
– Net income from other financial instruments designated at fair value	**–**	**–**	**291**	**–**	**–**	**–**	**–**
– Gains less losses from financial investments	**1,166**	**–**	**–**	**–**	**3,332**	**–**	**–**
Total gains or losses recognised in other comprehensive income	**(29)**	**(24)**	**–**	**(10)**	**(3,458)**	**(331)**	**(6)**
– Available-for-sale investments: fair value gains/(losses)	**31**	**–**	**–**	**–**	**(3,458)**	**–**	**–**
– Exchange differences	**(60)**	**(24)**	**–**	**(10)**	**–**	**(331)**	**(6)**
Purchases	**1,359**	**421**	**587**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**–**	**4,950**	**–**
Sales	**(2,419)**	**(630)**	**(45)**	**–**	**(4,169)**	**–**	**–**
Deposits/settlements	**(4,583)**	**–**	**(527)**	**397**	**–**	**(3,814)**	**301**
Transfers out	**–**	**(274)**	**–**	**(624)**	**–**	**(5,085)**	**(847)**
Transfers in	**–**	**11**	**252**	**34**	**–**	**77**	**106**
At 31 December 2014	**6,712**	**165**	**1,911**	**785**	**–**	**12,153**	**1,108**
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	**(88)**	**(2)**	**296**	**47**	**–**	**(3)**	**(110)**
– Trading income excluding net interest income	**–**	**(2)**	**–**	**47**	**–**	**(3)**	**(110)**
– Net income/(expense) from other financial instruments designated at fair value	**–**	**–**	**296**	**–**	**–**	**–**	**–**
– Impairment charges	**(88)**	**–**	**–**	**–**	**–**	**–**	**–**

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.*

49 Fair value of financial instruments carried at fair value *(continued)*

The group

	Assets					Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2013	11,712	232	1,549	825	3,878	11,091	3,659
Total gains or losses recognised in profit or loss	134	37	65	653	–	(802)	3,996
– Trading income excluding net interest income	–	37	–	653	–	(802)	3,996
– Net income from other financial instruments designated at fair value	–	–	65	–	–	–	–
– Gains less losses from financial investments	134	–	–	–	–	–	–
Total gains or losses recognised in other comprehensive income	1,295	–	–	(5)	–	(255)	(1)
– Available-for-sale investments: fair value gains	1,304	–	–	–	–	–	–
– Exchange differences	(9)	–	–	(5)	–	(255)	(1)
Purchases	557	854	402	–	–	–	–
Issues	–	–	–	–	–	7,114	–
Sales	(33)	(248)	(35)	–	–	–	–
Deposits/settlements	(2,704)	(31)	(209)	(65)	–	2,883	(5,839)
Transfers out	(4,295)	(195)	(530)	(616)	(3,878)	(2,273)	(426)
Transfers in	4,552	15	111	320	4,295	71	56
At 31 December 2013	11,218	664	1,353	1,112	4,295	17,829	1,445
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	–	93	65	583	–	18	(279)
– Trading income excluding net interest income	–	93	–	583	–	18	(279)
– Net income/(expense) from other financial instruments designated at fair value	–	–	65	–	–	–	–

1 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

Notes on the Financial Statements (continued)

49 Fair value of financial instruments carried at fair value *(continued)*

The Bank

	Assets				Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2014	**6,873**	**583**	**534**	**4,295**	**5,135**	**1,013**
Total gains or losses recognised in profit or loss	**(1)**	**(1)**	**(140)**	**3,332**	**(889)**	**116**
– Trading income excluding net interest income	–	(1)	(140)	–	(899)	116
– Net income from other financial instruments designated at fair value	–	–	–	–	–	–
– Gains less losses from financial investments	(1)	–	–	3,332	–	–
Total gains or losses recognised in other comprehensive income	**458**	**(24)**	**(6)**	**(3,458)**	**(36)**	**(3)**
– Available-for-sale investments: fair value gains/(losses)	485	–	–	(3,458)	–	–
– Exchange differences	(27)	(24)	(6)	–	(36)	(3)
Purchases	1,029	393	–	–	–	–
Issues	–	–	–	–	4,419	–
Sales	(51)	(631)	–	(4,169)	–	–
Deposits/settlements	(3,415)	–	398	–	(3,507)	301
Transfers out	–	(274)	(170)	–	(1,928)	(484)
Transfers in	–	11	33	–	25	106
At 31 December 2014	**4,893**	**57**	**649**	**–**	**3,209**	**1,049**
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	–	1	(23)	–	(4)	(91)
– Trading income excluding net interest income	–	1	(23)	–	(4)	(91)

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.*

49 Fair value of financial instruments carried at fair value *(continued)*

The Bank

	Assets				Liabilities	
	Available-for-sale HK$m	Held for trading HK$m	Derivatives HK$m	Assets held for sale HK$m	Held for trading HK$m	Derivatives HK$m
At 1 January 2013	7,608	163	439	3,878	3,857	3,534
Total gains or losses recognised in profit or loss	8	37	51	–	(420)	3,347
– Trading income excluding net interest income	–	37	51	–	(420)	3,347
– Net income from other financial instruments designated at fair value	–	–	–	–	–	–
– Gains less losses from financial investments	8	–	–	–	–	–
Total gains or losses recognised in other comprehensive income	1,134	–	(5)	–	15	(5)
– Available-for-sale investments: fair value gains	1,109	–	–	–	–	–
– Exchange differences	25	–	(5)	–	15	(5)
Purchases	390	835	–	–	–	–
Issues	–	–	–	–	6,168	–
Sales	(19)	(248)	–	–	–	–
Deposits/settlements	(1,892)	(24)	2	–	(3,639)	(5,836)
Transfers out	(4,295)	(195)	(273)	(3,878)	(846)	(83)
Transfers in	3,939	15	320	4,295	–	56
At 31 December 2013	6,873	583	534	4,295	5,135	1,013
Unrealised gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[1]	–	93	132	–	–	34
– Trading income excluding net interest income	–	93	132	–	9	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.*

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

The investments in unlisted equity shares classified as assets held for sale had been sold during the year.

Transfers out of Level 3 held for trading liabilities predominantly resulted from an increase in the observability of inputs such as correlations in pricing the instruments.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under 'Net trading income'.

Fair value changes on assets and liabilities designated at fair value are presented in the income statement under 'Net income/(expense) from financial instruments designated at fair value'.

Realised gains and losses from available-for-sale securities are presented under 'Gains less losses from financial investments' in the income statement while unrealised gains and losses are presented in 'Fair value changes taken to equity' within 'Available-for-sale investments' in other comprehensive income.

Notes on the Financial Statements (continued)

49 Fair value of financial instruments carried at fair value *(continued)*

Effects of changes in significant non-observable assumptions to reasonably possible alternatives

As discussed above, the fair values of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions:

Sensitivity of fair values to reasonably possible alternative assumptions

The group

	Reflected in income statement		Reflected in other comprehensive income	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable changes HK$m
At 31 December 2014				
Derivatives/trading assets/trading liabilities	**329**	**(322)**	**–**	**–**
Financial assets/liabilities designated at fair value	**191**	**(191)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**672**	**(674)**
At 31 December 2013				
Derivatives/trading assets/trading liabilities	287	(281)	–	–
Financial assets/liabilities designated at fair value	135	(135)	–	–
Financial investments: available-for-sale	–	–	827	(1,186)

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 2014				
Derivatives/trading assets/trading liabilities	**297**	**(290)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**486**	**(489)**
At 31 December 2013				
Derivatives/trading assets/trading liabilities	239	(233)	–	–
Financial investments: available-for-sale	–	–	669	(692)

Favourable and unfavourable changes are determined on the basis of sensitivity analysis. The sensitivity analysis aims to measure a range of fair values consistent with the application of a 95% confidence interval. Methodologies take account of the nature of the valuation technique employed, as well as the availability and reliability of observable proxy and historical data. When the available data is not amenable to statistical analysis, the quantification of uncertainty is judgemental, but remains guided by the 95% confidence interval.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or the most unfavourable change from varying the assumptions individually.

49 Fair value of financial instruments carried at fair value *(continued)*

Quantitative information about significant unobservable inputs in Level 3 valuations

The group

At 31 December 2014

Valuation technique	Key unobservable inputs	Assets- fair value HK$m	Liabilities- fair value HK$m	Range of inputs Lower	Range of inputs Higher
Structured notes and deposits					
Option model	Equity correlation	–	6,342	0.27	0.92
Option model	Equity volatility	–	3,354	12%	50%
Option model	Interest rate correlation	–	791	0.40	0.96
Option model	Foreign exchange volatility	–	1,509	4%	19%
Corporate bonds					
Market comparable approach	Bid quotes	765	–	97.60	99.69
Private equity including strategic investments					
Market comparable approach	Equity spot	3,368	–	n/a	n/a
Net asset value	Equity spot	704	–	n/a	n/a
Net asset value	Fund valuation	2,108	–	n/a	n/a
Market comparable approach	Comparability adjustments	821	–	0.10	0.30
Broker pricing	Bid quotes	610	–	0.44	0.47
Other		1,197	1,265		
		9,573	13,261		

The Bank

At 31 December 2014

Valuation technique	Key unobservable inputs	Assets- fair value HK$m	Liabilities- fair value HK$m	Range of inputs Lower	Range of inputs Higher
Structured notes and deposits					
Option model	Equity correlation	–	932	0.27	0.92
Option model	Equity volatility	–	1,350	16%	50%
Option model	Interest rate correlation	–	738	0.60	0.96
Corporate bonds					
Market comparable approach	Bid quotes	765	–	97.60	99.69
Private equity including strategic investments					
Market comparable approach	Equity spot	2,991	–	n/a	n/a
Broker pricing	Bid quotes	610	–	0.44	0.47
Other		1,233	1,238		
		5,599	4,258		

49 Fair value of financial instruments carried at fair value *(continued)*

The group

At 31 December 2013

Valuation technique	Key unobservable inputs	Assets-fair value HK$m	Liabilities-fair value HK$m	Range of inputs Lower	Higher
Structured notes and deposits					
Option model	Equity correlation	–	8,155	0.51	0.59
Option model	Equity volatility	–	4,783	7%	73%
Option model	Fund volatility	–	1,568	7%	73%
Option model	Foreign exchange volatility	–	2,200	2%	25%
Corporate bonds					
Market comparable approach	Bid quotes	3,797	–	100.05	100.62
Private equity including strategic investments					
Market comparable approach	Equity spot	2,775	–	n/a	n/a
Net asset value	Equity spot	686	–	n/a	n/a
Net asset value	Fund valuation	4,441	–	n/a	n/a
Other		6,943	2,568		
		18,642	19,274		

The Bank

At 31 December 2013

Valuation technique	Key unobservable inputs	Assets-fair value HK$m	Liabilities-fair value HK$m	Range of inputs Lower	Higher
Structured notes and deposits					
Option model	Equity correlation	–	776	0.51	0.59
Option model	Equity volatility	–	3,269	7%	73%
Option model	Foreign exchange volatility	–	77	3%	11%
Corporate bonds					
Market comparable approach	Bid quotes	3,797	–	100.05	100.62
Private equity including strategic investments					
Market comparable approach	Equity spot	2,434	–	n/a	n/a
Net asset value	Equity spot	111	–	n/a	n/a
Net asset value	Fund valuation	189	–	n/a	n/a
Other		5,754	2,026		
		12,285	6,148		

Key unobservable inputs to Level 3 financial instruments

The table above lists key unobservable inputs to Level 3 financial instruments, and provides the range of those inputs as at 31 December 2014 and 2013. A further description of the categories of key unobservable inputs is given below.

Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that the group may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of the group's long option positions (i.e. the positions in which the group has purchased options), while the group's short option positions (i.e. the positions in which the group has sold options) will suffer losses.

49 Fair value of financial instruments carried at fair value *(continued)*

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels. For example, while it is generally the case that foreign exchange volatilities are lower than equity volatilities, there may be examples in particular currency pairs or for particular equities where this is not the case.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data. For example, longer-dated volatilities may be extrapolated from shorter-dated volatilities.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference to market price. For example, foreign exchange volatilities for a pegged currency may be very low, whereas for non-managed currencies, the foreign exchange volatility may be higher. As a further example, volatilities for deep-in-the money or deep-out-of-the-money equity options may be significantly higher than at-the-money options. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. For example, an equity basket option has a payout that is dependent upon the performance of a basket of single stocks, and the correlation between the price movements of those stocks will be an input to the valuation. This is referred to as equity-equity correlation. There is a wide range of instruments for which correlation is an input, and consequently a wide range of both same-asset correlations (e.g. equity-equity correlation) and cross-asset correlations (e.g. foreign exchange rate-interest rate correlation) used. In general, the range of same-asset correlations will be narrower than the range of cross-asset correlations.

Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, the group trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

Private equity including strategic investments

The group's private equity and strategic investments are generally classified as available-for-sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. Given the bespoke nature of the analysis in respect of each holding, it is not practical to quote a range of key unobservable inputs.

Inter-relationships between key unobservable inputs

Key unobservable inputs to Level 3 financial instruments may not be independent of each other. As described above, market variables may be correlated. This correlation typically reflects the manner in which different markets tend to react to macro-economic or other events. For example, improving economic conditions may lead to a 'risk on' market, in which prices of risky assets such as equities and high yield bonds will rise, while 'safe haven' assets such as gold and US Treasuries decline. Furthermore, the impact of changing market variables upon the group portfolio will depend upon the group's net risk position in respect of each variable. For example, increasing high-yield bond prices will benefit long high-yield bond positions, but the value of any credit derivative protection held against those bonds will fall.

Notes on the Financial Statements (continued)

50 Fair values of financial instruments not carried at fair value

The classification of financial instruments is determined in accordance with the accounting policies set out in note 3. Fair values are determined according to the hierarchy set out in note 49.

Fair values of financial instruments which are not carried at fair value and bases of valuation

The group

		Fair values			
			Valuation techniques		
	Carrying amount	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Total
At 31 December 2014	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Assets					
Reverse repurchase agreements – non-trading	**218,901**	**–**	**210,267**	**8,709**	**218,976**
Placings with and advances to banks	**488,313**	**–**	**479,348**	**9,106**	**488,454**
Loans and advances to customers	**2,815,216**	**–**	**22,940**	**2,780,358**	**2,803,298**
Financial investment debt securities	**182,626**	**4,768**	**185,968**	**–**	**190,736**
Liabilities					
Repurchase agreements – non-trading	**28,379**	**–**	**28,379**	**–**	**28,379**
Deposits by banks	**226,713**	**–**	**226,044**	**668**	**226,712**
Customer accounts	**4,479,992**	**–**	**4,479,985**	**–**	**4,479,985**
Debt securities in issue	**45,297**	**1,129**	**43,316**	**880**	**45,325**
Subordinated liabilities	**12,832**	**–**	**2,267**	**9,683**	**11,950**
Preference shares	**36,582**	**–**	**–**	**32,623**	**32,623**
At 31 December 2013					
Assets					
Reverse repurchase agreements – non-trading	150,584	–	150,286	228	150,514
Placings with and advances to banks	564,521	–	532,952	31,475	564,427
Loans and advances to customers	2,619,245	–	5,472	2,600,180	2,605,652
Financial investment debt securities	179,465	4,222	175,852	41	180,115
Liabilities					
Repurchase agreements – non-trading	6,312	–	6,320	–	6,320
Deposits by banks	231,358	–	231,358	–	231,358
Customer accounts	4,253,698	–	4,253,339	–	4,253,339
Debt securities in issue	52,334	1,291	49,969	1,192	52,452
Subordinated liabilities	13,107	–	2,452	9,834	12,286
Preference shares	47,314	–	–	41,500	41,500

50 Fair values of financial instruments not carried at fair value *(continued)*

The Bank

		Fair values			
			Valuation techniques		
	Carrying amount	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Total
At 31 December 2014	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
Assets					
Reverse repurchase agreements – non-trading	**116,113**	**–**	**107,809**	**8,709**	**116,518**
Placings with and advances to banks	**206,309**	**–**	**197,632**	**8,718**	**206,350**
Loans and advances to customers	**1,590,711**	**–**	**17,108**	**1,566,741**	**1,583,849**
Financial investment debt securities	**–**	**–**	**–**	**–**	**–**
Liabilities					
Repurchase agreements – non-trading	**21,033**	**–**	**21,033**	**–**	**21,033**
Deposits by banks	**174,385**	**–**	**173,716**	**668**	**174,384**
Customer accounts	**2,814,510**	**–**	**2,814,085**	**–**	**2,814,085**
Debt securities in issue	**32,089**	**–**	**32,083**	**1**	**32,084**
Subordinated liabilities	**9,337**	**–**	**–**	**8,412**	**8,412**
Preference shares	**36,474**	**–**	**–**	**32,516**	**32,516**
At 31 December 2013					
Assets					
Reverse repurchase agreements – non-trading	86,601	–	86,608	–	86,608
Placings with and advances to banks	250,918	–	234,332	16,824	251,156
Loans and advances to customers	1,483,910	–	2,812	1,473,508	1,476,320
Financial investment debt securities	–	–	–	–	–
Liabilities					
Repurchase agreements – non-trading	5,951	–	5,951	–	5,951
Deposits by banks	192,025	–	192,024	–	192,024
Customer accounts	2,723,322	–	2,723,353	–	2,723,353
Debt securities in issue	30,062	–	30,149	1	30,150
Subordinated liabilities	9,346	–	–	8,448	8,448
Preference shares	47,205	–	–	41,391	41,391

Majority of the financial instruments not carried at fair value are measured at amortised cost. The following table lists those financial instruments for which their carrying amounts are a reasonable approximation of fair values because, for example, they are short term in nature or re-price to current market rates frequently:

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission to other banks
Hong Kong Government certificates of indebtedness	Hong Kong currency notes in circulation
Items in the course of collection from other banks	Acceptances endorsements
Acceptances endorsements	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals
Accrued income within 'Liabilities under insurance contracts'	Investment contracts with discretionary participation features

50 Fair values of financial instruments not carried at fair value *(continued)*

Valuation

The fair values of financial instruments that are not carried at fair value on the balance sheet are calculated as described below.

The calculation of fair value incorporates the group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available.

Repurchase and reverse repurchase agreements – non-trading

Fair values are estimated by using discounted cash flows, applying current rates. Fair values approximate carrying amounts as their balances are generally short dated.

Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which the group believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors.

The fair value of a loan reflects loan impairments at the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

Financial investments

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

Deposits by banks and customer accounts

Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is approximated by its carrying value.

Debt securities in issue and subordinated liabilities

Fair values are estimated by discounting future cash flows using discount rates for the applicable maturities and taking into account own credit spread.

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

51 Structured entities

The group enters into certain transactions with customers in the ordinary course of business which involve the use of structured entities ('SEs') to facilitate or secure customer transactions. Some of these structures are complex or non-transparent. The group's arrangements that involve SEs are authorised centrally prior to being established to ensure appropriate purpose and governance. The activities of SEs administered by the group are closely monitored by senior management. The group has involvement with both consolidated and unconsolidated SEs, which may be established by the group or by a third party. Structured entities are assessed for consolidation in accordance with the accounting policy set out in note 1d.

The group's transactions with consolidated and unconsolidated SEs are set out below.

Structured credit transactions

The group provides structured credit products to third-party professional and institutional investors who wish to obtain exposure to a reference portfolio of debt instruments.

In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SEs. The group enters into contracts with the SE, including derivatives, in order to pass the required risks and rewards of the reference portfolios to the SEs.

In certain transactions the group is exposed to risk often referred to as gap risk. Gap risk typically arises in transactions where the aggregate potential claims against the SE by the group pursuant to one or more derivatives could be greater than the value of the collateral held by the SE and securing such derivatives. The group often mitigates such gap risk by ensuring high quality collateral, hedging the risk, or incorporating features allowing managed liquidation of the portfolio.

Securitisations by the group

The group uses SEs to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and for capital efficiency purposes. The loans and advances are transferred by the group to the SEs for cash, and the SEs issue debt securities to investors to fund the cash purchases. The group may also act as a derivative counterparty or provide a guarantee. Credit enhancements to the underlying assets may be provided to obtain investment grade ratings on the senior debt issued by the SEs.

The group's exposure is the aggregate of any holdings of notes issued by these vehicles, the reserve account positions intended to provide credit support under certain pre-defined circumstances to senior note holders and any derivatives or guarantees provided. Off balance sheet financial guarantees are disclosed in note 42(b).

Third-party financing SEs

The group also transacts with third party SEs in the normal course of business for a number of purposes, for example, to provide finance to public and private sector infrastructure projects, for asset and structured finance transactions and for customers to raise finance against security.

The assets are generally ring-fenced by the SE and, in most cases, the customer, a sponsor or third party provides some credit enhancement or guarantee in the structure. The group also has interests in third-party established structured entities by holding notes issued by these entities or entering into derivatives where the group absorbs risk from the entities.

The derivative and lending exposures are generally secured by the SE's assets, with credit enhancement and/or guarantees provided by third parties. The group's risk in relation to the derivative contracts and trading positions with these SEs is managed within the group's market risk framework (see 'Market Risk' in the 'Risk Report'). Credit risk is managed within the group's credit risk framework (see 'Credit Risk' in the 'Risk Report').

51 Structured entities *(continued)*

Funds

The group has established and managed money market funds and non-money market investment funds to provide customers with investment opportunities. The group, as the fund manager, may be entitled to receive management and performance fees based on the assets under management.

The group purchases and holds units of HSBC managed and third party managed funds in order to facilitate both business and customer needs. The majority of these funds held relate to the insurance business. The risks of unit holding are managed under a trading mandate or the investment risks associated with the insurance business are managed through matching assets and liabilities for non-linked products. Investment strategies are set with the intention to provide sufficient investment return to satisfy policyholders' reasonable expectations. Policyholders bear the market risk for unit-linked products. This is discussed in more detail in 'Insurance Risk' within the 'Risk Report'.

Unconsolidated structured entities

The term 'unconsolidated structured entities' refers to all SEs that are not controlled by the group.

The table below shows the total assets of unconsolidated SEs in which the group has an interest at the reporting date, as well as the group's maximum exposure to loss in relation to those interests.

The maximum exposure to loss from the group's interests in unconsolidated SEs represents the maximum loss that the group could incur as a result of its involvement with unconsolidated SEs regardless of the probability of the loss being incurred.

For commitments and guarantees, the maximum exposure to loss is the notional amount of potential future losses.

For retained and purchased investments in and loans to unconsolidated SEs, the maximum exposure to loss is the carrying value of these interests at the balance sheet reporting date.

The maximum exposure to loss is stated gross of the effects of hedging and collateral arrangements entered into to mitigate the group's exposure to loss.

Income from unconsolidated SEs includes recurring and non-recurring fees, interest, dividends, gains or losses on the re-measurement or derecognition of interests in structured entities, any mark-to-market gains or losses on a net basis and gains or losses from the transfer of assets and liabilities to the structured entity.

51 Structured entities *(continued)*

Nature and risks associated with the group's interests in unconsolidated structured entities

	Securitisations HK$m	HSBC managed funds HK$m	Non-HSBC managed funds HK$m	Other HK$m	Total HK$m
At 31 December 2014					
Total assets	**19,442**	**1,142,657**	**9,720,665**	**45,903**	**10,928,667**
The group's interest- assets					
Trading assets	**–**	**98**	**–**	**–**	**98**
Financial assets designated at fair value	**–**	**958**	**4,888**	**–**	**5,846**
Derivatives	**14**	**–**	**–**	**187**	**201**
Loans and advances to customers	**6,270**	**–**	**–**	**8,645**	**14,915**
Financial investments	**–**	**15,894**	**36,013**	**–**	**51,907**
Other assets	**–**	**–**	**–**	**387**	**387**
Total assets in relation to the group's interests in the unconsolidated structured entities[1]	**6,284**	**16,950**	**40,901**	**9,219**	**73,354**
The group's interest- liabilities					
Derivatives	**111**	**–**	**–**	**10**	**121**
Total liabilities in relation to the group's interests in the unconsolidated structured entities	**111**	**–**	**–**	**10**	**121**
The group's maximum exposure	**7,001**	**16,950**	**40,922**	**9,606**	**74,479**
At 31 December 2013					
Total assets	22,342	1,064,278	11,320,620	39,267	12,446,507
The group's interest- assets					
Trading assets	–	81	–	–	81
Financial assets designated at fair value	–	1,015	6,852	–	7,867
Loans and advances to customers	6,728	–	–	8,910	15,638
Financial investments	–	13,116	30,139	–	43,255
Other assets	–	–	–	481	481
Total assets in relation to the group's interests in the unconsolidated structured entities[2]	6,728	14,212	36,991	9,391	67,322
The group's interest- liabilities					
Derivatives	49	–	–	210	259
Total liabilities in relation to the group's interests in the unconsolidated structured entities	49	–	–	210	259
The group's maximum exposure	7,474	14,212	37,842	9,761	69,289

1 *Amongst the group's interests in the assets of the unconsolidated structured entities, HK$16,853m (2013: HK$14,131m) of HSBC managed funds (out of total assets of HK$16,950m (2013: HK$14,212m)) and HK$40,777m (2013: HK$33,918m) of non-HSBC managed funds (out of total assets of HK$40,901m (2013: HK$36,991m)) are held by the insurance business.*

Structured entities sponsored by the group

The definition of a sponsor is given in note 3n. In some cases, the group does not have an interest in the unconsolidated structured entities that it has sponsored at the reporting date.

The amount of assets transferred to and income received from such sponsored entities at 31 December 2014 was not significant (2013: not significant).

52 Legal proceedings and regulatory matters

The group is party to legal proceedings and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, the Bank considers that none of these matters are material. The recognition of provisions is determined in accordance with the accounting policies set out in note 3(v). While the outcome of legal proceedings and regulatory matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of these matters as at 31 December 2014. Where an individual provision is material, the fact that a provision has been made is stated and quantified. Any provision recognised does not constitute an admission of wrongdoing or legal liability. It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

Anti-money laundering and sanctions-related

In October 2010, HSBC Bank USA entered into a consent cease-and-desist order with the Office of the Comptroller of the Currency (the 'OCC') and the indirect parent of that company, HSBC North America Holdings Inc. ('HNAH'), entered into a consent cease-and-desist order with the Federal Reserve Board (the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including risk management related to US Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. Steps continue to be taken to address the requirements of the Orders.

In December 2012, HSBC Holdings, HNAH and HSBC Bank USA entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA, AML and sanctions laws. Among those agreements, HSBC Holdings and HSBC Bank USA entered into a five-year deferred prosecution agreement with the US Department of Justice ('DoJ'), the US Attorney's Office for the Eastern District of New York, and the US Attorney's Office for the Northern District of West Virginia (the 'US DPA'); HSBC Holdings entered into a two-year deferred prosecution agreement with the New York County District Attorney (the 'DANY DPA'); and HSBC Holdings consented to a cease-and-desist order and HSBC Holdings and HNAH consented to a civil money penalty order with the Federal Reserve Board ('FRB'). In addition, HSBC Bank USA entered into a civil money penalty order with FinCEN and a separate civil money penalty order with the OCC. HSBC Holdings also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions and an undertaking with the UK Financial Conduct Authority ('FCA') to comply with certain forward-looking AML and sanctions-related obligations.

Under these agreements, HSBC Holdings and HSBC Bank USA made payments totalling US$1.9bn to US authorities and are continuing to comply with ongoing obligations. In July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of that agreement. Under the agreements with the DoJ, FCA, and the FRB, an independent monitor (who is, for FCA purposes, a 'skilled person' under Section 166 of the Financial Services and Markets Act) is evaluating and regularly assessing the effectiveness of HSBC's AML and sanctions compliance function and HSBC's progress in implementing its remedial obligations under the agreements.

HSBC Holdings has fulfilled all of the requirements imposed by the DANY DPA which expired by its terms at the end of the two-year period of that agreement in December 2014. If HSBC Holdings and HSBC Bank USA fulfil all of the requirements imposed by the US DPA, the DoJ charges against those entities will be dismissed at the end of the five-year period of that agreement. The DoJ may prosecute HSBC Holdings or HSBC Bank USA in relation to any matters that are the subject of the US DPA if HSBC Holdings or HSBC Bank USA breaches the terms of the US DPA.

52 Legal proceedings and regulatory matters *(continued)*

HSBC Bank USA also entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC's then most recent report of examination, and imposing certain restrictions on HSBC Bank USA directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HSBC Bank USA also entered into a separate consent order with the OCC requiring it to adopt an enterprise-wide compliance programme.

These settlements with US and UK authorities have led to private litigation, and do not preclude further private litigation related to HSBC's compliance with applicable BSA, AML, sanctions laws or other regulatory or law enforcement actions for BSA, AML, sanctions or other matters not covered by the various agreements.

US Tax investigations

The Bank continues to cooperate fully with the relevant US authorities, including with respect to US-based clients of the Bank in India.

Based on the facts currently known, with respect to this ongoing investigation, there is a high degree of uncertainty as to the terms on which it will be resolved and the timing of such resolution, including the amounts of fines and/or penalties, which could be significant.

Investigations and reviews into the setting of benchmark rates

Various regulators and competition and enforcement authorities in Asia-Pacific, including in Thailand, South Korea and Australia, are conducting investigations and reviews related to certain past submissions made by panel banks and the processes for making submissions in connection with the setting of benchmark interest rates. As certain group companies are members of such panels, the group has been the subject of regulatory demands for information and is cooperating with those investigations and reviews.

Based on the facts currently known, with respect to each of these ongoing investigations, there is a high degree of uncertainty as to the terms on which they will be resolved and the timing of such resolution, including the amounts of fines and/or penalties, which could be significant.

Foreign exchange rate investigations

Various regulators and competition and enforcement authorities around the world are conducting investigations and reviews into a number of firms, including group companies, related to trading on the foreign exchange markets.

In December 2014, the Hong Kong Monetary Authority ('HKMA') announced the completion of its investigation into the foreign exchange trading operations of the Bank. The investigation found no evidence of market manipulation and no monetary penalty was imposed. The Bank was required to implement various remedial actions.

The remaining investigations and reviews are ongoing. Based on the facts currently known there is a high degree of uncertainty as to the terms on which they will be resolved and the timing of such resolutions, including the amounts of fines and/or penalties, which could be significant.

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

On 13 February 2015, Hang Seng Bank Limited completed the disposal of 952,616,838 ordinary shares of Industrial Bank, representing approximately half of their holding in Industrial Bank. It is estimated that the net disposal gain will be approximately HK$2.8 billion.

56 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 23 February 2015.

Printed by DG3 Asia Limited, Hong Kong, on Revive 100 White Offset paper using vegetable oil-based inks. Made in Austria, the paper comprises 100% de-inked post-consumer waste. Pulps used are totally chlorine-free.

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