The Hongkong and Shanghai Banking Corporation Limited

Annual Report and Accounts 2010

HSBC

The world's local bank

Annual Report and Accounts 2010

Contents

Certain defined terms

This document comprises the *Annual Report and Accounts 2010* 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: Group Communications (Asia), Level 32, HSBC Main Building, 1 Queen's Road Central, Hong Kong. The report is also available, in English and Chinese, on the Bank's web site at www.hsbc.com.hk.

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

Financial Highlights

	2010	2009
For the year	**HK$m**	HK$m
		Restated [1]
Net operating income before loan impairment charges	**131,566**	117,998
Profit before tax	**77,885**	62,093
Profit attributable to shareholders	**57,597**	45,396
At the year-end		
Shareholders' equity	**320,130**	260,202
Total equity	**347,435**	286,627
Total capital base	**236,720**	220,612
Customer accounts	**3,313,244**	2,944,539
Total assets	**5,039,918**	4,360,748
Ratios	**%**	%
Return on average shareholders' equity	**21.1**	19.8
Post-tax return on average total assets	**1.33**	1.14
Cost efficiency ratio	**45.8**	44.4
Net interest margin	**1.83**	1.92
Capital adequacy ratios		
– core capital	**11.7**	12.2
– total capital	**14.7**	16.1

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

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

Serving the financial and wealth management needs of an international customer base, the Bank and its subsidiaries provide a complete range of personal, commercial and corporate banking and related financial services in 21 countries and territories in Asia-Pacific – with the largest network of any international financial institution in the region – and in six other countries around the world. Employing some 72,500 people, of whom 38,600 work for the Bank itself, the Bank and its subsidiaries had consolidated assets at 31 December 2010 of HK$5,040bn.

The Hongkong and Shanghai Banking Corporation Limited is a wholly owned subsidiary of HSBC Holdings plc, the holding company of the HSBC Group, which has an international network covering 87 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, the Middle East, North America and Latin America.

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

Report of the Directors

Board of Directors

Stuart T Gulliver, *Chairman*
Dr William Fung Kwok Lun, SBS, OBE, *Deputy Chairman*
Laura Cha May Lung, GBS, *Deputy Chairman*
Peter Wong Tung Shun, *Chief Executive*
Dr Raymond Ch'ien Kuo Fung, GBS, CBE
Naina L Kidwai
Margaret Leung Ko May Yee
Victor Li Tzar Kuoi
Dr Lo Ka Shui, GBS
Zia Mody
Christopher D Pratt
Andreas Sohmen-Pao
T Brian Stevenson, SBS
Dr Patrick Wang Shui Chung
Dr Rosanna Wong Yick-ming, DBE
Marjorie Yang Mun Tak

Principal Activities

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

Financial Statements

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

Reserves and dividends

Profits attributable to shareholders, before dividends, of HK$57,597m have been transferred to reserves. During the year, a surplus of HK$7,513m, net of the related deferred taxation effect, arising from professional valuations of premises and held by the Bank and the group was credited to reserves. Details of the movements in reserves, including appropriations therefrom, are set out in the Consolidated Statement of Changes in Equity and note 39 to the financial statements. The interim dividends paid in respect of 2010 are set out in note 9 to the financial statements. The Directors do not recommend the payment of a final dividend.

Directors

The names of the Directors at the date of this report are set out above. All the Directors served throughout the year save for N L Kidwai, who was appointed on 8 October 2010. V H C Cheng and S K Green resigned as Directors on 1 February and 3 December 2010 respectively. M F Geoghegan and A A Flockhart resigned as Directors on 31 December 2010. David Wei Zhe resigned as a Director on 22 February 2011. P A Thurston has been appointed as a Director with effect from 1 March 2011, or such later date that approval is received from the Hong Kong Monetary Authority.

Directors' Interests in Contracts

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

Directors' Rights to Acquire Shares or Debentures

To help align the interests of employees with shareholders, certain Directors have been granted options and conditional awards over HSBC Holdings plc ordinary shares by that company (being the ultimate holding company) pursuant to the HSBC Holdings Executive Share Option Scheme ('ESOS'), the HSBC Holdings Group Share Option Plan ('GSOP'), the HSBC Holdings Savings-Related Share Option Plan and the HSBC Share Plan, or acquired shares under the HSBC Holdings UK Share Incentive Plan.

Under the ESOS and GSOP, discretionary awards of share options, with vesting subject to the attainment of a pre-determined corporate performance condition, were made to employees at all levels of HSBC. The exercise price of options granted under the ESOS was the market value of the ordinary shares on the business day prior to the grant of the option. The exercise price of options granted under the GSOP is the higher of the average market value on the five business days prior to the grant of the option, or the market value of the ordinary shares on the date of grant of the option, or the nominal value of a share.

Under the HSBC Holdings Savings-Related Share Option Plan, eligible employees, including Directors, may be granted options over HSBC Holdings plc ordinary shares at a price per share which is fixed at the average of the middle market quotations of an ordinary share derived from the London Stock Exchange Daily Official List for the five dealing days preceding the date of the invitation to participate in the plan, discounted by 20%. The vesting of conditional awards of HSBC Holdings plc ordinary shares granted to Directors under the HSBC Share Plan is generally subject to the individual remaining in service for a period and, for Performance Share awards, the attainment of corporate performance conditions. Under the HSBC Holdings UK Share Incentive Plan eligible employees, including Directors, may make monthly contributions which are used to make market purchases of HSBC Holdings plc ordinary shares.

During the year, V H C Cheng, A A Flockhart, M F Geoghegan, S K Green, S T Gulliver, N L Kidwai, M M Y Leung and P T S Wong acquired shares in HSBC Holdings plc under the terms of the HSBC Share Plan.

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

Executive Committee

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

Louisa Cheang Wai Wan *(Regional Director, Personal Financial Services, Asia-Pacific)*, R H Cox *(Chief Risk Officer)*, S A Davis *(Chief Executive Officer, India),* N P Fretwell *(Head of Human Resources, Asia-Pacific)*, D L Fried *(Group Head of Insurance)*, Anita Fung Yuen Mei *(Head of Global Banking and Markets, Asia-Pacific)*, G D Harvey-Samuel *(Head of International)*, A C Hungate *(Chief Executive Officer, Singapore),* M M Hussain *(Chief Executive Officer, HSBC Bank Malaysia Berhad),* S C Legg *(Chief Financial Officer)*, M S McCombe *(Chief Executive Officer Hong Kong)*, C M Meares *(Chief Executive Officer, Global Private Banking),* E I Sinyak *(Chief Technology and Services Officer),* Cindy Tang Hsin *(Head of Group Communications, Asia-Pacific),* Helen Wong Pik Kuen *(President and Chief Executive Officer, HSBC Bank (China) Company Limited).*

Raymond Cheng Siu Hong *(Chief Technology and Services Officer, Asia-Pacific with effect from 1 March 2011)* and Donna Wong Ka Yuk *(Head of Human Resources, Asia-Pacific with effect from 1 March 2011)* will succeed E I Sinyak and N P Fretwell respectively as members of the Executive Committee with effect from 1 March 2011. N P Quinn *(Head of Commercial Banking, Asia-Pacific with effect from 1 April 2011)* will become a member of the Executive Committee with effect from 1 April 2011.

Audit Committee

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

Remuneration Committee

The Board of the Bank's ultimate parent company, HSBC Holdings plc, has established a Remuneration Committee comprising independent non-executive directors. Details of remuneration policy and principles are contained within the *Annual Report and Accounts 2010* and *Capital and Risk Management Pillar 3 Disclosures as at 31 December 2010* of HSBC Holdings plc.

Donations

Donations made by the Bank and its subsidiaries during the year amounted to HK$102m.

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

The Directors are of the view that the Accounts and Supplementary Notes for the year ended 31 December 2010, which will be published separately, fully comply with the Banking (Disclosure) Rules made under section 60A of the Banking Ordinance and that the Bank complies with the Hong Kong Monetary Authority Supervisory Policy Manual CG-1 'Corporate Governance of Locally Incorporated Authorised Institutions'.

Auditor

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

On behalf of the Board
Stuart T Gulliver, *Chairman*
28 February 2011

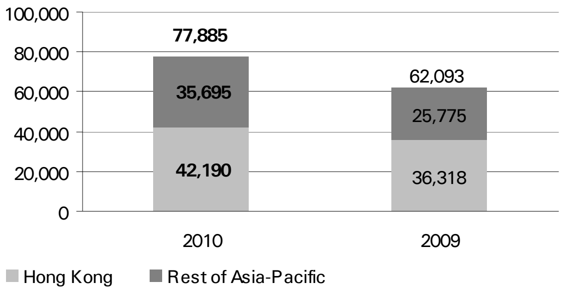
Financial Review

Summary of Financial Performance

Group Profit

Profit attributable to shareholders for 2010 reported by The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') increased by HK$12,201m, or 26.9%, to HK$57,597m in 2010. Profit before taxation increased by HK$15,792m, or 25.4%, to HK$77,885m.

Profit before tax (HK$m)



Geographical Regions

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

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

Financial Review (continued)

Geographical Regions *(continued)*

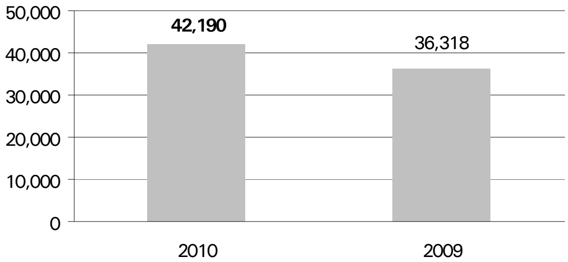
Profit before tax by geographical region

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Intra-segment elimination HK$m	Total HK$m
2010				
Net interest income	**31,736**	**30,123**	**17**	**61,876**
Net fee income	**21,080**	**14,203**	**–**	**35,283**
Net trading income	**8,699**	**12,034**	**(17)**	**20,716**
Net income from financial instruments designated at fair value	**3,454**	**303**	**–**	**3,757**
Gains less losses from financial investments	**937**	**1,079**	**–**	**2,016**
Dividend income	**545**	**19**	**–**	**564**
Net earned insurance premiums	**33,713**	**3,480**	**–**	**37,193**
Other operating income	**12,714**	**2,282**	**(4,992)**	**10,004**
Total operating income	**112,878**	**63,523**	**(4,992)**	**171,409**
Net insurance claims incurred and movement in policyholders' liabilities	**(37,022)**	**(2,821)**	**–**	**(39,843)**
Net operating income before loan impairment charges and other credit risk provisions	**75,856**	**60,702**	**(4,992)**	**131,566**
Loan impairment charges and other credit risk provisions	**(883)**	**(3,736)**	**–**	**(4,619)**
Net operating income	**74,973**	**56,966**	**(4,992)**	**126,947**
Operating expenses	**(33,053)**	**(32,183)**	**4,992**	**(60,244)**
Operating profit	**41,920**	**24,783**	**–**	**66,703**
Share of profit in associates and joint venture	**270**	**10,912**	**–**	**11,182**
Profit before tax	**42,190**	**35,695**	**–**	**77,885**
2009				
Net interest income	30,935	27,484	13	58,432
Net fee income	19,119	11,159	–	30,278
Net trading income	8,427	12,112	(13)	20,526
Net income from financial instruments designated at fair value	6,391	868	–	7,259
Gains less losses from financial investments	117	(248)	–	(131)
Dividend income	245	119	–	364
Net earned insurance premiums	28,566	2,829	–	31,395
Other operating income	9,539	1,746	(4,279)	7,006
Total operating income	103,339	56,069	(4,279)	155,129
Net insurance claims incurred and movement in policyholders' liabilities	(34,070)	(3,061)	–	(37,131)
Net operating income before loan impairment charges and other credit risk provisions	69,269	53,008	(4,279)	117,998
Loan impairment charges and other credit risk provisions	(3,875)	(7,360)	–	(11,235)
Net operating income	65,394	45,648	(4,279)	106,763
Operating expenses	(29,135)	(27,555)	4,279	(52,411)
Operating profit	36,259	18,093	–	54,352
Share of profit in associates and joint venture	59	7,682	–	7,741
Profit before tax	36,318	25,775	–	62,093

Geographical Regions *(continued)*

Hong Kong

Profit before tax (HK$m)



Hong Kong reported pre-tax profits of HK$42,190m compared with HK$36,318m in 2009, an increase of 16.2%, driven by strong insurance sales, increased fee income and lower loan impairment charges.

Lending balances rose across customer groups, with significant increases in both CMB and GB&M following strong economic growth and a recovery in trade flows. Revenue growth has in part been offset by an increase in staff and IT costs driven by business expansion to maintain our strong market position. Loan impairment charges were significantly lower than last year across all customer groups, reflecting an improvement in credit conditions.

We have maintained our market leadership in residential mortgages, credit cards, life insurance and deposits. Premier customer numbers increased by 31% compared with 31 December 2009 to more than 500,000 and the Advance proposition, which was launched in early 2010 to capture the mid-market segment, achieved a customer base of over 670,000 by year end. Premier and Advance numbers include both existing and new to bank customers. In life insurance, we retained the number one market share position as measured by new business annualised premium equivalent. This was a result of strong customer demand and a strategy targeted towards the high net worth customer segment. We continued the development of offshore renminbi-related products and maintained our position as a market leader for renminbi products in Hong Kong.

Net interest income increased by 2.6%, as strong loan growth, most notably in CMB and GB&M, was partly offset by lower spreads resulting from competitive pressures, the low interest rate environment and loan growth being weighted towards the latter part of the year.

Commercial lending growth was a result of the recovery in trade volumes, our continuing support to customers and the pursuit of our leading international business bank strategy. Growth was most pronounced in commercial, industrial and international trade-related lending. To a lesser extent, growth was also noted in commercial real estate and other property related lending, supported by a buoyant property-market. Personal lending balances were 18.4% higher, driven by residential mortgage lending where we continued to lend conservatively with an average loan-to-value ratio of 55% on new mortgage drawdowns and 38% on the overall portfolio.

Asset spreads narrowed in 2010 compared to 2009 as a result of competitive pressures particularly in trade-related lending and HIBOR-linked residential mortgages. In Balance Sheet Management, net interest income decreased as yield curves flattened and maturing higher yield positions were reinvested at lower rates.

Customer deposits increased reflecting growth in customer numbers in CMB as well as Premier in PFS. The benefit of these deposits was reduced by narrow deposit spreads as interest rates remained at historically low levels.

Net fee income increased by 10.3%, with fees from investment products growing as improved market sentiment led to higher demand, particularly in unit trusts, along with higher fees from funds under management as a result of higher net inflows and improved fund performance. There was growth in trade-related fees and income from payments and cash management as business volumes improved. Underwriting fees rose as several significant initial public offerings (IPOs) and loan syndications concluded in 2010.

Net trading income was 3.2% higher than in 2009. Increased holdings of trading debt securities led to an increase in net interest income. Foreign exchange revenues benefited from increased turnover on the back of client demand. This was partly offset by lower revenues from Credit trading following the strong results achieved in 2009 as spreads recovered from distressed levels and from Rates trading as market volatility reduced in 2010.

Financial Review (continued)

Geographical Regions *(continued)*

Net income from financial instruments designated at fair value was HK$3,454m compared with HK$6,391m in 2009. The movement was primarily due to lower revaluation gains in 2010 on assets held to support linked insurance liabilities following the strong rebound in stock markets in 2009. The value of our liabilities to policyholders is determined in line with the value of supporting assets, so to the extent that these lower investment gains were attributed to policyholders, there was a decrease in *net insurance claims incurred and movements in liabilities to policyholders*.

Net earned insurance premiums grew by 18.0% to HK$33,713m as successful sales campaigns drove strong growth, particularly in deferred annuity and unit-linked products. A life insurance product designed for high net worth individuals also performed well.

Net insurance claims incurred and movement in liabilities to policyholders increased by 8.7% in 2010 to HK$37,022m as increases in liabilities to policyholders arising from new business inflows were partly offset by lower investment returns in 2010 compared to 2009, as noted above.

Gains less losses from financial investments increased to HK$937m compared to HK$117m in 2009, mainly due to gains from the disposal of available-for-sale investments in Balance Sheet Management in the first half of 2010. In January 2010, we increased our stake in Bao Viet Holdings from 10% to 18% and accounted for it as an associate from then, leading to an accounting gain of HK$386m.

Other operating income increased by 33.3% to HK$12,714m largely due to an increase in present value of in-force business ('PVIF'), reflecting higher life insurance sales, as well as the gain recognised following the sale of HSBC Private Equity (Asia) Limited to its management, partly offset by the non-recurrence of a gain on sale of a property in 2009.

Loan impairment charges and other credit risk provisions decreased by 77.2% to HK$883m, reflecting the recovery in economic conditions. There were fewer large specific impairments in CMB and GB&M as credit conditions improved. Loan impairment charges also fell in PFS, mainly on unsecured lending as unemployment and bankruptcy levels fell.

Operating expenses rose by 13.4% as the business grew and the economy recovered. We continued to hire both customer facing and support staff to meet growing business demand. Marketing costs rose notably in PFS due to the launch of several large campaigns, including for Advance and credit cards, and rising transaction volumes led to increased back office and support costs.

Geographical Regions *(continued)*

Profit before tax by customer group and global business

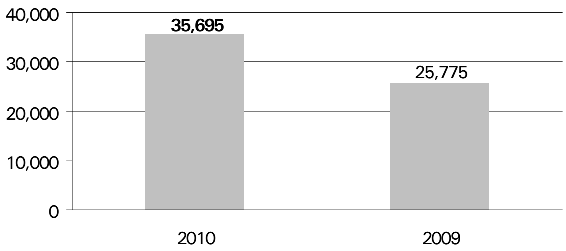
	Personal Financial Services HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Private Banking HK$m	Other HK$m	Intra-segment elimination HK$m	Hong Kong Total HK$m
2010							
Net interest income/(expense)	**20,332**	**8,595**	**7,101**	**–**	**(3,597)**	**(695)**	**31,736**
Net fee income	**11,820**	**4,922**	**4,227**	**–**	**111**	**–**	**21,080**
Net trading income/(expense)	**1,080**	**941**	**5,986**	**–**	**(1)**	**693**	**8,699**
Net income/(loss) from financial instruments designated at fair value	**3,113**	**(74)**	**470**	**–**	**(57)**	**2**	**3,454**
Gains less losses from financial investments	**(2)**	**–**	**451**	**–**	**488**	**–**	**937**
Dividend income	**–**	**10**	**80**	**–**	**455**	**–**	**545**
Net earned insurance premiums	**28,409**	**5,171**	**133**	**–**	**–**	**–**	**33,713**
Other operating income	**3,907**	**525**	**1,281**	**–**	**8,938**	**(1,937)**	**12,714**
Total operating income	**68,659**	**20,090**	**19,729**	**–**	**6,337**	**(1,937)**	**112,878**
Net insurance claims incurred and movement in policyholders' liabilities	**(32,576)**	**(4,346)**	**(100)**	**–**	**–**	**–**	**(37,022)**
Net operating income before loan impairment charges and other credit risk provisions	**36,083**	**15,744**	**19,629**	**–**	**6,337**	**(1,937)**	**75,856**
Loan impairment charges and other credit risk provisions	**(585)**	**(219)**	**(80)**	**–**	**1**	**–**	**(883)**
Net operating income	**35,498**	**15,525**	**19,549**	**–**	**6,338**	**(1,937)**	**74,973**
Operating expenses	**(12,679)**	**(5,077)**	**(8,900)**	**–**	**(8,334)**	**1,937**	**(33,053)**
Operating profit/(loss)	**22,819**	**10,448**	**10,649**	**–**	**(1,996)**	**–**	**41,920**
Share of profit/(loss) in associates and joint ventures	**43**	**56**	**26**	**–**	**145**	**–**	**270**
Profit/(loss) before tax	**22,862**	**10,504**	**10,675**	**–**	**(1,851)**	**–**	**42,190**
2009							
Net interest income/(expense)	20,039	7,274	8,912	–	(4,367)	(923)	30,935
Net fee income	10,933	4,106	3,760	–	320	–	19,119
Net trading income/(expense)	1,091	718	6,226	–	(529)	921	8,427
Net income/(loss) from financial instruments designated at fair value	5,650	(359)	1,072	–	26	2	6,391
Gains less losses from financial investments	623	136	(661)	–	19	–	117
Dividend income	5	11	71	–	158	–	245
Net earned insurance premiums	24,512	3,926	128	–	–	–	28,566
Other operating income	2,680	498	439	–	7,790	(1,868)	9,539
Total operating income/(expense)	65,533	16,310	19,947	–	3,417	(1,868)	103,339
Net insurance claims incurred and movement in policyholders' liabilities	(30,840)	(3,142)	(88)	–	–	–	(34,070)
Net operating income/(expense) before loan impairment charges and other credit risk provisions	34,693	13,168	19,859	–	3,417	(1,868)	69,269
Loan impairment charges and other credit risk provisions	(1,575)	(1,301)	(1,004)	–	5	–	(3,875)
Net operating income/(expense)	33,118	11,867	18,855	–	3,422	(1,868)	65,394
Operating expenses	(12,138)	(4,469)	(7,361)	–	(7,035)	1,868	(29,135)
Operating profit/(loss)	20,980	7,398	11,494	–	(3,613)	–	36,259
Share of profit in associates and joint ventures	40	10	11	–	(2)	–	59
Profit/(loss) before tax	21,020	7,408	11,505	–	(3,615)	–	36,318

Financial Review (continued)

Geographical Regions *(continued)*

Rest of Asia-Pacific

Profit before tax (HK$m)



Rest of Asia-Pacific reported pre-tax profits of HK$35,695m compared with HK$25,775m in 2009, an increase of 38.5%. The economic performance of the region was reflected in a recovery in trade volumes, an increase in our customers' appetite for investment-related products, strong growth in lending balances and a significant decline in loan impairment charges. There was also a significant increase in the contribution from associates in mainland China. These factors contributed to the increased profitability, offset by a rise in operating expenses to support this growth.

During 2010 we continued to target growth particularly in the key regional markets of mainland China, India, Indonesia, Singapore, Malaysia and Australia. We have consolidated our position as the leading foreign bank in mainland China with 106 outlets in 27 cities, 16 rural bank outlets and 38 Hang Seng outlets in 13 cities. We maintained our leadership in the development of RMB products and now have RMB settlement capability in 36 countries covering all six continents. In July 2010 we agreed to acquire a substantial part of The Royal Bank of Scotland Group plc's commercial and retail businesses in India. In Malaysia, 4 additional Amanah branches were opened and our first Amanah branch opened in Bangladesh, further expanding our footprint in this sector.

Net interest income increased by 9.6%, following strong loan growth throughout the region as business and consumer confidence increased, partly offset by narrower asset spreads in the face of strong competition. Higher lending balances resulted from business growth in both GB&M and CMB across the key regional markets of mainland China, Singapore, India, Australia, Malaysia and Indonesia. This reflected our targeted business strategy and the recovery in trade volumes in the region. PFS lending balances also rose, mainly in the mortgage book, most notably in Singapore, Australia and Malaysia, as well as in Taiwan and mainland China, supported by successful marketing campaigns.

Narrower asset spreads were also the result of a shift to lower risk customers following the managed reduction of certain unsecured lending portfolios, most notably in India.

Customer deposits grew by 19.9% primarily in mainland China, Australia and Singapore, as a result of a targeted strategy to attract new customers in higher value segments, coupled with improved economic conditions in the region.

Balance Sheet Management income declined from the very strong results in 2009 as higher yielding trades matured, interest rates generally remained low and yield curves flattened.

Net fee income was 27.3% higher, with particular growth in GB&M following an increase in funds under management driven by inflows and an improvement in equity markets. There was also an increase in trade-related fees, credit facilities and payments and cash management in CMB as trade activity recovered. In PFS fee income also rose from the increased sales of investment and insurance products.

Net trading income declined by 0.6%, as reduced market volatility led to lower Credit and Rates trading income. In India, Rates trading income fell as gains achieved in 2009 from narrowing bond yields did not recur. Lower trading revenues in South Korea reflected a non-recurrence of one-off gains recognised in 2009. This was partly offset by higher foreign exchange income in mainland China, India and Malaysia as a result of strong volumes on the back of economic growth and increased client hedging requirements. Interest income from trading activities also increased, resulting from increased holdings of debt securities.

Net income from financial instruments designated at fair value was HK$303m, compared with HK$868m in 2009. The movement was due to higher revaluation gains in 2009 on assets held to support insurance business liabilities as equity markets had experienced a strong rebound. To the extent that the lower investment gains in 2010 were attributed to policyholders, there was a decrease in *net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments recorded income of HK$1,079m compared to a loss of HK$248m in 2009 as a result of a gain on disposal of an equity investment in a Singaporean property company, coupled with gains on sales of other available-for-sale investments and the non-recurrence of impairments reported in 2009.

Other operating income increased by 30.7% to HK$2,282m. This was primarily due to an increase in PVIF reflecting higher new life insurance sales in Taiwan, mainland China and Malaysia, as well as recoveries against initial fair values on loan portfolios acquired with PT Bank Ekonomi Raharja Tbk in Indonesia and from The Chinese Bank Co., Ltd in Taiwan.

Net earned insurance premiums increased by 23% to HK$3,480m, largely due to higher sales in Taiwan, mainland China and Malaysia, primarily from successful product launches and marketing campaigns. Growth in the insurance business resulted in a related increase in *net insurance claims incurred and movement in liabilities to policyholders,* which was more than offset by the lower investment gains reported above in *net income from financial instruments designated at fair value.*

Loan impairment charges and other credit risk provisions decreased by 49.2% to HK$3,736m. Loan impairment charges fell in PFS, most notably in India as certain unsecured and higher risk lending portfolios were managed down, and as economic and credit conditions improved across the region. Fewer specific impairments were recognised in CMB as a result of the recovery in the economic environment. These were partly offset by certain specific impairment charges in GB&M incurred in Singapore.

Operating expenses increased by 16.8% to HK$32,183m in support of business growth and to capitalise on the region's economic recovery. Examples were the ongoing expansion of the branch network in mainland China and opening of the new headquarters in Shanghai, as well as the local incorporation and expansion of the Taiwan operations. Staff numbers rose to support business expansion, particularly in the key regional markets of mainland China, Indonesia, Singapore and Australia. Higher marketing costs were incurred in India, Australia, Taiwan, Singapore and Malaysia and higher business volumes led to increased intercompany processing costs.

Share of profit from associates and joint ventures in the region increased by 42.0% to HK$10,912m, with a higher contribution from Bank of Communications due to lending growth and higher net fee income from cards, wealth management and settlement activity. Growth in lending and an increase in fee income led to a higher contribution from Industrial Bank.

Financial Review (continued)

Profit before tax by customer group and global business

	Personal Financial Services HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Private Banking HK$m	Other HK$m	Intra-segment elimination HK$m	Rest of Asia-Pacific Total HK$m
2010							
Net interest income/(expense)	**12,281**	**7,281**	**12,165**	**127**	**390**	**(2,121)**	**30,123**
Net fee income/(expense)	**5,197**	**3,432**	**5,529**	**144**	**(99)**	**–**	**14,203**
Net trading income/(expense)	**630**	**1,003**	**8,572**	**48**	**(340)**	**2,121**	**12,034**
Net income/(loss) from financial instruments designated at fair value	**319**	**14**	**(7)**	**–**	**(23)**	**–**	**303**
Gains less losses from financial investments	**8**	**21**	**388**	**–**	**662**	**–**	**1,079**
Dividend income	**–**	**–**	**3**	**–**	**16**	**–**	**19**
Net earned insurance premiums	**2,994**	**486**	**–**	**–**	**–**	**–**	**3,480**
Other operating income	**841**	**676**	**379**	**9**	**820**	**(443)**	**2,282**
Total operating income	**22,270**	**12,913**	**27,029**	**328**	**1,426**	**(443)**	**63,523**
Net insurance claims incurred and movement in policyholders' liabilities	**(2,514)**	**(307)**	**–**	**–**	**–**	**–**	**(2,821)**
Net operating income before loan impairment charges and other credit risk provisions	**19,756**	**12,606**	**27,029**	**328**	**1,426**	**(443)**	**60,702**
Loan impairment charges and other credit risk provisions	**(2,315)**	**(209)**	**(1,209)**	**(5)**	**2**	**–**	**(3,736)**
Net operating income	**17,441**	**12,397**	**25,820**	**323**	**1,428**	**(443)**	**56,966**
Operating expenses	**(16,819)**	**(6,207)**	**(8,538)**	**(348)**	**(714)**	**443**	**(32,183)**
Operating profit/(loss)	**622**	**6,190**	**17,282**	**(25)**	**714**	**–**	**24,783**
Share of profit in associates and joint ventures	**1,471**	**5,833**	**3,077**	**–**	**531**	**–**	**10,912**
Profit/(loss) before tax	**2,093**	**12,023**	**20,359**	**(25)**	**1,245**	**–**	**35,695**
2009							
Net interest income/(expense)	11,568	6,248	10,213	121	171	(837)	27,484
Net fee income/(expense)	4,296	2,569	4,388	51	(145)	–	11,159
Net trading income/(expense)	613	1,040	9,412	98	112	837	12,112
Net income/(loss) from financial instruments designated at fair value	851	8	(13)	–	22	–	868
Gains less losses from financial investments	41	18	(111)	–	(196)	–	(248)
Dividend income	1	–	1	–	117	–	119
Net earned insurance premiums	2,613	216	–	–	–	–	2,829
Other operating income	519	514	254	16	682	(239)	1,746
Total operating income	20,502	10,613	24,144	286	763	(239)	56,069
Net insurance claims incurred and movement in policyholders' liabilities	(2,947)	(114)	–	–	–	–	(3,061)
Net operating income before loan impairment charges and other credit risk provisions	17,555	10,499	24,144	286	763	(239)	53,008
Loan impairment charges and other credit risk provisions	(5,028)	(2,150)	(173)	–	(9)	–	(7,360)
Net operating income	12,527	8,349	23,971	286	754	(239)	45,648
Operating expenses	(14,260)	(4,934)	(7,334)	(358)	(908)	239	(27,555)
Operating profit/(loss)	(1,733)	3,415	16,637	(72)	(154)	–	18,093
Share of profit in associates and joint ventures	1,106	4,393	2,181	–	2	–	7,682
Profit/(loss) before tax	(627)	7,808	18,818	(72)	(152)	–	25,775

Net interest income

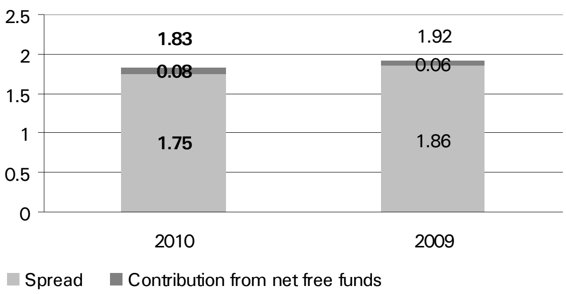
Net interest income increased by HK$3,444m or 5.9% compared to 2009 on the back of strong loan growth across customer groups, weighted towards the second half of the year. Net interest income continued to be affected by the compression of asset spreads and the low interest rate environment constrained deposit spreads.

Average interest-earning assets increased by HK$341,291m or 11.2% compared to 2009. Loans and advances to customers increased significantly as the economy strengthened across the region. Loan growth was most significant in CMB and GB&M, notably in commercial, industrial and international trade-related lending, and the buoyant property market led to increased commercial real estate and mortgage lending.

	2010 HK$m	2009 HK$m
Average interest-earning assets	**3,388,861**	3,047,570

Net interest margin decreased to 1.83%, a reduction of nine basis points when compared to 2009. The lower interest margin reflects the continued pressure on asset spreads. Net interest spread declined by 11 basis points to 1.75%. The contribution of net free funds increased by two basis points to eight basis points, reflecting the growth in the deposit base, offset by margin pressure.

Net interest margin (%)



Net interest margin

	2010 %	2009 %
Hong Kong:		
The Bank	**1.38**	1.52
Hang Seng Bank	**1.91**	2.11
Rest of Asia-Pacific	**2.04**	2.19

In **Hong Kong**, the Bank recorded a drop in net interest margin of 14 basis points to 1.38% for the year. Asset yields remained under pressure, particularly in HIBOR-linked residential mortgages which were launched early in 2010 and accounted for most new mortgage drawdowns by year end, as well as in trade-related lending. The margin in the second half improved to 1.40% from 1.35% in the first half, as a greater proportion of the commercial surplus was directed towards customer lending.

At **Hang Seng Bank**, the net interest margin declined by 20 basis points to 1.91% while the net interest spread also declined by 20 basis points to 1.86%. Strong growth in customer advances was partly offset by the continuing compression of margins, and the re-pricing of assets at lower market rates reduced the contribution from Balance Sheet Management.

In the **Rest of Asia-Pacific**, net interest margin was 2.04%, 15 basis points lower than 2009. Net interest spread narrowed by 10 basis points to 1.89%. The lower margin reflected continued pressure on asset spreads and the shift to lower risk customers. Strong loan growth across the region, notably in Singapore and mainland China, led to a 9.6% increase in net interest income.

Financial Review (continued)

Net fee income

Net fee income was HK$5,005m, or 16.5%, higher than 2009.

Income from funds under management was 40.0% higher than in 2009 as improved investor sentiment led to fund inflows and equity markets continued to perform strongly.

Fees from unit trusts rose by 87.2%, with notable increases coming from Hong Kong, Taiwan, India and Singapore. The launch of new products, marketing campaigns and improved investor sentiment led to a significant increase in business.

Fees from credit facilities increased by 30.5% as demand for credit was strong and more syndicated loans were arranged for large corporates, especially in Hong Kong, India and Singapore. Fees from remittances and trade finance were up 19.3% and 11.4% respectively, with higher transaction volumes particularly in Hong Kong, mainland China and Singapore.

Fee income from cards rose as transaction volumes and overseas spending increased, notably in Hong Kong and Indonesia, as well as an increase in card issuance in Australia.

Other fee income rose by 19.4%, driven by higher fees from the Mandatory Provident Fund, the completion of several large project advisory transactions in Hong Kong, Japan and Singapore, along with fees generated from a number of equity underwriting participations, notably in Hong Kong and Singapore.

	2010 HK$m	2009 HK$m
Account services	**2,314**	2,181
Credit facilities	**2,642**	2,025
Import/export	**4,171**	3,744
Remittances	**2,457**	2,059
Securities/stockbroking	**8,744**	8,628
Cards	**5,963**	5,673
Insurance	**626**	478
Unit trusts	**3,218**	1,719
Funds under management	**4,658**	3,327
Other	**6,864**	5,749
Fee income	**41,657**	35,583
Fee expense	**(6,374)**	(5,305)
Net fee income	**35,283**	30,278

Net trading income

Net trading income increased by HK$190m, or 0.9%.

Dealing profits fell by 4.9% or HK$791m, reflecting the exceptional profit captured last year, mainly from gains on held-for-trading investments as well as Rates trading, which benefited from volatile market conditions in 2009, especially in Hong Kong, India and South Korea. In 2010, foreign exchange income grew as economic growth led to increased client demand, especially in Hong Kong, mainland China, Japan, India and Malaysia. Client hedging requirements also increased, notably in mainland China and Malaysia.

Interest on trading assets and liabilities rose by HK$914m, or 23.7%, primarily due to an increase in trading debt securities, notably in Hong Kong and India.

	2010 HK$m	2009 HK$m
Dealing profits	**15,484**	16,275
Loss from hedging activities	**(11)**	(23)
Net interest income	**4,767**	3,853
Dividend income from trading securities	**476**	421
Net trading income	**20,716**	20,526

Gains less losses from financial investments

Gains on disposal of available-for-sale securities increased by HK$1,174m. This was mainly attributable to the sale of debt securities in Hong Kong and an equity stake in a property company in Singapore. There was also a gain on the reclassification of Bao Viet Holdings to an associate following the purchase of additional shares in January 2010. The gain in 2009 included the disposal of Visa Inc. shares.

Impairment of available-for-sale equity investments decreased HK$973m in 2010 as improved market conditions generally reduced the level of write-downs of strategic investments in the year.

	2010 HK$m	2009 HK$m
Gains on disposal of available-for-sale securities	**2,365**	1,191
Impairment of available-for-sale equity investments	**(349)**	(1,322)
Gains less losses from financial investments	**2,016**	(131)

Other operating income

The movement in the present value of in-force insurance business rose substantially in 2010, primarily due to an increase in sales of life insurance products in Hong Kong during the year.

Gains on investment properties increased reflecting the favourable property market conditions in Hong Kong in 2010. The profit on disposal of property, plant and equipment, and assets held for sale was lower following the profit on sale of a property in Hong Kong in 2009.

The gain on disposal of subsidiaries, associates and business portfolios mainly represented gains recognised following the sale of the private equity businesses during the year.

The increase in 'Other' largely comprises higher recoveries of IT and other operating costs from shared services activities incurred on behalf of fellow Group companies. It also included recoveries against initial fair value on loan portfolios acquired with Bank Ekonomi in Indonesia and from The Chinese Bank in Taiwan.

	2010 HK$m	2009 HK$m
Rental income from investment properties	**170**	169
Movement in present value of in-force insurance business	**4,106**	2,888
Gains on investment properties	**483**	262
Gains on disposal of property, plant and equipment, and assets held for sale	**13**	410
Gain/(loss) on disposal of subsidiaries, associates and business portfolios	**603**	(6)
Surplus/(deficit) arising on property revaluation	**102**	(109)
Other	**4,527**	3,392
Other operating income	**10,004**	7,006

Insurance income

Net Interest Income increased 24.3% as funds under management grew, including from the Mandatory Provident Fund (MPF) and Occupational Retirement Schemes Ordinance (ORSO). Net fee income increased 39.3% from rising fund balances in both MPF and ORSO and favourable fund valuations from improved equity market performance in 2010.

Net income from financial instruments designated at fair value declined by 45.2% due to lower revaluation gains on equities supporting unit-linked insurance funds. The larger revaluation gains in 2009 reflected the strong rebound in equity markets, whereas in 2010 markets rose more modestly. To the extent that gains on revaluation are recognised here, an offsetting movement is reported under 'Net insurance claims incurred and movements in policyholders' liabilities'.

In January 2010 we increased our stake in Bao Viet Holdings, Vietnam's leading insurance and financial services group, from 10% to 18% and treated it as an associate from then. This led to the accounting gain of HK$386m which is included in Gains less losses from financial investments.

Net insurance premiums rose by 18.5%, mainly from higher sales of the deferred annuity and unit-linked products. Non-life premiums also increased through improved sales on medical, accident and health and general liability products.

The movement in present value of in-force business increased by 42.2% reflecting higher new life insurance sales during the year.

	2010 **HK$m**	2009 HK$m
Net interest income	**5,832**	4,691
Net fee income	**1,070**	768
Net trading loss	**(5)**	(8)
Net income from financial instruments designated at fair value	**3,371**	6,150
Gains less losses from financial investments	**386**	(7)
Dividend income	**–**	29
Net earned insurance premiums	**37,193**	31,395
Movement in present value of in-force business	**4,106**	2,888
Other operating income	**70**	29
	52,023	45,935
Net insurance claims incurred and movement in policyholder liabilities	**(39,843)**	(37,131)
Net operating income	**12,180**	8,804

Loan impairment charges and other credit risk provisions

The net charge for loan impairment and other credit risk provisions decreased by HK$6,616m or 58.9% compared to 2009.

The net charge for individually assessed allowances decreased HK$1,967m as a number of large specific impairment charges recorded in 2009 did not recur, specifically for customers in Hong Kong, India and the Private Equity business. The overall decline was partly offset by an impairment charge against a specific GB&M exposure.

The net charge for collectively assessed impairment allowances fell by HK$4,024m, mainly driven by a managed reduction in cards and unsecured lending portfolios in India. Hong Kong has also experienced lower impairment charges against credit cards reflecting an improvement in delinquency rates. The improved economic environment also contributed to lower charges against corporate portfolios.

Net charge for other credit risk provisions fell primarily due to lower impairment charges and some impairment releases against asset-backed securities in 2010.

Net charge for loan impairment provisions by region

	2010 HK$m	2009 HK$m
Hong Kong	**919**	3,487
Rest of Asia-Pacific	**3,769**	7,192
Total	**4,688**	10,679

Net charge for loan impairment and other credit risk provisions

	2010 HK$m	2009 HK$m
Net charge for impairment of customer advances		
– Individually assessed impairment allowances:		
New allowances	**3,605**	5,504
Releases	**(1,069)**	(1,135)
Recoveries	**(322)**	(188)
	2,214	4,181
– Net charge for collectively assessed impairment allowances	**2,474**	6,498
	4,688	10,679
Net charge for other credit risk provisions	**(69)**	556
Net charge for loan impairment and other credit risk provisions	**4,619**	11,235

Financial Review (continued)

Operating Expenses

Total employee compensation and benefits rose by HK$4,181m, or 14.6%. Wages and salaries were HK$3,898m higher, due to the annual salary increment in early 2010 and higher performance related pay reflecting the overall 2010 performance, along with the increase in staff numbers in both frontline and support functions.

Higher headcount in 2010 reflected the ongoing expansion in a number of countries, including Hong Kong, mainland China, Taiwan, Indonesia, Singapore and Australia.

*Staff numbers by region**

	2010	2009
Hong Kong:		
The bank and wholly owned subsidiaries	**19,932**	18,358
Hang Seng Bank Hong Kong	**7,960**	7,834
Total Hong Kong	**27,892**	26,192
Rest of Asia-Pacific:		
Australia	**1,843**	1,599
Mainland China	**7,705**	7,204
Malaysia	**4,948**	5,024
India	**8,040**	8,337
Indonesia	**5,304**	5,042
Singapore	**3,045**	2,784
Taiwan	**3,511**	2,866
Sri Lanka	**1,735**	1,517
Others	**8,544**	8,209
Total rest of Asia-Pacific	**44,675**	42,582
Total	**72,567**	68,774

* *Full time equivalent at 31 December 2010.*

General and administrative expenses increased by 14.9%, or HK$2,902m in 2010.

Charges in respect of premises and equipment were up HK$306m, or 5.1%, with higher costs in Hong Kong from rising property and IT network rental charges. In the rest of Asia Pacific, increases in mainland China and Malaysia mainly reflected ongoing local business expansion through the opening of new branches and country headquarters.

Other administrative expenses increased by HK$1,886m, or 18.2%, on the back of increasing recruitment, consultancy, business travel and processing expenditure across the region to support growing business activities. Meanwhile, marketing expenses were 22.8% or HK$723m higher, as more marketing activity was carried out for propositions such as Advance, Premier, Cards and wealth management. These activities were undertaken to capitalise on the region's continued economic strength.

	2010	2009
	%	%
Cost efficiency ratio	**45.8**	44.4

Operating expenses (HK$m)

	2010	2009
	HK$m	HK$m
Employee compensation and benefits	**32,766**	28,585
General and administrative expenses	**22,389**	19,487
Depreciation of property plant and equipment	**3,425**	3,162
Amortisation of intangible assets	**1,664**	1,177
Total	**60,244**	52,411

Share of profit in associates and joint ventures

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

	2010	2009
	HK$m	HK$m
Share of profit in associates and joint ventures	**11,182**	7,741

Tax expense

The effective rate of tax for 2010 was 18.8% compared with 19.1% in 2009.

	2010	2009
	%	%
Effective rate of tax (%)	**18.8**	19.1

Assets

Total assets increased by HK$679bn, or 15.6%, since 31 December 2009.

Net advances to customers increased by HK$540.4bn, or 40.0%, since the end of 2009.

Net advances in Hong Kong increased by HK$312.0bn, or 41.9%, during 2010. The increase was largely attributable to significant growth in Corporate and Commercial lending (up HK$244.3bn), with increases in all sectors, reflecting higher demand due to the general improvement in economic conditions. Personal lending increased by HK$63.9bn, largely driven by mortgage lending which increased by HK$54.9bn. The growth in mortgages came from a buoyant property market and the success of HIBOR-linked mortgages which accounted for the majority of new mortgage lending by year end.

In the Rest of Asia-Pacific, net advances to customers increased by HK$228.4bn, or 37.7%, of which the impact of foreign exchange translation was HK$46.5bn. The underlying increase was mainly from Corporate and Commercial lending (up HK$148.0bn). Residential mortgages increased by HK$36.6bn, with growth notably in Australia, Singapore, Malaysia, Taiwan, and mainland China.

Assets 2010[1]

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

Assets 2009[1]

	HK$m	%
Cash and short term funds	892,175	21.1
Placings with banks maturing after one month and certificates of deposit	144,458	3.4
Trading assets	322,731	7.6
Advances to customers	1,350,644	32.0
Financial investments	882,689	20.9
Other	632,637	15.0
Total	4,225,334	100.0

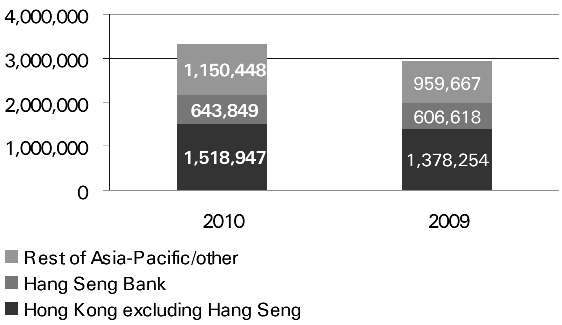
1 *Excluding Hong Kong Government certificates of indebtedness*

Financial Review (continued)

Customer accounts

Customer accounts increased by HK$368.7bn, or 12.5%, during 2010.

Customer accounts by region

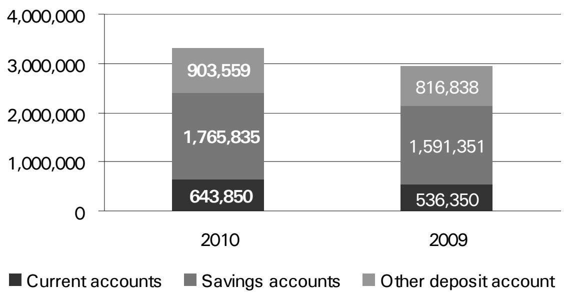


In Hong Kong, customer accounts increased by HK$177.9bn, or 9.0%, and in the Rest of Asia-Pacific customer accounts increased by HK$190.8bn or 19.9% as compared to 2009.

The group's advances-to-deposits ratio increased to 57.1% at 31 December 2010, from 45.9% at 31 December 2009 as more of the commercial surplus was deployed to customer lending.

	2010	2009
Advances: deposits ratio (%)	**57.1**	45.9

Customer accounts



Equity

Equity increased by HK$61bn, or 21.2%, to HK$347bn. The increase came principally from retained profits. In addition, increases in the value of available-for-sale securities, largely from the group's investment in Ping An Insurance, as well as property revaluation reserves and exchange differences, also contributed to the increase.

Capital Adequacy

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

The methods for calculating risk weighted assets for each type of risk are discussed in note 52(f) to the Financial Statements on page 188.

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

Capital structure at 31 December

	2010 HK$m	2009 HK$m
Core capital:		
Share capital per balance sheet	**22,494**	22,494
Revaluation reserve capitalisation issue	**(1,454)**	(1,454)
Paid-up ordinary share capital	**21,040**	21,040
Paid-up irredeemable non-cumulative preference shares	**51,714**	51,590
Reserves per balance sheet	**297,636**	223,294
Proposed dividend	**(12,000)**	(8,850)
Unconsolidated subsidiaries	**(26,320)**	(19,913)
Cash flow hedging reserve	**(106)**	(848)
Regulatory reserve	**(7,702)**	(6,413)
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities and debt securities	**(92,065)**	(56,661)
Unrealised gains on equities and debt securities designated at fair value	**(191)**	(75)
Own credit spread	**(231)**	(64)
Total reserves included in core capital	**159,021**	130,470
Non-controlling interests per balance sheet	**27,305**	24,939
Non-controlling interests in unconsolidated investments	**(2,574)**	(4,295)
Regulatory adjustments to non-controlling interests	**(2,002)**	(1,742)
Non-controlling interests	**22,729**	18,902
Goodwill and intangible assets	**(19,977)**	(19,682)
50% of unconsolidated investments	**(44,946)**	(35,059)
50% of securitisation positions and other deductions	**(192)**	(40)
Deductions	**(65,115)**	(54,781)
Total core capital	**189,389**	167,221
Supplementary capital:		
Paid-up irredeemable cumulative preference shares	**16,557**	16,517
Perpetual subordinated debt	**9,404**	9,393
Paid-up term preference shares	**33,035**	32,956
Term subordinated debt	**17,957**	14,406
Property revaluation reserves[1]	**7,977**	6,742
Unrealised gains on available-for-sale equities and debt securities[2]	**3,194**	3,961
Unrealised gains on equities and debt securities designated at fair value	**86**	34
Regulatory reserve[3]	**1,100**	937
Collective impairment allowances[3]	**625**	858
Excess impairment allowances over expected losses[4]	**2,534**	2,686
Supplementary capital before deductions	**92,469**	88,490
50% of unconsolidated investments	**(44,946)**	(35,059)
50% of securitisation positions and other deductions	**(192)**	(40)
Deductions	**(45,138)**	(35,099)
Total supplementary capital	**47,331**	53,391
Capital base[5]	**236,720**	220,612

Financial Review (continued)

Capital Adequacy *(continued)*

Risk weighted assets at 31 December

	2010 HK$m	2009 HK$m
Risk weighted assets		
Credit risk	**1,303,535**	1,075,841
Counterparty credit risk	**56,451**	48,733
Market risk	**35,251**	31,848
Operational risk	**216,866**	214,532
Total	**1,612,103**	1,370,954

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

	2010	2009
Core capital ratio[5]	**11.7%**	12.2%
Capital adequacy ratio[5]	**14.7%**	16.1%

Reserves and deductible items

	2010 HK$m	2009 HK$m
Published reserves	**138,680**	113,618
Profit and loss account	**20,341**	16,852
Total reserves included in core capital[5]	**159,021**	130,470

	2010 HK$m	2009 HK$m
Total of items deductible 50% from core capital and 50% from supplementary capital	**90,276**	70,198

1 *Includes the revaluation surplus on investment properties which is reported as part of retained profits and adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.*
2 *Includes adjustments made in accordance with the Banking (Capital) Rules issued by the HKMA.*
3 *Total regulatory reserve and collective impairment allowances are apportioned between the standardised approach and internal ratings-based approach in accordance with the Banking (Capital) Rules issued by the HKMA. Those apportioned to the standardised approach are included in supplementary capital. Those apportioned to the internal ratings-based approach are excluded from supplementary capital.*
4 *Excess impairment allowances over expected losses are applicable to non-securitisation exposures calculated by using the internal ratings based approach.*
5 *The 2009 capital base, risk weighted assets and capital ratios have not been restated for the effects of HKAS 17 'Leases'.*

Non-bank mainland exposures

The analysis of non-bank mainland exposures is based on the categories of non-bank counterparties and the type of direct exposures defined by the HKMA under the Banking (Disclosure) Rules with reference to the HKMA return for non-bank mainland exposures, which includes the mainland exposures extended by the Bank and its banking subsidiary in mainland China as at 31 December 2010 and as at 31 December 2009.

Non-bank mainland exposures

	On-balance sheet exposure HK$m	Off-balance sheet exposure HK$m	Total exposures HK$m	Specific provisions HK$m
At 31 December 2010				
Mainland entities	**28,577**	**13,533**	**42,110**	**1**
Companies and individuals outside the mainland where the credit is granted for use in the mainland	**48,674**	**40,994**	**89,668**	**641**
Other counterparties the exposures to whom are considered by the Bank to be non-bank mainland exposures	**4,264**	**2,725**	**6,989**	**–**
	81,515	**57,252**	**138,767**	**642**
Mainland exposures of wholly owned mainland subsidiaries:				
Loans and advances	**111,146**	**2,995**	**114,141**	**36**
Debt securities and other	**54,473**	**9,940**	**64,413**	**–**
	165,619	**12,935**	**178,554**	**36**
	247,134	**70,187**	**317,321**	**678**
At 31 December 2009				
Mainland entities	20,155	11,344	31,499	1
Companies and individuals outside the mainland where the credit is granted for use in the mainland	36,844	36,997	73,841	810
Other counterparties the exposures to whom are considered by the Bank to be non-bank mainland exposures	155	3,207	3,362	–
	57,154	51,548	108,702	811
Mainland exposures of wholly owned mainland subsidiaries:				
Loans and advances	76,607	2,689	79,296	47
Debt securities and other	51,080	9,763	60,843	–
	127,687	12,452	140,139	47
	184,841	64,000	248,841	858

Advances to customers by geographical area

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

	Hong Kong HK$m	Rest of Asia-Pacific/ Other HK$m	Total HK$m
At 31 December 2010			
Gross advances to customers	**889,862**	**1,014,192**	**1,904,054**
At 31 December 2009			
Gross advances to customers	683,553	681,371	1,364,924

Cross-Border Exposure

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

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

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

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

Cross border exposure

	Banks and other financial institutions HK$m	Public sector entities HK$m	Others HK$m	Total HK$m
As at 31 December 2010				
Americas				
United States	**104,109**	**93,618**	**48,703**	**246,430**
Others	**20,390**	**14,361**	**67,699**	**102,450**
	124,499	**107,979**	**116,402**	**348,880**
Europe				
United Kingdom	**151,629**	**1,364**	**12,543**	**165,536**
Others	**128,561**	**58,372**	**21,594**	**208,527**
	280,190	**59,736**	**34,137**	**374,063**
Asia-Pacific excluding Hong Kong				
China	**156,972**	**9,782**	**64,089**	**230,843**
Others	**95,700**	**132,909**	**211,971**	**440,580**
	252,672	**142,691**	**276,060**	**671,423**
As at 31 December 2009				
Americas				
United States	124,438	89,352	48,777	262,567
Others	20,249	10,595	45,805	76,649
	144,687	99,947	94,582	339,216
Europe				
United Kingdom	228,935	854	13,247	243,036
Others	182,577	50,833	19,040	252,450
	411,512	51,687	32,287	495,486
Asia-Pacific excluding Hong Kong	197,633	92,634	178,339	468,606

Risk Management

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

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

Credit risk, liquidity risk, market risk, operational risk, insurance risk and capital management are discussed in detail in Note 52 to the Financial Statements on pages 159 to 188.

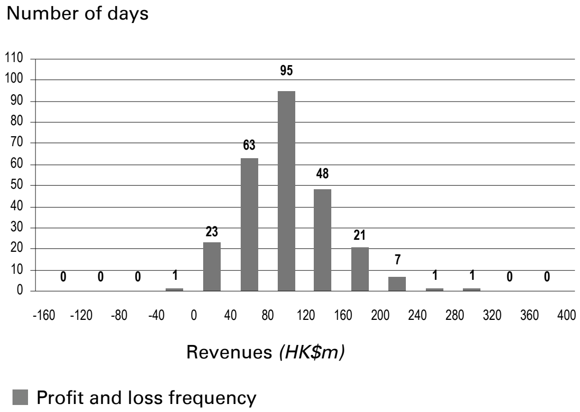
Market Risk Management

The nature of market risk and the principal tool used to monitor and limit market risk exposure (value at risk) are discussed in Note 52 on the Financial Statements on pages 171 to 175.

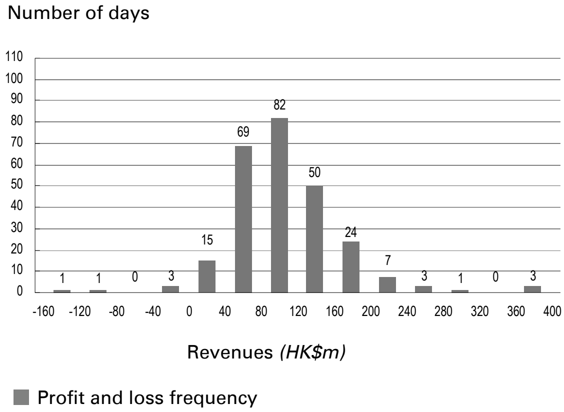
The average daily revenue earned from market risk-related treasury activities in 2010, including accrual book net interest income and funding related to dealing positions, was HK$100m compared with HK$106m in 2009. The standard deviation of these daily revenues was HK$49m (HK$62m for 2009).

An analysis of the frequency distribution of daily revenues shows that negative revenues occurred on 1 day in 2010. The most frequent result was a daily revenue of between HK$80m and HK$120m with 95 occurrences. The highest daily revenue was HK$299m. The most frequent result in 2009 was a daily revenue of between HK$80m and HK$120m with 82 occurrences. The highest daily revenue in 2009 was HK$393m.

Daily distribution of market risk revenues 2010



Daily distribution of market risk revenues 2009



Reputational Risk Management

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

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

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

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

Financial Statements

Consolidated income statement for the year ended 31 December 2010

	Note	2010 HK$m	2009 HK$m Restated[1]
Interest income	4(a)	**85,523**	82,550
Interest expense	4(b)	**(23,647)**	(24,118)
Net interest income		**61,876**	58,432
Fee income		**41,657**	35,583
Fee expense		**(6,374)**	(5,305)
Net fee income	4(c)	**35,283**	30,278
Net trading income	4(d)	**20,716**	20,526
Net income from financial instruments designated at fair value	4(e)	**3,757**	7,259
Gains less losses from financial investments	4(f)	**2,016**	(131)
Dividend income	4(g)	**564**	364
Net earned insurance premiums	5(b)	**37,193**	31,395
Other operating income	4(h)	**10,004**	7,006
Total operating income		**171,409**	155,129
Net insurance claims incurred and movement in policyholders' liabilities	5(c)	**(39,843)**	(37,131)
Net operating income before loan impairment charges and other credit risk provisions		**131,566**	117,998
Loan impairment charges and other credit risk provisions	4(i)	**(4,619)**	(11,235)
Net operating income		**126,947**	106,763
Employee compensation and benefits	6(a)	**(32,766)**	(28,585)
General and administrative expenses	4(j)	**(22,389)**	(19,487)
Depreciation of property, plant and equipment	26	**(3,425)**	(3,162)
Amortisation and impairment of intangible assets	25(c)	**(1,664)**	(1,177)
Total operating expenses		**(60,244)**	(52,411)
Operating profit		**66,703**	54,352
Share of profit in associates and joint ventures		**11,182**	7,741
Profit before tax		**77,885**	62,093
Tax expense	7	**(14,608)**	(11,883)
Profit for the year		**63,277**	50,210
Profit attributable to shareholders		**57,597**	45,396
Profit attributable to non-controlling interests		**5,680**	4,814

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2010

	2010 HK$m	2009 HK$m *Restated*[1]
Profit for the year	**63,277**	50,210
Other comprehensive income		
Available-for-sale investments:		
– fair value changes taken to equity	**18,252**	31,250
– fair value changes transferred to the income statement on disposal	**(2,076)**	(1,174)
– amounts derecognised on deconsolidation	**(1,849)**	–
– amounts transferred to the income statement on impairment	**(24)**	472
– fair value changes transferred to the income statement on hedged items due to hedged risk	**(500)**	483
– income taxes	**330**	(1,241)
Cash flow hedges:		
– fair value changes taken to equity	**654**	1,650
– fair value changes transferred to the income statement	**(1,591)**	(3,026)
– income taxes	**155**	204
Property revaluation:		
– fair value changes taken to equity	**9,936**	4,588
– income taxes	**(1,766)**	(639)
Share of changes in equity of associates and joint ventures	**(66)**	212
Exchange differences	**8,881**	5,344
Actuarial (losses)/gains on post-employment benefits:		
– before income taxes	**(807)**	3,606
– income taxes	**149**	(559)
Other comprehensive income for the year, net of tax	**29,678**	41,170
Total comprehensive income for the year, net of tax	**92,955**	91,380
Total comprehensive income for the year attributable to:		
– shareholders	**86,473**	84,133
– non-controlling interests	**6,482**	7,247
	92,955	91,380

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Consolidated balance sheet at 31 December 2010

	Note	2010 HK$m	2009 HK$m Restated[1]
ASSETS			
Cash and short-term funds	*11*	**807,985**	892,175
Items in the course of collection from other banks		**16,878**	15,528
Placings with banks maturing after one month	*12*	**149,557**	107,070
Certificates of deposit	*13*	**73,247**	37,388
Hong Kong Government certificates of indebtedness	*14*	**148,134**	135,414
Trading assets	*15*	**390,208**	322,731
Financial assets designated at fair value	*16*	**54,604**	48,087
Derivatives	*17*	**302,622**	235,171
Advances to customers	*18*	**1,891,060**	1,350,644
Financial investments	*21*	**826,662**	882,689
Amounts due from Group companies		**137,633**	134,511
Interests in associates and joint ventures	*24*	**75,568**	53,683
Goodwill and intangible assets	*25*	**29,690**	25,069
Property, plant and equipment	*26*	**72,347**	58,810
Deferred tax assets	*7*	**2,515**	2,668
Retirement benefit assets	*6*	**301**	292
Other assets	*28*	**60,907**	58,818
Total assets		**5,039,918**	4,360,748
LIABILITIES			
Hong Kong currency notes in circulation	*14*	**148,134**	135,414
Items in the course of transmission to other banks		**26,495**	22,960
Deposits by banks		**167,827**	111,206
Customer accounts	*29*	**3,313,244**	2,944,539
Trading liabilities	*30*	**151,534**	154,366
Financial liabilities designated at fair value	*31*	**40,327**	36,709
Derivatives	*17*	**309,838**	232,846
Debt securities in issue	*32*	**59,283**	43,396
Retirement benefit liabilities	*6*	**4,713**	3,922
Amounts due to Group companies		**83,128**	50,842
Other liabilities and provisions	*33*	**70,946**	55,982
Liabilities under insurance contracts issued	*34*	**177,970**	144,928
Current tax liabilities	*7*	**4,419**	4,119
Deferred tax liabilities	*7*	**11,913**	10,503
Subordinated liabilities	*36*	**21,254**	21,181
Preference shares	*37*	**101,458**	101,208
Total liabilities		**4,692,483**	4,074,121
EQUITY			
Share capital	*38*	**22,494**	22,494
Other reserves		**124,382**	89,603
Retained profits		**161,254**	139,255
Proposed fourth interim dividend	*9*	**12,000**	8,850
Total shareholders' equity		**320,130**	260,202
Non-controlling interests		**27,305**	26,425
Total equity		**347,435**	286,627
Total equity and liabilities		**5,039,918**	4,360,748

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Directors
Stuart T Gulliver
Margaret K M Y Leung
Peter T S Wong

Secretary
Paul A Stafford

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

	2010									
			Other reserves							
	Share capital	Retained profits and proposed dividend	Property revaluation reserve	Available-for-sale investment reserve	Cash flow hedge reserve	Foreign exchange reserve	Other	Total shareholders' equity	Non-controlling interests	Total equity
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
At 1 January	22,494	148,105	22,983	43,385	848	6,998	15,389	260,202	26,425	286,627
Profit for the year	–	57,597	–	–	–	–	–	57,597	5,680	63,277
Other comprehensive income (net of tax)	–	(766)	7,605	14,168	(742)	8,791	(180)	28,876	802	29,678
Available-for-sale investments	–	–	–	14,095	–	–	–	14,095	38	14,133
Cash flow hedges	–	–	–	–	(743)	–	–	(743)	(39)	(782)
Property revaluation	–	(100)	7,604	–	–	–	–	7,504	666	8,170
Actuarial losses on defined benefit plans	–	(660)	–	–	–	–	–	(660)	2	(658)
Share of other comprehensive income of associates and joint ventures	–	(2)	1	113	–	–	(178)	(66)	–	(66)
Exchange differences	–	(4)	–	(40)	1	8,791	(2)	8,746	135	8,881
Total comprehensive income for the year	–	56,831	7,605	14,168	(742)	8,791	(180)	86,473	6,482	92,955
Dividends paid	–	(26,850)	–	–	–	–	–	(26,850)	(3,899)	(30,749)
Movement in respect of share-based payment arrangements	–	159	–	–	–	–	219	378	36	414
Changes in ownership interest in subsidiaries	–	(88)	–	–	–	–	–	(88)	–	(88)
Changes in non-controlling interests on deconsolidation	–	–	–	–	–	–	–	–	(1,708)	(1,708)
Other movements	–	10	1	4	–	–	–	15	(31)	(16)
Transfers	–	(4,913)	(609)	(4)	–	–	5,526	–	–	–
At 31 December	22,494	173,254	29,980	57,553	106	15,789	20,954	320,130	27,305	347,435

Consolidated statement of changes in equity for the year ended 31 December 2009

	2009									
			Other reserves							
	Share capital	Retained profits and proposed dividend	Property revaluation reserve	Available-for-sale investment reserve	Cash flow hedge reserve	Foreign exchange reserve	Other	Total share-holders' equity	Non-controlling interests	Total equity
	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m	HK$m
As previously reported	22,494	134,255	8,578	15,103	1,833	1,666	9,683	193,612	22,874	216,486
Restatement for HKAS 17	–	5	11,864	–	–	–	–	11,869	1,265	13,134
At 1 January	22,494	134,260	20,442	15,103	1,833	1,666	9,683	205,481	24,139	229,620
Profit for the year	–	45,396	–	–	–	–	–	45,396	4,814	50,210
Other comprehensive income (net of tax)	–	2,380	3,561	28,294	(985)	5,332	155	38,737	2,433	41,170
Available-for-sale investments	–	–	–	28,174	–	–	–	28,174	1,616	29,790
Cash flow hedges	–	–	–	–	(1,025)	–	–	(1,025)	(147)	(1,172)
Property revaluation	–	(93)	3,561	–	–	–	–	3,468	481	3,949
Actuarial gains on defined benefit plans	–	2,451	–	–	–	–	–	2,451	596	3,047
Share of other comprehensive income of associates and joint ventures	–	4	–	53	–	–	155	212	–	212
Exchange differences	–	18	–	67	40	5,332	–	5,457	(113)	5,344
Total comprehensive income for the year	–	47,776	3,561	28,294	(985)	5,332	155	84,133	7,247	91,380
Dividends paid	–	(28,840)	–	–	–	–	–	(28,840)	(4,830)	(33,670)
Movement in respect of share-based payment arrangements	–	330	–	–	–	–	(800)	(470)	37	(433)
Other movements	–	(73)	(16)	(11)	–	–	(2)	(102)	(168)	(270)
Transfers	–	(5,348)	(1,004)	(1)	–	–	6,353	–	–	–
At 31 December	22,494	148,105	22,983	43,385	848	6,998	15,389	260,202	26,425	286,627

Financial Statements (continued)

Consolidated statement of cash flows for the year ended 31 December 2010

	Note	2010 HK$m	2009 HK$m
Operating activities			
Cash (used in)/generated from operations	42	**(107,924)**	123,789
Interest received on financial investments		**12,711**	15,420
Dividends received on financial investments		**560**	306
Dividends received from associates		**2,768**	2,565
Taxation paid		**(13,269)**	(10,239)
Net cash (outflow)/inflow from operating activities		**(105,154)**	131,841
Investing activities			
Purchase of financial investments		**(475,669)**	(533,217)
Proceeds from sale or redemption of financial investments		**548,115**	423,421
Purchase of property, plant and equipment		**(6,165)**	(1,984)
Proceeds from sale of property, plant and equipment and assets held for sale		**63**	1,848
Purchase of other intangible assets		**(1,373)**	(1,271)
Net cash (outflow)/inflow in respect of the acquisition of and increased shareholding in subsidiaries	43	**(127)**	15,271
Net cash outflow in respect of the sale of subsidiaries	43	**(13)**	–
Net cash outflow in respect of the purchase of interests in associates and joint ventures		**(10,676)**	(43)
Net cash inflow from the sale of interests in business portfolios	43	**–**	251
Proceeds from the sale of interests in associates		**136**	20
Net cash inflow/(outflow) from investing activities		**54,291**	(95,704)
Net cash (outflow)/inflow before financing		**(50,863)**	36,137
Financing			
Issue of preference share capital		**–**	8,282
Change in non-controlling interests		**(24)**	(160)
Repayment of subordinated liabilities		**(2,055)**	(659)
Issue of subordinated liabilities		**1,533**	–
Ordinary dividends paid	9	**(26,850)**	(28,840)
Dividends paid to non-controlling interests		**(3,899)**	(4,830)
Interest paid on preference shares		**(3,118)**	(4,034)
Interest paid on subordinated liabilities		**(582)**	(741)
Net cash outflow from financing		**(34,995)**	(30,982)
(Decrease)/increase in cash and cash equivalents	43	**(85,858)**	5,155

Bank balance sheet at 31 December 2010

	Note	2010 HK$m	2009 HK$m Restated[1]
ASSETS			
Cash and short-term funds	*11*	**551,003**	657,765
Items in the course of collection from other banks		**12,143**	11,151
Placings with banks maturing after one month	*12*	**74,791**	67,299
Certificates of deposit	*13*	**27,888**	20,492
Hong Kong Government certificates of indebtedness	*14*	**148,134**	135,414
Trading assets	*15*	**297,929**	216,480
Financial assets designated at fair value	*16*	**2,086**	1,801
Derivatives	*17*	**295,479**	230,998
Advances to customers	*18*	**1,016,312**	752,574
Financial investments	*21*	**503,752**	564,738
Amounts due from group companies		**198,322**	161,755
Investments in subsidiaries	*23*	**52,924**	39,606
Interests in associates and joint ventures	*24*	**28,139**	21,132
Goodwill and intangible assets	*25*	**4,713**	6,754
Property, plant and equipment	*26*	**45,061**	35,341
Deferred tax assets	*7*	**1,104**	1,436
Retirement benefit assets	*6*	**179**	176
Other assets	*28*	**31,873**	35,419
Total assets		**3,291,832**	2,960,331
LIABILITIES			
Hong Kong currency notes in circulation	*14*	**148,134**	135,414
Items in the course of transmission to other banks		**17,951**	15,796
Deposits by banks		**130,476**	94,861
Customer accounts	*29*	**2,044,664**	1,902,571
Trading liabilities	*30*	**91,184**	103,456
Financial liabilities designated at fair value	*31*	**6,581**	1,857
Derivatives	*17*	**303,882**	230,143
Debt securities in issue	*32*	**43,139**	28,250
Retirement benefit liabilities	*6*	**2,465**	1,986
Amounts due to group companies		**145,894**	123,202
Other liabilities and provisions	*33*	**44,032**	38,029
Current tax liabilities	*7*	**2,686**	3,456
Deferred tax liabilities	*7*	**5,525**	5,411
Subordinated liabilities	*36*	**9,404**	9,925
Preference shares	*37*	**101,306**	101,063
Total liabilities		**3,097,323**	2,795,420
EQUITY			
Share capital	*38*	**22,494**	22,494
Other reserves	*39*	**71,929**	53,580
Retained profits	*39*	**88,086**	79,987
Proposed fourth interim dividend	*9*	**12,000**	8,850
Total equity		**194,509**	164,911
Total equity and liabilities		**3,291,832**	2,960,331

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Directors
Stuart T Gulliver
Margaret K M Y Leung
Peter T S Wong

Secretary
Paul A Stafford

Notes on the Financial Statements

1 Basis of preparation

a The consolidated financial statements comprise the accounts of The Hongkong and Shanghai Banking Corporation Limited ('the Bank') and its subsidiaries ('the group') as of 31 December 2010.

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

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

b The consolidated financial statements include the attributable share of the results and reserves of associates and joint ventures based on accounts prepared for dates not earlier than three months prior to 31 December 2010.

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

A revised HKFRS 3 'Business Combinations' and an amended HKAS 27 'Consolidated and Separate Financial Statements'. The main changes are:

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- all consideration transferred, including contingent consideration, is recognised and measured at fair value at the acquisition date;
- equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;
- changes in a parent's ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- an option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interest) in the entity either at fair value, or at the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired.

For the group, the revised HKFRS 3 and the amendments to HKAS 27 apply prospectively to acquisitions and transactions taking place on or after 1 January 2010, and have no significant effect on these consolidated financial statements.

In addition, the group also adopted a number of HKFRSs or amendments to HKFRSs which had an insignificant or no effect on the consolidated financial statements. These are:

- Amendment to HKAS 39 'Financial Instruments: Recognition and Measurement' - 'Eligible Hedged Items';
- Amendments to HKFRS 2 'Share-based Payment' - 'Group Cash-settled Share-based Payment Transactions';
- Hong Kong (IFRIC) Interpretation 17 'Distributions of Non-cash Assets to Owners';
- HKFRS 1 (Revised) 'First-time Adoption of Hong Kong Financial Reporting Standards';
- Amendments to HKFRS 1 'First-time Adoption of Hong Kong Financial Reporting Standards' - 'Additional Exemptions for First-time Adopters';
- Amendment to HKFRS 1 'First-time Adoption of Hong Kong Financial Reporting Standards' - 'Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters';
- Hong Kong (IFRIC) Interpretation 18 'Transfers of Assets from Customers';
- HK Interpretation 5 'Presentation of financial statements – classification by the borrower of a term loan that contains a repayment on demand clause'; and
- Other amendments made under 'Improvements to HKFRSs' in May 2009, except the amendment to leases as discussed below.

1 Basis of preparation *(continued)*

The HKICPA issued two chapters in the first phase of updating the 'Conceptual Framework' in October 2010 which are effective immediately upon issue – Chapter 1 *The objective of financial reporting* and Chapter 3 *Qualitative characteristics of useful financial information*. The adoption of the Conceptual Framework did not have any significant effect on the consolidated financial statements.

Hong Kong Accounting Standard 17, 'Leases' (HKAS 17) has been amended with effect from 1 January 2010 ("the amendment") as part of the 'Improvements to HKFRS' issued in May 2009. Since 2005, and prior to the amendment, a number of significant interests in long-term leasehold land owned by the group were recorded as prepaid operating leases, measured at historical cost less amortisation and included within 'Other assets' in the balance sheet. Following the application of the amendment in 2010, such interests are reclassified as prepaid finance leases on the basis that substantially all of the risks and rewards of ownership have been transferred to the group. They are included within 'Property, plant and equipment' in the balance sheet and carried at valuation (as discussed in note 3(o)). The amendment has been applied retrospectively and the corresponding prior-year comparatives have been adjusted accordingly.

The effects of the amendment to HKAS 17 on the position at 31 December 2008 are not shown as a separate column in the primary financial statements in view of its immaterial impact on the balance sheet as a whole. The affected primary statement lines are presented together as follows:

(i) For the group

	As reported HK$m	Adjustment HK$m	Restated HK$m
Year ended 31 December 2009			
Profit for the year	50,644	(434)	50,210
Total comprehensive income	88,614	2,766	91,380
Profit attributable to non-controlling interests	4,836	(22)	4,814
As at 31 December 2009			
Property, plant and equipment	36,327	22,483	58,810
Other assets	62,256	(3,438)	58,818
Deferred tax liabilities	7,358	3,145	10,503
Other reserves	75,213	14,390	89,603
Retained profits	139,231	24	139,255
Non-controlling interests	24,939	1,486	26,425
As at 31 December 2008			
Property, plant and equipment	35,885	19,260	55,145
Other assets	75,931	(3,527)	72,404
Deferred tax liabilities	4,433	2,599	7,032
Other reserves	36,863	11,864	48,727
Retained profits	123,085	5	123,090
Non-controlling interests	22,874	1,265	24,139

(i) For the Bank

	As reported HK$m	Adjustment HK$m	Restated HK$m
As at 31 December 2009			
Property, plant and equipment	20,182	15,159	35,341
Other assets	37,891	(2,472)	35,419
Deferred tax liabilities	3,318	2,093	5,411
Other reserves	42,986	10,594	53,580
As at 31 December 2008			
Property, plant and equipment	21,384	12,533	33,917
Other assets	50,012	(2,489)	47,523
Deferred tax liabilities	2,107	1,657	3,764
Other reserves	19,633	8,387	28,020

2 Critical accounting estimates and judgements in applying accounting policies

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

Disclosures under HKFRS 4 and HKFRS 7 relating to the nature and extent of risks have been included in note 52 'Risk management'.

Loan impairment

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

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

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

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is included in note 3(f) and is discussed further within note 17 'Derivatives' and note 51 'Fair value of financial instruments'.

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

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

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

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

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

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

A change in the fair value of a financial asset which is classified as 'available-for sale' is recorded directly in equity until the financial asset is sold, when the cumulative change in fair value is charged or credited to the income statement. When a decline in the fair value of an available-for sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in equity is removed from equity and recognised in the income statement, reducing the group's operating profit.

Impairment of available-for-sale financial investments

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

Liabilities under investment contracts

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

Insurance contracts

Classification

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

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

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

Insurance liabilities

The estimation of insurance liabilities involves selecting statistical models and making assumptions about future events which need to be frequently calibrated against experience and forecasts. The sensitivity of insurance liabilities to potential changes in key assumptions is set out in note 52.

Held-to-maturity securities

As indicated in note 3(g), certain debt instruments within the 'Financial investments' category are classified as held-to-maturity investments. In order to be able to use this classification, the group needs to exercise judgement upon initial recognition of the investments as to whether it has the positive intention and ability to hold them until maturity. A failure to hold these investments to maturity, in all but a limited number of circumstances, would result in the entire held-to-maturity category being reclassified as 'available-for-sale'. They would then be measured at fair value. The carrying amount and the fair value of held-to-maturity securities at 31 December 2010 are disclosed in note 51.

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies

a *Interest income and expense*

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

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts. Such transaction costs (for example, mortgage rebates) are incremental to the group and are directly attributable to a transaction.

Interest on impaired financial assets is recognised at the original effective interest rate of the financial asset applied to the impaired carrying amount. The accounting policy for recognising impairment of loans and advances is set out in note 3(d) below.

b *Non interest income*

(i) Fee income

The group earns fee income from a diverse range of services it provides to its customers. Fee income is accounted for as follows:

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

3 Summary of significant accounting policies *(continued)*

(ii) Dividend income

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

(iii) Net income from financial instruments designated at fair value

Net income from financial instruments designated at fair value comprises all gains and losses from changes in the fair value (net of accrued coupon) of such financial assets and financial liabilities, together with interest income and expense and dividend income attributable to those financial instruments.

(iv) Net trading income

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

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c *Advances to customers and placings with banks*

Loans and advances to banks and customers include loans and advances originated by the group which are not classified as either held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when borrowers repay their obligations, 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 impairment losses. Where loans and advances are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

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

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d *Loan impairment*

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

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

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

(i) Individually significant loans

Impairment losses on individually significant accounts are assessed by an evaluation of the exposures on a case-by-case basis. The group assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant.

The criteria used by the group to determine that there is such objective evidence include, *inter alia:*

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial restructuring; and
- a significant downgrading in credit rating by an external rating agency.

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

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and capability to trade successfully out of financial difficulties and generate sufficient cash flow to service their debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, 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 relevant foreign currency if loans are not in local currency; and
- where available, the secondary market price for the debt.

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

(ii) Collectively assessed loans

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

- in respect of losses which have been incurred but have not yet been identified on loans subject to individual assessment for impairment (see section (i) above); and
- for homogeneous groups of loans that are not considered individually significant.

3 Summary of significant accounting policies *(continued)*

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of impairment has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment allowance. The impairment calculated by this method represents impairments that have occurred at the balance sheet date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account:

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

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

Homogeneous groups of loans

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

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

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

(iii) Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

(iv) Reversals of impairment

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

(v) Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included within 'Other operating income' in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised as a gain in 'Other operating income' in the income statement.

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

(vi) Renegotiated loans

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

e *Trading assets and trading liabilities*

Treasury bills, loans and advances to and from customers, loans and advances to and from banks, debt securities, structured deposits, equity shares, own debt issued and short positions in securities which have been acquired or incurred principally for the purpose of selling or repurchasing in the near term or are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking are classified as held for trading. This designation, once made, is irrevocable in respect of the financial instruments to which it is made. Such financial assets or financial liabilities are recognised initially at fair value, with transaction costs taken to the income statement, and are subsequently remeasured at fair value. All subsequent gains and losses from changes in the fair value of these assets and liabilities, together with related interest income and expense and dividends, are recognised in the income statement within 'Net trading income' as they arise. Financial assets and financial liabilities are recognised using trade date accounting.

f *Financial instruments designated at fair value*

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

Financial assets and financial liabilities so designated are recognised initially at fair value, with transaction costs taken directly to the income statement, and are subsequently remeasured at fair value. This designation, once made, is irrevocable in respect of the financial instruments to which it is made. Financial assets and financial liabilities are recognised using trade date accounting.

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

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

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

3 Summary of significant accounting policies *(continued)*

The group may designate financial instruments at fair value where the designation:

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

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g *Financial investments*

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

Available-for-sale

Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value and changes therein are recognised in equity in the 'Available-for-sale investment reserve' until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as 'Gains less losses from financial investments'.

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

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of financial assets. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset and can be reliably estimated.

If the available-for-sale financial asset is impaired, the difference between the financial asset's acquisition cost (net of any principal repayments and amortisation) and the current fair value, less any previous impairment loss recognised in the income statement, is removed from equity and recognised in the income statement.

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

3 Summary of significant accounting policies *(continued)*

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

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement if, and only if, there is objective evidence of impairment. Objective evidence of impairment occurs when, as a result of one or more loss events, the estimated future cash flows of the financial asset are impacted and can be reliably measured. Where there is no objective evidence of impairment, the decline in the fair value of the financial asset is recognised directly in equity. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value;
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in equity. Impairment losses recognised on an equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group has the positive intention and ability to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

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h *Determination of fair value*

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

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

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

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

When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when group enters into an offsetting transaction.

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

3 Summary of significant accounting policies *(continued)*

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

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

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

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

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j *Derivative financial instruments and hedge accounting*

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

Fair values are obtained from quoted market prices in active markets, or by using valuation techniques, including recent market transactions, where an active market does not exist. Valuation techniques include discounted cash flow models and option pricing models as appropriate. All derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative.

In the normal course of business, the fair value of a derivative on initial recognition is considered to be the transaction price (i.e. the fair value of the consideration given or received). However, in certain circumstances the fair value of an instrument will be evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets, including interest rate yield curves, option volatilities and currency rates. When such evidence exists and results in a value which is different from the transaction price, the group recognises a trading profit or loss on inception of the derivative.

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract, the terms of the embedded derivative are the same as those of a stand-alone derivative, and the combined contract is not designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

Derivative assets and liabilities from different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists, and the cash flows are intended to be settled either simultaneously or on a net basis.

The method of recognising the resulting fair value gains or losses depends on whether the derivative is held for trading, or is designated as a hedging instrument, and if so, the nature of the risk being hedged.

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

3 Summary of significant accounting policies *(continued)*

Hedge accounting

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

Fair value hedge

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

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

Cash flow hedge

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

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

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

Net investment hedge

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

Hedge effectiveness testing

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

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

3 Summary of significant accounting policies *(continued)*

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'. For fair value hedge relationships, regression analysis is used to test hedge effectiveness. For cash flow hedge relationships, effectiveness is tested by applying the change in variable cash flow method.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness, the changes in fair value or cash flows, at each reporting date or based on recent history, must offset each other. The group considers that a hedge is highly effective when the offset is within the range of 80% to 125%.

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k *Derecognition of financial assets and liabilities*

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

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

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l *Offsetting financial assets and financial liabilities*

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

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m *Subsidiaries, associates and joint ventures*

The group

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

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

Associates are entities over which the group has significant influence but not control or joint control. Joint ventures involve contractual arrangements whereby the group undertakes an economic activity with one or more parties and that economic activity is subject to joint control. Investments in associates and joint ventures 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.

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

The Bank

The Bank's investments in subsidiaries, associates and joint ventures are stated at cost less impairment losses, if any. 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 investment in subsidiary's recoverable amount since the last impairment loss recognised.

n *Goodwill and intangible assets*

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

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

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

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

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

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

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

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

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

o *Property, plant and equipment*

(i) Land and buildings

The following 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:

- freehold land and buildings;
- leasehold land and buildings where the value of the land cannot be reliably separated from the value of the building at inception of the lease and the premises are not clearly held under an operating lease; and
- leasehold land and buildings where the value of the land can be reliably separated from the value of the building at inception of the lease and the term of the lease is not less than 50 years since substantially all the risk and rewards of ownership have been transferred to the group.

3 Summary of significant accounting policies *(continued)*

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

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

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

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

(ii) Other plant and equipment

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

(iii) Investment properties

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

(iv) 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 interest in leasehold land and land use rights separately as operating leases. These leases are recorded at original cost and amortised over the term of the lease. Where the cost of the land is unknown, or cannot be reliably determined, the land and buildings are accounted for together, as discussed above in 3(o)(i).

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

3 Summary of significant accounting policies *(continued)*

p *Finance and operating leases*

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

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

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

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

(v) There are no freehold interests in land in Hong Kong or mainland China. Leasehold land is included under 'Other assets' in the balance sheet if such land is considered to be held under operating leases (as described in note 3(o)(iv) above) and is stated at cost less amortisation and impairment losses. Amortisation is calculated to write off the cost of the land on a straight-line basis over the terms of the leases, which are generally below 50 years.

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q *Income tax*

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

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

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

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

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

3 Summary of significant accounting policies *(continued)*

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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r *Pension and other post-retirement benefits*

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

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

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

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

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s *Share-based payments*

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

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

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

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

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

3 Summary of significant accounting policies *(continued)*

t *Foreign currencies*

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

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

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

u *Provisions*

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

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

v *Financial guarantee contracts*

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

3 Summary of significant accounting policies *(continued)*

w *Insurance contracts*

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

Insurance contracts are accounted for as follows:

Premiums

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

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 and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the shareholders' interest in the profits expected to emerge from these contracts written at the balance sheet date.

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

Claims and reinsurance recoveries

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

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising during the year include maturities, surrenders and death claims.

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

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

Notes on the Financial Statements (continued)

3 Summary of significant accounting policies *(continued)*

Liabilities under insurance contracts

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

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

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

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

x *Investment contracts*

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

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

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

y *Dividends*

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

z *Debt securities in issue and subordinated liabilities*

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

aa *Cash and cash equivalents*

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

ab *Share capital*

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

4 Operating profit

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

a *Interest income*

	2010 HK$m	2009 HK$m
Interest income on listed securities	**8,012**	8,094
Interest income on unlisted securities	**15,878**	16,849
Other interest income	**69,053**	64,382
	92,943	89,325
Less: interest income classified as 'Net trading income' (note 4(d))	**(7,366)**	(6,701)
Less: interest income classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**(54)**	(74)
	85,523	82,550

Included in the above is interest income accrued on impaired financial assets of HK$465m (2009: HK$480m), including unwinding of discounts on loan impairment losses of HK$324m (2009: HK$297m).

b *Interest expense*

	2010 HK$m	2009 HK$m
Interest expense on subordinated liabilities, other debt securities in issue, customer accounts and deposits by banks maturing after five years	**704**	964
Interest expense on preference shares	**2,659**	3,937
Other interest expense	**22,908**	22,097
	26,271	26,998
Less: interest expense classified as 'Net trading income' (note 4(d))	**(2,599)**	(2,848)
Less: interest expense classified as 'Net income from financial instruments designated at fair value' (note 4(e))	**(25)**	(32)
	23,647	24,118

c *Net fee income*

	2010 HK$m	2009 HK$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	**13,172**	11,844
– fee expense	**(1,404)**	(1,225)
	11,768	10,619
Net fee income on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers		
– fee income	**8,717**	6,711
– fee expense	**(1,005)**	(761)
	7,712	5,950

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

d *Net trading income*

	2010 HK$m	2009 HK$m
Dealing profits	**15,484**	16,275
– Foreign exchange	**13,036**	12,613
– Interest rate derivatives	**978**	1,591
– Debt securities	**672**	999
– Equities and other trading	**798**	1,072
Loss from hedging activities	**(11)**	(23)
Fair value hedges		
– Net gain / (loss) on hedged items attributable to the hedged risk	**563**	(413)
– Net (loss) / gain on hedging instruments	**(579)**	375
Cash flow hedges		
– Net hedging gain	**5**	15
Interest on trading assets and liabilities	**4,767**	3,853
– Interest income (note 4(a))	**7,366**	6,701
– Interest expense (note 4(b))	**(2,599)**	(2,848)
Dividend income from trading securities	**476**	421
– Listed investments	**391**	291
– Unlisted investments	**85**	130
	20,716	20,526

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

	2010 HK$m	2009 HK$m
Income on assets designated at fair value which back insurance and investment contracts	**4,509**	9,100
Change in fair value of liabilities to customers under investment contracts	**(1,217)**	(2,854)
	3,292	6,246
Net change in fair value of other financial assets/liabilities designated at fair value[1]	**436**	971
Interest on financial assets and liabilities designated at fair value		
– Interest income (note 4(a))	**54**	74
– Interest expense (note 4(b))	**(25)**	(32)
	3,757	7,259

1 *Gains and losses from changes in the fair value of the group's issued debt securities may arise from changes in the group's own credit risk. In 2010 the group recognised a HK$51m loss on changes in the fair value of these instruments arising from changes in own credit risk (2009:HK$35m loss).*

f *Gains less losses from financial investments*

	2010 HK$m	2009 HK$m
Gains on disposal of available-for-sale securities	**2,365**	1,191
Impairment of available-for-sale equity investments	**(349)**	(1,322)
	2,016	(131)

There are no gains or losses on the disposal of held-to-maturity investments in the year (2009: nil).

4 Operating profit *(continued)*

g *Dividend income*

	2010 HK$m	2009 HK$m
Listed investments	**418**	228
Unlisted investments	**146**	136
	564	364

h *Other operating income*

	2010 HK$m	2009 HK$m *Restated*[1]
Rental income from investment properties	**170**	169
Movement in present value of in-force insurance business	**4,106**	2,888
Gains on investment properties	**483**	262
Gains on disposal of property, plant and equipment, and assets held for sale	**13**	410
Gain/(loss) on disposal of subsidiaries, associates and business portfolios	**603**	(6)
Surplus/(deficit) arising on property revaluation	**102**	(109)
Other	**4,527**	3,392
	10,004	7,006

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Included within 'Other' are recoveries against initial fair value on loan portfolios of HK$1,049m (2009: HK$664m). There are no gains or losses on the disposal of financial liabilities measured at amortised cost during the year (2009: nil).

i *Loan impairment charges and other credit risk provisions*

	2010 HK$m	2009 HK$m
Net charge for impairment of customer advances		
– Individually assessed impairment allowances:		
New allowances	**3,605**	5,504
Releases	**(1,069)**	(1,135)
Recoveries	**(322)**	(188)
	2,214	4,181
– Net charge for collectively assessed impairment allowances	**2,474**	6,498
Net charge for other credit risk provisions	**(69)**	556
Net charge for loan impairment and other credit risk provisions	**4,619**	11,235

Included in the net charge for other credit risk provisions is an impairment release of HK$38m against available-for-sale debt securities (2009: impairment charge of HK$365m). There are no impairment losses or provisions relating to held-to-maturity investments (2009: nil).

Notes on the Financial Statements (continued)

4 Operating profit *(continued)*

j *General and administrative expenses*

	2010 HK$m	2009 HK$m *Restated* [1]
Premises and equipment		
– Rental expenses	**2,749**	2,747
– Amortisation of prepaid operating lease payments	**18**	18
– Other premises and equipment	**3,496**	3,192
	6,263	5,957
Marketing and advertising expenses	**3,891**	3,168
Other administrative expenses	**12,254**	10,368
Litigation and other provisions	**(19)**	(6)
	22,389	19,487

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Included in operating expenses are direct operating expenses of HK$20m (2009: HK$21m) arising from investment properties that generated rental income during the year. Direct operating expenses arising from investment properties that did not generate rental income amounted to HK$2m (2009: HK$1m).

Included in operating expenses are minimum lease payments under operating leases of HK$2,934m (2009: HK$2,806m).

k *Auditors' remuneration*

Auditors' remuneration amounted to HK$76m (2009: HK$72m), of which HK$29m (2009: HK$29m) related to the Bank.

5 Insurance income

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

a *Insurance income*

	2010 HK$m	2009 HK$m
Net interest income	**5,832**	4,691
Net fee income	**1,070**	768
Net trading loss	**(5)**	(8)
Net income from financial instruments designated at fair value	**3,371**	6,150
Gains less losses from financial investments	**386**	(7)
Dividend income	**–**	29
Net earned insurance premiums (note 5(b))	**37,193**	31,395
Movement in present value of in-force business	**4,106**	2,888
Other operating income	**70**	29
	52,023	45,935
Net insurance claims incurred and movement in policyholders' liabilities (note 5(c))	**(39,843)**	(37,131)
Net operating income	**12,180**	8,804

b *Net earned insurance premiums*

	Non-life insurance HK$m	Life insurance (non-linked) HK$m	Life insurance (linked) HK$m	Investment contracts with discretionary participation features HK$m	Total HK$m
2010					
Gross written premiums	**3,166**	**30,729**	**4,224**	**–**	**38,119**
Movement in unearned premiums	**(235)**	**–**	**–**	**–**	**(235)**
Gross earned premiums	**2,931**	**30,729**	**4,224**	**–**	**37,884**
Gross written premiums ceded to reinsurers	**(457)**	**(267)**	**(8)**	**–**	**(732)**
Reinsurers' share of movement in unearned premiums	**41**	**–**	**–**	**–**	**41**
Reinsurers' share of gross earned premiums	**(416)**	**(267)**	**(8)**	**–**	**(691)**
Net earned premiums	**2,515**	**30,462**	**4,216**	**–**	**37,193**
2009					
Gross written premiums	2,754	27,391	1,933	–	32,078
Movement in unearned premiums	(116)	–	–	–	(116)
Gross earned premiums	2,638	27,391	1,933	–	31,962
Gross written premiums ceded to reinsurers	(394)	(197)	(9)	–	(600)
Reinsurers' share of movement in unearned premiums	33	–	–	–	33
Reinsurers' share of gross earned premiums	(361)	(197)	(9)	–	(567)
Net earned premiums	2,277	27,194	1,924	–	31,395

Notes on the Financial Statements (continued)

5 Insurance income *(continued)*

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

	Non-life insurance HK$m	Life insurance (non-linked) HK$m	Life insurance (linked) HK$m	Investment contracts with discretionary participation features HK$m	Total HK$m
2010					
Claims, benefits and surrenders paid	**1,290**	**4,030**	**2,330**	**122**	**7,772**
Movement in provision	**(14)**	**28,866**	**2,672**	**(119)**	**31,405**
Gross claims incurred and movement in policyholders' liabilities	**1,276**	**32,896**	**5,002**	**3**	**39,177**
Reinsurers' share of claims, benefits and surrenders paid	**(160)**	**(157)**	**(298)**	**–**	**(615)**
Reinsurers' share of movement in provision	**20**	**3**	**1,258**	**–**	**1,281**
Reinsurers' share of claims incurred and movement in policyholders' liabilities	**(140)**	**(154)**	**960**	**–**	**666**
Net insurance claims incurred and movement in policyholders' liabilities	**1,136**	**32,742**	**5,962**	**3**	**39,843**
2009					
Claims, benefits and surrenders paid	1,227	3,001	884	2	5,114
Movement in provision	(143)	25,293	5,706	–	30,856
Gross claims incurred and movement in policyholders' liabilities	1,084	28,294	6,590	2	35,970
Reinsurers' share of claims, benefits and surrenders paid	(110)	(149)	(95)	–	(354)
Reinsurers' share of movement in provision	18	92	1,405	–	1,515
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(92)	(57)	1,310	–	1,161
Net insurance claims incurred and movement in policyholders' liabilities	992	28,237	7,900	2	37,131

6 Employee compensation and benefits

a *Employee compensation and benefits*

	2010 **HK$m**	2009 HK$m
Wages and salaries	**30,412**	26,514
Social security costs	**736**	698
Retirement benefit costs		
– Defined contribution plans	**920**	811
– Defined benefit plans	**698**	562
	32,766	28,585

b *Directors' emoluments*

The aggregate emoluments of the Directors of the Bank calculated in accordance with section 161 of the Hong Kong Companies Ordinance of HK$117m (2009: HK$129m). This comprises fees of HK$7m (2009: HK$6m) and other emoluments of HK$110m (2009: HK$123m) which includes pension benefits of HK$6m (2009: HK$5m).

c *Retirement benefit pension plans*

The group operates 77 (2009: 69) retirement benefit plans, with a total cost of HK$1,618m (2009: HK$1,373m), of which HK$649m (2009: HK$532m) relates to overseas plans and HK$28m (2009: HK$35m) are sponsored by HSBC Asia Holdings BV.

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

The group's defined benefit plans, which cover 37% (2009: 39%) of employees, are predominantly funded plans with assets which, in the case of the larger plans, are held either under insurance policies or in trust funds separate from the group. The cost relating to the funded plans was HK$628m (2009: HK$533m) which was assessed in accordance with the advice of qualified actuaries; the plans are reviewed at least on a triennial basis or in accordance with local practice and regulations. The actuarial assumptions used to calculate the projected benefit obligations of the group's retirement benefits plans vary according to the economic conditions of the countries in which they are situated.

(i) Defined benefit plan principal actuarial assumptions

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

	2010 **% p.a.**	2009 % p.a.
Discount rate	**2.85**	2.58
Expected rates of return on plan assets[1]		
– equities	**8.8**	8.5
– bonds	**3.8**	3.6
– other	**5.1**	0.9
Rate of pay increase		
– long term	**5.0**	5.0
Mortality table	**HKLT2001[2]**	HKLT2001[2]

1 *The expected rates of return are weighted on the basis of the fair value of the plan assets.*
2 *HKLT2001 – Hong Kong Life Tables 2001.*

The overall expected long-term rate of return on assets as at 31 December 2010 is 4.9% (2009: 5.8%). The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based on historical market returns adjusted for additional factors such as the current rate of inflation and interest rates.

6 Employee compensation and benefits *(continued)*

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of The Hongkong and Shanghai Banking Corporation Limited and certain other employees of the HSBC Group. The latest actuarial valuation of the defined benefit plan was made at 31 December 2009, and was performed by Estella Chiu, Fellow of the Society of Actuaries of the United States of America, of HSBC Insurance (Asia) Limited, a subsidiary of The Hongkong and Shanghai Banking Corporation Limited. At the valuation date, the market value of the defined benefit scheme's assets was HK$8,436m. On an ongoing basis, the actuarial value of the scheme's assets represented 105% of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to HK$551m. On a wind-up basis, the scheme's assets represented 107% of the members' vested benefits, based on current salaries, and the resulting surplus amounted to HK$690m. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 6% per annum and long-term salary increases of 5% per annum.

(ii) Value recognised in the balance sheet

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Equities	**3,144**	2,285	**1,416**	996
Bonds	**9,626**	9,995	**6,625**	6,855
Other	**2,117**	2,038	**1,818**	1,776
Fair value of plan assets	**14,887**	14,318	**9,859**	9,627
Present value of funded obligations	**19,021**	17,823	**11,958**	11,366
Present value of unfunded obligations	**287**	125	**198**	71
Defined benefit obligations	**19,308**	17,948	**12,156**	11,437
Past service cost not recognised	**10**	–	**12**	–
Effect of limit on plan surpluses	**1**	–	**1**	–
Net defined benefit liability	**(4,412)**	(3,630)	**(2,286)**	(1,810)
Reported as 'Assets'	**301**	292	**179**	176
Reported as 'Liabilities'	**(4,713)**	(3,922)	**(2,465)**	(1,986)
Net defined benefit liability	**(4,412)**	(3,630)	**(2,286)**	(1,810)

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

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**17,948**	20,954	**11,437**	12,841
Current service cost	**979**	1,153	**626**	721
Interest cost	**508**	307	**334**	207
Contributions by employees	**2**	2	**–**	–
Actuarial (gains)/losses	**808**	(3,200)	**712**	(1,472)
Benefits paid	**(1,104)**	(1,299)	**(704)**	(842)
Past service cost – vested immediately	**56**	–	**47**	–
Past service cost – unvested benefits	**12**	–	**15**	–
Reduction in liabilities resulting from curtailments	**–**	(48)	**–**	(48)
Exchange and other movements	**99**	79	**(311)**	30
At 31 December	**19,308**	17,948	**12,156**	11,437

6 Employee compensation and benefits *(continued)*

(iv) Changes in the fair value of plan assets

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**14,318**	13,588	**9,627**	9,379
Expected return	**847**	891	**587**	639
Contributions by the group	**705**	736	**479**	484
Contributions by employees	**2**	2	**–**	–
Actuarial gains/(losses)	**2**	368	**(59)**	(47)
Benefits paid	**(1,052)**	(1,261)	**(672)**	(822)
Assets distributed on curtailments	**–**	(33)	**–**	(33)
Exchange and other movements	**65**	27	**(103)**	27
At 31 December	**14,887**	14,318	**9,859**	9,627

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

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Equities	**427**	418	**366**	369
Others	**92**	103	**50**	62
	519	521	**416**	431

The group's actual gain on plan assets for the year ended 31 December 2010 was HK$849m (2009: HK$1,259m gain). The Bank's actual gain on plan assets for the year ended 31 December 2010 was HK$528m (2009: HK$592m gain).

The group expects to make HK$759m of contributions to defined benefit pension plans during the following year (2009: HK$706m). Contributions to be made by the Bank are expected to be HK$472m (2009: HK$453m).

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

	2010	2009
	HK$m	HK$m
Current service cost	**979**	1,153
Interest cost	**508**	307
Expected return on plan assets	**(847)**	(891)
Past service costs	**58**	–
Gains on curtailments	**–**	(7)
Total net expense	**698**	562

The total net actuarial loss recognised in total equity during 2010 in respect of defined benefit pension plans was HK$807m (2009: HK$3,606m gain). After deduction of non-controlling interests, a loss of HK$810m (2009: HK$2,893m gain) was recognised in total shareholders' equity. Total net actuarial losses recognised outside of the income statement to date are HK$6,779m (2009: HK$5,972m). After deduction of non-controlling interests, the total net actuarial losses recognised in total shareholders' equity to date are HK$5,917m (2009: HK$5,107m).

Total net actuarial loss recognised in the Bank's retained profits during 2010 in respect of defined benefit pension plans were HK$772m (2009: HK$1,463m gain). Total net actuarial losses recognised outside of the income statement to date are HK$4,261m (2009: HK$3,489m).

Notes on the Financial Statements (continued)

6 Employee compensation and benefits *(continued)*

The total effect of the limit on plan surpluses recognised within actuarial losses in equity for both the group and the Bank during 2010 was HK$1m (2009: HK$38m, excluding exchange differences of HK$2m).

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

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

The scheme is denominated in Sterling with the following details:

	2010 **% p.a.**	2009 % p.a.
Assumptions as at 31 December		
Inflation	**3.70**	3.70
Salary increases	**5.45**	5.45
Pension increases	**3.70**	3.70
Discount rate	**5.40**	5.70
Expected return on assets	**5.51**	5.51
Mortality table	**PNA00YOB**[1]	PNA00YOB[1]

1 *The 'PNA00 Year of Birth' tables are based on the 2000 series of tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries. The mortality rates (that is, the probability of death in a given year) in these tables have been reduced by 20%. An allowance for future improvements in mortality after 2000 has been made in line with those underlying the medium cohort improvements applicable to the series, subject to a minimum improvement of 1% per annum.*

6 Employee compensation and benefits *(continued)*

The International Staff Scheme

	2010 **£m**	2009 £m
Funded status at 31 December		
Plan assets	**686**	604
Defined benefit obligations	**(737)**	(693)
Net defined benefit liability	**(51)**	(89)
Categories of assets at 31 December		
Bonds	**520**	428
Property	**33**	18
Other	**133**	158
Fair value of plan assets	**686**	604
Reconciliation of defined benefit obligations at 31 December		
At 1 January	**693**	523
Current service cost	**14**	11
Interest cost	**39**	34
Contributions by employees	**1**	1
Actuarial losses	**19**	154
Benefits paid	**(29)**	(30)
At 31 December	**737**	693
Reconciliation of the fair value of plan assets at 31 December		
At 1 January	**604**	545
Expected return	**33**	24
Actuarial gains/(losses)	**66**	(45)
Contributions by the group	**11**	109
Contributions by employees	**1**	1
Benefits paid	**(29)**	(30)
At 31 December	**686**	604
Estimated contributions in the following year		
Estimated company contributions in the financial year	**11**	12
Estimated employee contributions in the financial year	**1**	1
Estimated total contributions in the financial year	**12**	13

(vi) Amounts for the current and previous years

	Group					Bank				
	2010 **HK$m**	2009 HK$m	2008 HK$m	2007 HK$m	2006 HK$m	**2010** **HK$m**	2009 HK$m	2008 HK$m	2007 HK$m	2006 HK$m
Defined benefit obligations	**19,308**	17,948	20,954	17,966	13,134	**12,156**	11,437	12,841	11,310	8,674
Plan assets	**14,887**	14,318	13,588	16,572	14,860	**9,859**	9,627	9,379	10,506	9,500
Net (deficit)/surplus	**(4,421)**	(3,630)	(7,366)	(1,394)	1,726	**(2,297)**	(1,810)	(3,462)	(804)	826
Experience gains/(losses) on plan liabilities	**214**	(408)	132	790	420	**175**	(60)	363	585	384
Experience gains/(losses) on plan assets	**2**	368	(3,591)	948	953	**(59)**	(47)	(1,400)	487	499

Notes on the Financial Statements (continued)

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% (2009: 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 2010. Deferred taxation is provided for in accordance with the group's accounting policy in note 3(q).

The charge for taxation in the income statement comprises:

	2010	2009
	HK$m	HK$m
		Restated [1]
Current income tax		
– Hong Kong profits tax – on current year profit	**6,378**	6,010
– Hong Kong profits tax – adjustments in respect of prior years	**93**	(171)
– Overseas taxation – on current year profit	**7,470**	6,397
– Overseas taxation – adjustments in respect of prior years	**117**	(222)
	14,058	12,014
Deferred tax		
– Origination and reversal of temporary differences	**710**	(388)
– Adjustments in respect of prior years	**(160)**	257
	550	(131)
	14,608	11,883

7 Tax expense *(continued)*

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

(i) Deferred tax assets

Group

	Accelerated capital allowances and other short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Others HK$m	Total HK$m
2010						
At 1 January	**1,100**	**–**	**1,460**	**(447)**	**555**	**2,668**
Exchange and other adjustments	**85**	**–**	**40**	**(372)**	**(5)**	**(252)**
Credit/(charge) to income statement	**484**	**–**	**(604)**	**(9)**	**38**	**(91)**
(Charge)/credit to reserves	**–**	**–**	**–**	**(24)**	**214**	**190**
At 31 December	**1,669**	**–**	**896**	**(852)**	**802**	**2,515**
2009						
At 1 January	355	–	1,197	(1,147)	1,294	1,699
Exchange and other adjustments	384	–	32	713	(914)	215
(Charge)/credit to income statement	364	–	224	(3)	(21)	564
(Charge)/credit to reserves	(3)	–	7	(10)	196	190
At 31 December	1,100	–	1,460	(447)	555	2,668

Bank

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Others HK$m	Total HK$m
2010						
At 1 January	**414**	**–**	**1,246**	**(452)**	**228**	**1,436**
Exchange and other adjustments	**115**	**–**	**42**	**(323)**	**47**	**(119)**
Credit/(charge) to income statement	**87**	**–**	**(442)**	**(9)**	**(36)**	**(400)**
(Charge)/credit to reserves	**–**	**–**	**–**	**(13)**	**200**	**187**
At 31 December	**616**	**–**	**846**	**(797)**	**439**	**1,104**
2009						
At 1 January	279	–	854	(389)	75	819
Exchange and other adjustments	4	–	67	(67)	(16)	(12)
Credit/(charge) to income statement	131	–	319	(3)	(94)	353
Charge to reserves	–	–	6	7	263	276
At 31 December	414	–	1,246	(452)	228	1,436

Notes on the Financial Statements (continued)

7 Tax expense *(continued)*

(ii) Deferred tax liabilities

Group

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Others HK$m	Total HK$m
2010						
At 1 January	**2,059**	**(32)**	**(373)**	**6,085**	**2,764**	**10,503**
Exchange and other adjustments	**1,926**	**–**	**(12)**	**(315)**	**(1,915)**	**(316)**
Charge/(credit) to income statement	**693**	**1**	**90**	**(14)**	**(311)**	**459**
Charge/(credit) to reserves	**2**	**–**	**–**	**1,700**	**(435)**	**1,267**
At 31 December	**4,680**	**(31)**	**(295)**	**7,456**	**103**	**11,913**
2009						
As previously reported	2,306	(31)	(265)	2,168	255	4,433
Restatement for HKAS 17	–	–	–	2,599	–	2,599
At 1 January	2,306	(31)	(265)	4,767	255	7,032
Exchange and other adjustments	338	5	(155)	803	(413)	578
(Credit)/charge to income statement	(585)	(6)	42	(82)	1,064	433
Charge to reserves	–	–	5	597	1,858	2,460
At 31 December	2,059	(32)	(373)	6,085	2,764	10,503

Bank

	Accelerated capital allowances and short term timing differences HK$m	Leasing transactions HK$m	Impairment allowances on financial assets HK$m	Revaluation of properties HK$m	Others HK$m	Total HK$m
2010						
At 1 January	**1,790**	**(32)**	**(232)**	**3,343**	**542**	**5,411**
Exchange and other adjustments	**(495)**	**–**	**–**	**(263)**	**641**	**(117)**
(Credit)/charge to income statement	**(171)**	**1**	**21**	**(39)**	**(323)**	**(511)**
Charge/(credit) to reserves	**–**	**–**	**–**	**1,189**	**(447)**	**742**
At 31 December	**1,124**	**(31)**	**(211)**	**4,230**	**413**	**5,525**
2009						
As previously reported	2,172	(38)	(267)	1,431	(1,191)	2,107
Restatement for HKAS 17	–	–	–	1,657	–	1,657
At 1 January	2,172	(38)	(267)	3,088	(1,191)	3,764
Exchange and other adjustments	64	6	9	(1)	549	627
(Credit)/charge to income statement	(446)	–	21	(65)	160	(330)
Charge to reserves	–	–	5	321	1,024	1,350
At 31 December	1,790	(32)	(232)	3,343	542	5,411

7 Tax expense *(continued)*

(iii) Net deferred tax liabilities

	Group			Bank		
	2010	**2009**	**2008**	**2010**	**2009**	**2008**
	HK$m	**HK$m**	**HK$m**	**HK$m**	**HK$m**	**HK$m**
		Restated [1]	*Restated* [1]		*Restated* [1]	*Restated* [1]
Deferred tax liabilities recognised on the balance sheet	**11,913**	10,503	7,032	**5,525**	5,411	3,764
Deferred tax assets recognised on the balance sheet	**(2,515)**	(2,668)	(1,699)	**(1,104)**	(1,436)	(819)
	9,398	7,835	5,333	**4,421**	3,975	2,945

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

The amount of unused tax losses for which no deferred tax asset is recognised in the balance sheet is HK$3,390m (2009: HK$3,410m). The losses do not expire under current tax legislation.

Deferred tax of HK$617m (2009: HK$443m) 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 when remittance is not contemplated, and for those associates and interests in joint ventures where it has been determined that no additional tax will arise.

c *Provisions for taxation*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
		Restated [1]		*Restated* [1]
Hong Kong profits tax	**981**	722	**366**	368
Overseas taxation	**3,438**	3,397	**2,320**	3,088
Current tax liabilities	**4,419**	4,119	**2,686**	3,456
Deferred tax liabilities	**11,913**	10,503	**5,525**	5,411
	16,332	14,622	**8,211**	8,867

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

	2010	2009
	HK$m	HK$m
		Restated [1]
Profit before tax	**77,885**	62,093
Notional tax on profit before tax, calculated at the rates applicable to profits in the countries concerned	**14,880**	11,730
Tax effect of non-taxable revenue (net of non-deductible expenses)	**(792)**	(120)
Tax effect of prior year's tax losses utilised this year (net of unused tax losses not recognised)	**(94)**	(30)
Under / (over) provision in prior years	**50**	(136)
Others	**564**	439
	14,608	11,883

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Notes on the Financial Statements (continued)

8 Profit attributable to shareholders

The consolidated profit attributable to shareholders includes a profit of HK$38,227m (2009 restated: HK$35,278m) which has been dealt with in the accounts of the Bank.

9 Dividends

	2010		2009	
	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	**0.98**	**8,850**	1.24	11,170
– first interim dividend paid	**0.67**	**6,000**	0.65	5,890
– second interim dividend paid	**0.67**	**6,000**	0.65	5,890
– third interim dividend paid	**0.67**	**6,000**	0.65	5,890
	2.99	**26,850**	3.19	28,840

The Directors have declared a fourth interim dividend in respect of the financial year ending 31 December 2010 of HK$12,000m (HK$1.33 per ordinary share).

10 Analysis of financial assets and liabilities by measurement basis

Group

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

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

Group

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

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

Bank

	At 31 December 2010								
	Held for trading HK$m	Designated at fair value HK$m	Held-to-maturity securities HK$m	Loans and receivables HK$m	Available-for-sale securities HK$m	Financial assets and liabilities at amortised cost HK$m	Derivatives designated as fair value hedging instruments HK$m	Derivatives designated as cash flow hedging instruments HK$m	Total HK$m
Assets									
Cash and short-term funds	–	–	–	244,121	252,727	54,155	–	–	551,003
Items in the course of collection from other banks	–	–	–	–	–	12,143	–	–	12,143
Placings with banks maturing after one month	–	–	–	74,791	–	–	–	–	74,791
Certificates of deposit	–	–	–	–	27,888	–	–	–	27,888
Hong Kong Government certificates of indebtedness	–	–	–	–	–	148,134	–	–	148,134
Trading assets	297,929	–	–	–	–	–	–	–	297,929
Financial assets designated at fair value	–	2,086	–	–	–	–	–	–	2,086
Derivatives	294,739	–	–	–	–	–	122	618	295,479
Advances to customers	–	–	–	1,016,312	–	–	–	–	1,016,312
Financial investments	–	–	–	–	503,752	–	–	–	503,752
Amounts due from Group companies	43,340	–	–	–	–	154,982	–	–	198,322
Other assets	–	–	–	–	–	28,980	–	–	28,980
Total financial assets	636,008	2,086	–	1,335,224	784,367	398,394	122	618	3,156,819
Liabilities									
Hong Kong currency notes in circulation	–	–	–	–	–	148,134	–	–	148,134
Items in the course of transmission to other banks	–	–	–	–	–	17,951	–	–	17,951
Deposits by banks	–	–	–	–	–	130,476	–	–	130,476
Customer accounts	–	–	–	–	–	2,044,664	–	–	2,044,664
Trading liabilities	91,184	–	–	–	–	–	–	–	91,184
Financial liabilities designated at fair value	–	6,581	–	–	–	–	–	–	6,581
Derivatives	302,365	–	–	–	–	–	1,474	43	303,882
Debt securities in issue	–	–	–	–	–	43,139	–	–	43,139
Amounts due to Group companies	15,529	–	–	–	–	130,365	–	–	145,894
Other liabilities	–	–	–	–	–	40,712	–	–	40,712
Subordinated liabilities	–	–	–	–	–	9,404	–	–	9,404
Preference shares	–	–	–	–	–	101,306	–	–	101,306
Total financial liabilities	409,078	6,581	–	–	–	2,666,151	1,474	43	3,083,327

Notes on the Financial Statements (continued)

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

Bank

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

11 Cash and short-term funds

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Cash in hand	**13,001**	11,761	**7,086**	6,854
Sight balances with central banks	**68,380**	79,014	**47,069**	78,967
Placings with banks with remaining maturity of one month or less	**447,524**	441,862	**244,121**	275,538
Treasury bills and other eligible bills	**279,080**	359,538	**252,727**	296,406
	807,985	892,175	**551,003**	657,765

As at 31 December 2010, included within notes 11 and 12, the total amount placed with central banks by the group, including sight balances, amounted to HK$232,779m (2009: HK$256,074m). Placings with central banks made by the Bank amounted to HK$135,453m (2009: HK$182,643m).

Treasury bills and other eligible bills are analysed as follows:

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Treasury bills and other eligible bills – available-for-sale				
– not subject to repledge or resale by counterparties	**279,080**	359,538	**252,727**	296,406
	279,080	359,538	**252,727**	296,406

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

12 Placings with banks maturing after one month

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Gross placings with banks maturing after one month but not more than one year	**142,313**	103,252	**70,731**	64,219
Gross placings with banks maturing after one year	**7,244**	3,818	**4,060**	3,080
Total placings with banks	**149,557**	107,070	**74,791**	67,299

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

13 Certificates of deposit

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Held-to-maturity	**6,290**	4,458	**–**	–
Available-for-sale	**66,957**	32,930	**27,888**	20,492
	73,247	37,388	**27,888**	20,492

Certificates of deposit held are largely unlisted. There were no disposals of held-to-maturity certificates of deposit during the year (2009: nil).

14 Hong Kong currency notes in circulation

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

Notes on the Financial Statements (continued)

15 Trading assets

	Group 2010 HK$m	Group 2009 HK$m	Bank 2010 HK$m	Bank 2009 HK$m
Debt securities	**200,379**	138,020	**155,174**	104,158
Equity shares	**17,798**	13,780	**17,620**	13,077
Treasury bills and other eligible bills	**140,873**	145,676	**112,602**	82,680
Other	**31,158**	25,255	**12,533**	16,565
	390,208	322,731	**297,929**	216,480
Trading assets				
– which may be repledged or resold by counterparties	**5,619**	921	**5,619**	711
– not subject to repledge or resale by counterparties	**384,589**	321,810	**292,310**	215,769
	390,208	322,731	**297,929**	216,480

The amount of listed treasury bills and other eligible bills amounted to HK$2,624m at both group and Bank level as at 31 December 2010 (2009: HK$23,819m). These related to treasury bills listed on the Korean Stock Exchange.

a *Debt securities*

	Group 2010 HK$m	Group 2009 HK$m	Bank 2010 HK$m	Bank 2009 HK$m
Listed				
– listed in Hong Kong	**21,713**	21,323	**17,837**	18,612
– listed outside Hong Kong	**81,496**	48,654	**81,228**	48,497
	103,209	69,977	**99,065**	67,109
Unlisted	**97,170**	68,043	**56,109**	37,049
	200,379	138,020	**155,174**	104,158
Issued by public bodies				
– central governments and central banks	**143,684**	96,713	**103,286**	70,330
– other public sector entities	**9,266**	5,361	**9,165**	4,220
	152,950	102,074	**112,451**	74,550
Issued by				
– banks	**26,424**	20,934	**25,380**	16,330
– corporate entities	**21,005**	15,012	**17,343**	13,278
	200,379	138,020	**155,174**	104,158

b *Equity shares*

	Group 2010 HK$m	Group 2009 HK$m	Bank 2010 HK$m	Bank 2009 HK$m
Listed				
– listed in Hong Kong	**3,711**	3,106	**3,702**	3,100
– listed outside Hong Kong	**10,910**	8,851	**10,910**	8,333
	14,621	11,957	**14,612**	11,433
Unlisted	**3,177**	1,823	**3,008**	1,644
	17,798	13,780	**17,620**	13,077
Issued by				
– banks	**1,287**	1,270	**1,287**	1,270
– corporate entities	**16,511**	12,510	**16,333**	11,807
	17,798	13,780	**17,620**	13,077

16 Financial assets designated at fair value

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Debt securities	**17,299**	18,300	**2,086**	1,801
Equity shares	**36,674**	29,392	**–**	–
Other	**631**	395	**–**	–
	54,604	48,087	**2,086**	1,801

a *Debt securities*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**1,909**	1,409	**826**	802
– listed outside Hong Kong	**4,297**	2,939	**1,111**	770
	6,206	4,348	**1,937**	1,572
Unlisted	**11,093**	13,952	**149**	229
	17,299	18,300	**2,086**	1,801
Issued by public bodies				
– central governments and central banks	**2,266**	3,134	**593**	587
– other public sector entities	**2,402**	2,395	**270**	354
	4,668	5,529	**863**	941
Issued by other bodies				
– banks	**5,757**	7,577	**–**	–
– corporate entities	**6,874**	5,194	**1,223**	860
	17,299	18,300	**2,086**	1,801

b *Equity shares*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**4,299**	2,883	**–**	–
– listed outside Hong Kong	**13,907**	11,165	**–**	–
	18,206	14,048	**–**	–
Unlisted	**18,468**	15,344	**–**	–
	36,674	29,392	**–**	–
Issued by				
– banks	**1,677**	1,326	**–**	–
– corporate entities	**34,997**	28,066	**–**	–
	36,674	29,392	**–**	–

17 Derivatives

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

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

Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis. Changes in the values of derivatives are recognised in accordance with the group's accounting policy as described in note 3(j).

Use of derivatives

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

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

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

a *Trading derivatives*

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

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

17 Derivatives *(continued)*

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

	2010		2009	
	Group	**Bank**	Group	Bank
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**8,834,664**	**8,077,649**	5,398,523	4,796,545
Interest rate	**15,574,450**	**15,328,936**	10,150,894	9,998,057
Equities	**456,339**	**459,264**	246,876	255,708
Credit derivatives	**531,899**	**531,887**	612,691	614,144
Commodity and other	**38,530**	**31,436**	24,953	19,485
Total derivatives	**25,435,882**	**24,429,172**	16,433,937	15,683,939

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

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

	2010		2009	
	Group	**Bank**	Group	Bank
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**19,483**	**684**	3,182	546
Interest rate	**8,105**	**5,780**	1,167	1,007
Equities	**–**	**–**	775	702
Credit derivatives	**–**	**–**	–	–
Commodity and other	**–**	**–**	–	–
Total derivatives	**27,588**	**6,464**	5,124	2,255

(ii) Fair values of outstanding trading derivatives

Group

	2010		2009	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**159,083**	**166,848**	89,770	88,031
Interest rate	**120,077**	**118,474**	114,110	111,864
Equities	**16,424**	**16,275**	15,979	17,618
Credit derivatives	**5,233**	**4,968**	12,621	12,141
Commodity and other	**487**	**660**	566	430
Total derivatives	**301,304**	**307,225**	233,046	230,084

Bank

	2010		2009	
	Assets	**Liabilities**	Assets	Liabilities
	HK$m	**HK$m**	HK$m	HK$m
Exchange rate	**154,351**	**163,172**	86,348	86,763
Interest rate	**118,611**	**116,916**	113,061	110,600
Equities	**16,242**	**16,509**	16,872	17,848
Credit derivatives	**5,296**	**5,119**	12,624	12,584
Commodity and other	**239**	**649**	447	428
Total derivatives	**294,739**	**302,365**	229,352	228,223

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

(iii) Risk exposure by counterparty type

	2010		2009	
	Group	**Bank**	Group	Bank
	%	**%**	%	%
Government	**–**	**–**	–	–
Banks	**78**	**79**	78	78
Other financial institutions	**8**	**8**	8	8
Other	**14**	**13**	14	14
Total	**100**	**100**	100	100

b *Hedging instruments*

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

The accounting treatment of 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 net investment hedges.

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

	Group		Bank	
	Cash flow hedge HK$m	Fair value hedge HK$m	Cash flow hedge HK$m	Fair value hedge HK$m
Interest rate				
At 31 December 2010	**250,303**	**113,458**	**124,688**	**72,976**
At 31 December 2009	251,130	129,509	168,163	101,363

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

	Group		Bank	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
Interest rate				
At 31 December 2010	**422**	**2,488**	**122**	**1,474**
At 31 December 2009	148	2,533	101	1,864

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

	Group		Bank	
	Assets HK$m	Liabilities HK$m	Assets HK$m	Liabilities HK$m
Interest rate				
At 31 December 2010	**896**	**125**	**618**	**43**
At 31 December 2009	1,977	229	1,545	56

17 Derivatives *(continued)*

The cash flows of the above hedging derivatives are expected to affect the income statement in 2011 and beyond.

The group's cash flow hedges consist principally of interest rate swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their own contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement. During the year to 31 December 2010, the amount transferred to the income statement comprised HK$1,430m (2009: HK$2,689m) included in net interest income.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2010, a gain of HK$5m (2009: gain of HK$15m) was recognised due to hedge ineffectiveness and termination of forecast transactions.

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2010 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 2010			
Cash inflows from assets	**177,416**	**96,529**	**31,841**
Cash outflows from liabilities	**(4,301)**	**(4,003)**	**(2,574)**
Net cash inflows	**173,115**	**92,526**	**29,267**
At 31 December 2009			
Cash inflows from assets	220,822	209,085	27,546
Cash outflows from liabilities	(5,784)	(5,783)	(3,877)
Net cash inflow	215,038	203,302	23,669

Notes on the Financial Statements (continued)

17 Derivatives *(continued)*

c *Unobservable inception profits*

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

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

Group

	2010	2009
	HK$m	HK$m
Balance at 1 January	**128**	119
Deferrals on new transactions	**94**	82
Reduction due to amortisation	**(55)**	(37)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(69)**	(48)
Exchange differences and others	**3**	12
Balance at 31 December	**101**	128

Bank

	2010	2009
	HK$m	HK$m
Balance at 1 January	**124**	119
Deferrals on new transactions	**81**	78
Reduction due to amortisation	**(55)**	(37)
Reduction due to redemption/sales/transfers/improved observability/risk hedged	**(62)**	(40)
Exchange differences and others	**3**	4
Balance at 31 December	**91**	124

18 Advances to customers

a *Advances to customers*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers	**1,904,054**	1,364,924	**1,025,285**	762,425
Impairment allowances (note 19(a))	**(12,994)**	(14,280)	**(8,973)**	(9,851)
	1,891,060	1,350,644	**1,016,312**	752,574

18 Advances to customers *(continued)*

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

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

Group

2010	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
Residential mortgages	**299,271**	**221,558**	**520,829**
Hong Kong Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**27,496**	**–**	**27,496**
Credit card advances	**37,351**	**34,287**	**71,638**
Other personal	**47,874**	**37,779**	**85,653**
Total personal	**411,992**	**293,624**	**705,616**
Commercial, industrial and international trade	**260,020**	**325,253**	**585,273**
Commercial real estate	**150,142**	**67,804**	**217,946**
Other property-related lending	**118,401**	**42,231**	**160,632**
Government	**18,185**	**3,223**	**21,408**
Other commercial	**78,676**	**93,569**	**172,245**
Total corporate and commercial	**625,424**	**532,080**	**1,157,504**
Non-bank financial institutions	**21,952**	**16,486**	**38,438**
Settlement accounts	**2,020**	**476**	**2,496**
Total financial	**23,972**	**16,962**	**40,934**
Gross advances to customers	**1,061,388**	**842,666**	**1,904,054**
Individually assessed impairment allowances	**(2,615)**	**(5,644)**	**(8,259)**
Collectively assessed impairment allowances	**(2,178)**	**(2,557)**	**(4,735)**
Net advances to customers	**1,056,595**	**834,465**	**1,891,060**
2009			
Residential mortgages	244,328	169,016	413,344
Hong Kong Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	26,801	–	26,801
Credit card advances	35,545	31,654	67,199
Other personal	41,384	35,550	76,934
Total personal	348,058	236,220	584,278
Commercial, industrial and international trade	137,461	219,631	357,092
Commercial real estate	105,404	50,131	155,535
Other property-related lending	78,028	30,030	108,058
Government	3,416	4,615	8,031
Other commercial	56,821	55,312	112,133
Total corporate and commercial	381,130	359,719	740,849
Non-bank financial institutions	19,088	17,976	37,064
Settlement accounts	2,437	296	2,733
Total financial	21,525	18,272	39,797
Gross advances to customers	750,713	614,211	1,364,924
Individually assessed impairment allowances	(3,724)	(4,364)	(8,088)
Collectively assessed impairment allowances	(2,412)	(3,780)	(6,192)
Net advances to customers	744,577	606,067	1,350,644

Notes on the Financial Statements (continued)

18 Advances to customers *(continued)*

Bank

2010	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
Residential mortgages	**168,936**	**85,761**	**254,697**
Hong Kong Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	**12,663**	**–**	**12,663**
Credit card advances	**21,616**	**14,942**	**36,558**
Other personal	**27,833**	**19,451**	**47,284**
Total personal	**231,048**	**120,154**	**351,202**
Commercial, industrial and international trade	**162,419**	**157,112**	**319,531**
Commercial real estate	**112,390**	**36,477**	**148,867**
Other property-related lending	**26,686**	**19,513**	**46,199**
Government	**17,463**	**3,137**	**20,600**
Other commercial	**53,106**	**54,494**	**107,600**
Total corporate and commercial	**372,064**	**270,733**	**642,797**
Non-bank financial institutions	**19,931**	**11,240**	**31,171**
Settlement accounts	**–**	**115**	**115**
Total financial	**19,931**	**11,355**	**31,286**
Gross advances to customers	**623,043**	**402,242**	**1,025,285**
Individually assessed impairment allowances	**(1,775)**	**(4,171)**	**(5,946)**
Collectively assessed impairment allowances	**(1,589)**	**(1,438)**	**(3,027)**
Net advances to customers	**619,679**	**396,633**	**1,016,312**
2009			
Residential mortgages	132,426	87,732	220,158
Hong Kong Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme mortgages	12,155	–	12,155
Credit card advances	21,727	18,749	40,476
Other personal	24,037	20,959	44,996
Total personal	190,345	127,440	317,785
Commercial, industrial and international trade	91,703	110,668	202,371
Commercial real estate	76,826	27,732	104,558
Other property-related lending	16,546	12,935	29,481
Government	2,675	3,986	6,661
Other commercial	37,194	33,147	70,341
Total corporate and commercial	224,944	188,468	413,412
Non-bank financial institutions	16,233	14,930	31,163
Settlement accounts	–	65	65
Total financial	16,233	14,995	31,228
Gross advances to customers	431,522	330,903	762,425
Individually assessed impairment allowances	(2,290)	(3,081)	(5,371)
Collectively assessed impairment allowances	(1,702)	(2,778)	(4,480)
Net advances to customers	427,530	325,044	752,574

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.

18 Advances to customers *(continued)*

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

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

Group

	Gross Advances		Collateral and other security	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**83,565**	50,034	**21,771**	15,140
Property investment	**186,120**	144,396	**142,691**	107,472
Financial concerns	**12,346**	9,442	**2,362**	2,203
Stockbrokers	**1,993**	1,155	**178**	227
Wholesale and retail trade	**68,403**	46,145	**17,921**	14,199
Manufacturing	**37,284**	27,318	**7,353**	5,597
Transport and transport equipment	**24,764**	21,543	**17,637**	16,036
Recreational activities	**945**	330	**532**	18
Information technology	**5,844**	5,336	**13**	33
Others	**80,677**	49,963	**19,892**	16,212
	501,941	355,662	**230,350**	177,137
Individuals				
Advances for the purchase of flats under the Hong Kong Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**27,496**	26,801	**27,458**	26,619
Advances for the purchase of other residential properties	**267,133**	217,626	**267,089**	217,187
Credit card advances	**37,351**	35,545	**-**	–
Others	**36,634**	32,641	**11,757**	12,010
	368,614	312,613	**306,304**	255,816
Gross advances to customers for use in Hong Kong	**870,555**	668,275	**536,654**	432,953
Trade finance	**135,650**	54,015	**27,332**	17,297
Gross advances to customers for use outside Hong Kong made by branches of the Bank and subsidiaries in Hong Kong	**55,183**	28,423	**1,365**	905
Gross advances to customers made by branches of the Bank and subsidiaries in Hong Kong	**1,061,388**	750,713	**565,351**	451,155
Gross advances to customers made by branches of the Bank and subsidiaries outside Hong Kong	**842,666**	614,211	**353,358**	274,986
Gross advances to customers	**1,904,054**	1,364,924	**918,709**	726,141

Notes on the Financial Statements (continued)

18 Advances to customers *(continued)*

Bank

	Gross Advances		Collateral and other security	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Gross advances to customers for use in Hong Kong				
Industrial, commercial and financial				
Property development	**42,602**	26,416	**8,145**	6,615
Property investment	**86,332**	69,132	**58,616**	45,504
Financial concerns	**9,243**	6,683	**1,383**	1,282
Stockbrokers	**1,828**	675	**42**	21
Wholesale and retail trade	**57,057**	38,332	**13,058**	10,335
Manufacturing	**20,112**	15,234	**1,949**	1,924
Transport and transport equipment	**16,824**	15,033	**12,141**	10,611
Recreational activities	**413**	293	**2**	3
Information technology	**3,887**	4,089	**–**	2
Others	**49,450**	23,188	**5,043**	3,726
	287,748	199,075	**100,379**	80,023
Individuals				
Advances for the purchase of flats under the Hong Kong Government's Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme	**12,663**	12,155	**12,624**	11,991
Advances for the purchase of other residential properties	**154,739**	120,975	**154,696**	120,852
Credit card advances	**21,616**	21,727	**–**	–
Others	**22,847**	20,626	**7,489**	6,543
	211,865	175,483	**174,809**	139,386
Gross advances to customers for use in Hong Kong	**499,613**	374,558	**275,188**	219,409
Trade finance	**71,990**	34,800	**15,698**	10,451
Gross advances to customers for use outside Hong Kong made by branches of the Bank in Hong Kong	**51,440**	22,164	**675**	225
Gross advances to customers made by branches of the Bank in Hong Kong	**623,043**	431,522	**291,561**	230,085
Gross advances to customers made by branches of the Bank outside Hong Kong	**402,242**	330,903	**144,280**	141,611
Gross advances to customers	**1,025,285**	762,425	**435,841**	371,696

The categories of advances, and the relevant definitions, used by the Hong Kong Monetary Authority differ from those used for internal purposes by the HSBC Group, including The Hongkong and Shanghai Banking Corporation Limited and its subsidiaries, as disclosed in note 18(b).

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.

Collateral includes any tangible security that has a determinable fair market value and is readily marketable. This includes (but is not limited to) cash and deposits, stocks and bonds, mortgages over properties and charges over other fixed assets such as plant and equipment. Where collateral values are greater than gross advances, only the amount of collateral up to the gross advance has been included.

18 Advances to customers *(continued)*

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

Group

	2010			2009		
	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	**2,947**	**562**	**3,509**	3,086	576	3,662
– After one year but within five years	**7,104**	**1,441**	**8,545**	7,404	1,329	8,733
– After five years	**13,071**	**2,034**	**15,105**	9,754	1,441	11,195
	23,122	**4,037**	**27,159**	20,244	3,346	23,590
Impairment allowances	**(62)**			(68)		
Net investment in finance leases and hire purchase contracts	**23,060**			20,176		

Bank

	2010			2009		
	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	**1,803**	**247**	**2,050**	1,826	277	2,103
– After one year but within five years	**4,045**	**644**	**4,689**	4,158	693	4,851
– After five years	**6,917**	**824**	**7,741**	5,753	806	6,559
	12,765	**1,715**	**14,480**	11,737	1,776	13,513
Impairment allowances	**(21)**			(38)		
Net investment in finance leases and hire purchase contracts	**12,744**			11,699		

Notes on the Financial Statements (continued)

19 Impairment allowances against advances to customers

a *Impairment allowances against advances to customers*

Group

2010	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**8,088**	**6,192**	**14,280**
Amounts written off	**(1,995)**	**(5,326)**	**(7,321)**
Recoveries of advances written off in previous years	**322**	**1,442**	**1,764**
Net charge to income statement (note 4(i))	**2,214**	**2,474**	**4,688**
Unwinding of discount of loan impairment	**(81)**	**(243)**	**(324)**
Exchange and other adjustments	**(289)**	**196**	**(93)**
At 31 December (note 18(a))	**8,259**	**4,735**	**12,994**
2009			
At 1 January	5,033	5,925	10,958
Amounts written off	(1,610)	(7,761)	(9,371)
Recoveries of advances written off in previous years	188	1,102	1,290
Net charge to income statement (note 4(i))	4,181	6,498	10,679
Unwinding of discount of loan impairment	(82)	(215)	(297)
Exchange and other adjustments	378	643	1,021
At 31 December (note 18(a))	8,088	6,192	14,280

Bank

2010	Individually assessed allowances HK$m	Collectively assessed allowances HK$m	Total HK$m
At 1 January	**5,371**	**4,480**	**9,851**
Amounts written off	**(1,220)**	**(3,835)**	**(5,055)**
Recoveries of advances written off in previous years	**119**	**968**	**1,087**
Net charge to income statement	**1,727**	**1,796**	**3,523**
Unwinding of discount of loan impairment	**(47)**	**(190)**	**(237)**
Exchange and other adjustments	**(4)**	**(192)**	**(196)**
At 31 December (note 18(a))	**5,946**	**3,027**	**8,973**
2009			
At 1 January	3,616	4,676	8,292
Amounts written off	(997)	(6,261)	(7,258)
Recoveries of advances written off in previous years	112	839	951
Net charge to income statement	2,508	5,325	7,833
Unwinding of discount of loan impairment	(50)	(214)	(264)
Exchange and other adjustments	182	115	297
At 31 December (note 18(a))	5,371	4,480	9,851

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

b *Impaired advances to customers and allowances*

Group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
2010			
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	**4,987**	**11,294**	**16,281**
Individually assessed allowances	**(2,615)**	**(5,644)**	**(8,259)**
	2,372	**5,650**	**8,022**
Individually assessed allowances as a percentage of gross impaired advances	**52.4%**	**50.0%**	**50.7%**
Gross impaired advances as a percentage of gross advances to customers	**0.5%**	**1.3%**	**0.9%**
2009			
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	6,358	9,838	16,196
Individually assessed allowances	(3,724)	(4,364)	(8,088)
	2,634	5,474	8,108
Individually assessed allowances as a percentage of gross impaired advances	58.6%	44.4%	49.9%
Gross impaired advances as a percentage of gross advances to customers	0.8%	1.6%	1.2%

Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
2010			
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	**3,436**	**7,160**	**10,596**
Individually assessed allowances	**(1,775)**	**(4,171)**	**(5,946)**
	1,661	**2,989**	**4,650**
Individually assessed allowances as a percentage of gross impaired advances	**51.7%**	**58.3%**	**56.1%**
Gross impaired advances as a percentage of gross advances to customers	**0.6%**	**1.8%**	**1.0%**
2009			
Advances to customers which are considered to be impaired are as follows:			
Gross impaired advances[1]	3,737	6,324	10,061
Individually assessed allowances	(2,290)	(3,081)	(5,371)
	1,447	3,243	4,690
Individually assessed allowances as a percentage of gross impaired advances	61.3%	48.7%	53.4%
Gross impaired advances as a percentage of gross advances to customers	0.9%	1.9%	1.3%

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

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

Notes on the Financial Statements (continued)

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

c *Individually assessed impaired advances*

Group

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2010			
Gross individually assessed impaired advances	**4,804**	**10,210**	**15,014**
Individually assessed impairment allowances	**(2,615)**	**(5,644)**	**(8,259)**
	2,189	**4,566**	**6,755**
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.5%**	**1.2%**	**0.8%**
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**1,463**	**2,887**	**4,350**
At 31 December 2009			
Gross individually assessed impaired advances	6,222	8,330	14,552
Individually assessed impairment allowances	(3,724)	(4,364)	(8,088)
	2,498	3,966	6,464
Gross individually assessed impaired advances as a percentage of gross advances to customers	0.8%	1.4%	1.1%
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	1,879	3,284	5,163

Bank

	Hong Kong HK$m	Rest of Asia-Pacific HK$m	Total HK$m
At 31 December 2010			
Gross individually assessed impaired advances	**3,359**	**6,521**	**9,880**
Individually assessed impairment allowances	**(1,775)**	**(4,171)**	**(5,946)**
	1,584	**2,350**	**3,934**
Gross individually assessed impaired advances as a percentage of gross advances to customers	**0.5%**	**1.6%**	**1.0%**
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	**877**	**879**	**1,756**
At 31 December 2009			
Gross individually assessed impaired advances	3,617	5,216	8,833
Individually assessed impairment allowances	(2,290)	(3,081)	(5,371)
	1,327	2,135	3,462
Gross individually assessed impaired advances as a percentage of gross advances to customers	0.8%	1.6%	1.2%
Fair value of collateral which has been taken into account in respect of individually assessed impaired advances to customers	1,093	1,620	2,713

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

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

Group

	Total gross 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 2010						
Residential mortgages	**520,829**	**2,274**	**(375)**	**(216)**	**4**	**78**
Commercial, industrial and international trade	**585,273**	**8,445**	**(5,989)**	**(1,898)**	**1,096**	**1,049**
Commercial real estate	**217,946**	**893**	**(254)**	**(54)**	**76**	**192**
At 31 December 2009						
Residential mortgages	413,344	2,772	(323)	(326)	43	76
Commercial, industrial and international trade	357,092	8,079	(5,766)	(2,243)	2,973	1,275
Commercial real estate	155,535	1,339	(560)	(96)	662	12

Bank

	Total gross 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 2010						
Residential mortgages	**254,697**	**585**	**(95)**	**(98)**	**(27)**	**43**
Commercial, industrial and international trade	**319,531**	**6,173**	**(4,395)**	**(1,198)**	**915**	**883**
Commercial real estate	**148,867**	**349**	**(60)**	**(22)**	**20**	**116**
At 31 December 2009						
Residential mortgages	220,158	1,749	(160)	(184)	35	61
Commercial, industrial and international trade	202,371	5,395	(4,146)	(1,471)	2,172	801
Commercial real estate	104,558	242	(51)	(62)	(30)	12

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

Notes on the Financial Statements (continued)

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

d *Overdue advances to customers*

Group

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
2010						
Gross advances to customers which have been overdue with respect to either principal or interest for periods of						
– more than three months but not more than six months	**341**	**0.0**	**1,906**	**0.2**	**2,247**	**0.1**
– more than six months but not more than one year	**974**	**0.1**	**825**	**0.1**	**1,799**	**0.1**
– more than one year	**2,234**	**0.2**	**4,345**	**0.5**	**6,579**	**0.4**
	3,549	**0.3**	**7,076**	**0.8**	**10,625**	**0.6**
Individually assessed impairment allowances made in respect of such overdue advances	**(1,923)**		**(3,824)**		**(5,747)**	
Fair value of collateral held in respect of overdue advances	**823**		**2,044**		**2,867**	
2009						
Gross advances to customers which have been overdue with respect to either principal or interest for periods of						
– more than three months but not more than six months	583	0.1	2,728	0.4	3,311	0.2
– more than six months but not more than one year	1,206	0.1	1,888	0.3	3,094	0.2
– more than one year	1,963	0.3	2,865	0.5	4,828	0.4
	3,752	0.5	7,481	1.2	11,233	0.8
Individually assessed impairment allowances made in respect of such overdue advances	(2,224)		(2,957)		(5,181)	
Fair value of collateral held in respect of overdue advances	959		2,123		3,082	

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

Bank

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
2010						
Gross advances to customers which have been overdue with respect to either principal or interest for periods of						
– more than three months but not more than six months	**204**	**0.0**	**854**	**0.2**	**1,058**	**0.1**
– more than six months but not more than one year	**886**	**0.2**	**391**	**0.1**	**1,277**	**0.1**
– more than one year	**1,330**	**0.2**	**2,574**	**0.6**	**3,904**	**0.4**
	2,420	**0.4**	**3,819**	**0.9**	**6,239**	**0.6**
Individually assessed impairment allowances made in respect of such overdue advances	**(1,115)**		**(2,496)**		**(3,611)**	
Fair value of collateral held in respect of overdue advances	**529**		**607**		**1,136**	
2009						
Gross advances to customers which have been overdue with respect to either principal or interest for periods of						
– more than three months but not more than six months	362	0.1	1,780	0.5	2,142	0.3
– more than six months but not more than one year	865	0.2	1,293	0.4	2,158	0.3
– more than one year	1,421	0.3	1,544	0.5	2,965	0.4
	2,648	0.6	4,617	1.4	7,265	1.0
Individually assessed impairment allowances made in respect of such overdue advances	(1,341)		(1,828)		(3,169)	
Fair value of collateral held in respect of overdue advances	704		877		1,581	

e *Rescheduled advances to customers*

Group

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
2010	**891**	**0.1**	**2,793**	**0.3**	**3,684**	**0.2**
2009	2,379	0.3	2,671	0.4	5,050	0.4

Bank

	Hong Kong		Rest of Asia-Pacific		Total	
	HK$m	%	HK$m	%	HK$m	%
2010	**772**	**0.1**	**1,251**	**0.3**	**2,023**	**0.2**
2009	1,813	0.4	2,327	0.7	4,140	0.5

Rescheduled advances to customers are those advances which have been restructured or renegotiated because of a deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule. Rescheduled advances to customers are stated net of any advances which have subsequently become overdue for more than three months and which are included in 'Overdue advances to customers' (note 19(d)).

Notes on the Financial Statements (continued)

20 Impairment allowances against advances to banks and other assets

There are no significant impaired or rescheduled advances to banks or overdue or rescheduled other assets as at 31 December 2010 and 31 December 2009. Information relating to overdue balances can be found in note 52.

21 Financial investments

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Debt securities				
– held-to-maturity	**121,743**	106,263	**–**	–
– available-for-sale	**632,084**	718,195	**442,336**	515,923
Equity shares				
– available-for-sale	**72,835**	58,231	**61,416**	48,815
	826,662	882,689	**503,752**	564,738
Financial investments				
– which may be repledged or resold by counterparties	**1,297**	418	**1,090**	277
– not subject to repledge or resale by counterparties	**825,365**	882,271	**502,662**	564,461
	826,662	882,689	**503,752**	564,738

a *Held-to-maturity debt securities*

Group

	Book value		Fair value	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**2,496**	1,688	**2,733**	1,671
– listed outside Hong Kong	**30,013**	16,836	**30,941**	17,178
	32,509	18,524	**33,674**	18,849
Unlisted	**89,234**	87,739	**92,737**	89,864
	121,743	106,263	**126,411**	108,713
Issued by public bodies				
– central governments and central banks	**2,309**	2,211	**2,471**	2,313
– other public sector entities	**18,074**	16,775	**19,230**	17,302
	20,383	18,986	**21,701**	19,615
Issued by				
– banks	**72,428**	65,997	**74,876**	67,631
– corporate entities	**28,932**	21,280	**29,834**	21,467
	121,743	106,263	**126,411**	108,713

21 Financial investments *(continued)*

b *Available-for-sale debt securities*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**9,519**	7,581	**1,337**	1,311
– listed outside Hong Kong	**261,968**	281,462	**200,125**	220,397
	271,487	289,043	**201,462**	221,708
Unlisted	**360,597**	429,152	**240,874**	294,215
	632,084	718,195	**442,336**	515,923
Issued by public bodies				
– central governments and central banks	**263,426**	246,206	**199,397**	188,703
– other public sector entities	**63,972**	61,076	**46,542**	40,290
	327,398	307,282	**245,939**	228,993
Issued by				
– banks	**257,408**	360,112	**159,631**	247,796
– corporate entities	**47,278**	50,801	**36,766**	39,134
	632,084	718,195	**442,336**	515,923

c *Available-for-sale equity shares*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Listed				
– listed in Hong Kong	**53,867**	43,253	**53,224**	41,772
– listed outside Hong Kong	**699**	1,226	**529**	934
	54,566	44,479	**53,753**	42,706
Unlisted	**18,269**	13,752	**7,663**	6,109
	72,835	58,231	**61,416**	48,815
Issued by				
– banks	**11,376**	8,848	**4,957**	4,221
– corporate entities	**61,459**	49,383	**56,459**	44,594
	72,835	58,231	**61,416**	48,815

Notes on the Financial Statements (continued)

22 Transfers of financial assets not qualifying for derecognition

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

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

The majority of transferred financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets transferred to third parties that did not qualify for derecognition during 2010 and 2009, and their associated financial liabilities:

Group

	2010		2009	
	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	**14,652**	**14,210**	879	898
Securities lending agreements	**594**	**65**	852	32
	15,246	**14,275**	1,731	930

Bank

	2010		2009	
	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	**6,692**	**6,485**	277	295
Securities lending agreements	**387**	**65**	711	32
	7,079	**6,550**	988	327

The carrying amount of assets transferred by the group to other HSBC Group entities under repurchase agreements is HK$48m (2009: HK$474m) and by the Bank is HK$11,647m (2009: HK$10,126m). The associated liability assumed by the group is HK$48m (2009: HK$472m) and by the Bank is HK$11,715m (2009: HK$10,122m).

The carrying amount of assets transferred under securities lending agreements to other HSBC Group entities is HK$2,341m (2009: HK$514m) by both the group and the Bank. The associated liabilities assumed are HK$2,458m (2009: HK$577m).

23 Investments in subsidiaries

	Bank 2010 HK$m	Bank 2009 HK$m
Investments in subsidiaries:		
Unlisted investments	**52,059**	38,741
Listed investment	**865**	865
	52,924	39,606

The principal subsidiaries of the Bank are:

	Place of incorporation	Principal activity	Issued equity capital	Group's interest in equity capital
Hang Seng Bank Limited	Hong Kong	Banking	HK$9,559m	62.14%
HSBC Bank (China) Company Limited	PRC[1]	Banking	RMB8,000m	100%
HSBC Bank Malaysia Berhad	Malaysia	Banking	RM$115m	100%
HSBC Bank Australia Limited[2]	Australia	Banking	A$751m	100%
HSBC Bank (Taiwan) Limited[2]	Taiwan	Banking	TWD30,000m	100%
HSBC Insurance (Asia) Limited[2]	Hong Kong	Insurance	HK$318m	100%
HSBC Life (International) Limited[2]	Bermuda	Retirement benefits and life insurance	HK$421m	100%

1 *People's Republic of China*
2 *Held indirectly*

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

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

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

Acquisitions

On 2 July 2010, the group entered into an agreement to acquire The Royal Bank of Scotland Group plc's retail and commercial banking businesses in India. The total consideration will comprise a premium of up to US$95m over the net asset value of the businesses being acquired. The purchase price will be reduced in respect of 90% of any credit losses incurred on the unsecured lending portfolio in the two years subsequent to completion. The initial consideration paid will be reduced by an estimate of these losses with an adjustment to reflect the actual losses at the end of the two year protection period. The acquisition is subject to regulatory approvals and is expected to complete in the first half of 2011.

Disposals

On 30 November 2010, the group completed the sale of an 80.1% interest in HSBC Private Equity (Asia) Limited ('HPEA') to HPEA's management. As a result, the group no longer controls The HSBC Private Equity Fund 3 ('HPEF3'). The group previously consolidated HPEF3 by virtue of its control over HPEA, which in turn controlled HPEF3. Upon deconsolidation, the group retains its 38.8% interest in HPEF3 as an available for sale investment. HPEF3 has been renamed The Headland Private Equity Fund 3 Limited. HPEF3 generated net profits after tax of HK$108m for the period to 30 November 2010. The group's pre-tax gain on deconsolidation was HK$602m.

The following assets and liabilities of HPEF3 were deconsolidated: Financial assets designated at fair value HK$2,390m; Financial investments HK$2,623m; Other assets HK$410m; and Deposits by banks HK$560m.

Notes on the Financial Statements (continued)

24 Interests in associates and joint ventures

	Group	
	2010	2009
	HK$m	HK$m
Share of net assets	**68,046**	46,804
Goodwill	**5,405**	4,842
Intangible assets	**2,690**	2,649
Deferred tax on intangible assets	**(573)**	(612)
	75,568	53,683

At 31 December 2010, the group's interests in associates amounted to HK$74,099m (2009: HK$52,473m).

	Bank	
	2010	2009
	HK$m	HK$m
Unlisted investments	**1,578**	1,751
Listed investments	**26,561**	19,381
	28,139	21,132

Shareholdings in associates held by the Bank include listed investments of HK$26,561m (2009: HK$19,381m). As at the balance sheet date, the fair value of these investments held by the group, based on quoted market prices, was HK$108,458m (2009: HK$113,163m).

a *Principal associates*

The principal associates of the group are:

	Place of incorporation	**Principal activity**	**Issued equity capital**	**Group's interest in equity capital**
Listed				
Bank of Communications Co., Ltd	PRC[1]	Banking	RMB56,260m	19.03%
Industrial Bank Co., Ltd.[3]	PRC[1]	Banking	RMB5,992m	12.80%
Bao Viet Holdings[3]	Vietnam	Insurance	VND6,267bn	18.00%
Unlisted				
Barrowgate Limited[3]	Hong Kong	Property investment	–[2]	24.64%
OCLP Holdings, Inc.	Philippines	Property investment	PHP1,342m	34.08%
Vietnam Technological and Commercial Joint Stock Bank	Vietnam	Banking	VND6,932bn	19.79%
Yantai Bank Co., Limited[3]	PRC[1]	Banking	RMB2,000m	20.00%

1 *People's Republic of China*
2 *Issued equity capital is less than HK$1m*
3 *Held indirectly*

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

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

Hang Seng Bank Limited holds a 12.80% stake in Industrial Bank Co., Ltd. and The Hongkong and Shanghai Banking Corporation Limited holds a 19.03% interest in Bank of Communications Co., Ltd. These companies are accounted for as associated companies, as the group has representation on the Board of Directors of each bank, and, in accordance with the Technical Support and Assistance Agreements, the group is assisting in the development of financial and operating policies. In respect of Bank of Communications Co., Ltd, a number of staff have been seconded to assist in this process.

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

In respect of the year ended 31 December 2010, Bank of Communications Co., Ltd and Industrial Bank Co., Ltd were included in these financial statements based on financial statements drawn up to 30 September 2010, but taking into account the financial effect of significant transactions or events in the subsequent period from 1 October 2010 to 31 December 2010. The group has taken advantage of the provision contained in Hong Kong Accounting Standard 28 'Investments in Associates' whereby it is permitted to include the attributable share of associates' results based on accounts drawn up to a non-coterminous period end where the difference is no greater than three months.

On 19 January 2010 the group, through its subsidiary HSBC Insurance (Asia-Pacific) Holdings Limited, increased its shareholding in Bao Viet Holdings to 18% from 10% through the purchase of additional shares for a consideration of VND1,880bn. Bao Viet Holdings was accounted for as an associate from that date due to the group's representation on the Board of Directors and, in accordance with the Technical Support and Capability Transfer Agreement, the group is assisting in the development of financial and operating policies.

In the first half of 2010, the group participated in Industrial Bank Co., Ltd's rights issue. This increased the group's equity interest from 12.78% to 12.80%.

In July 2010, Vietnam Technological and Commercial Joint Stock Bank issued shares to its employees. This reduced the group's equity interest from 19.91% to 19.79%.

During 2010, Bank of Communications Co., Ltd completed its 'A' and 'H' share rights issues and the group took up its rights in full. This increased the group's equity interest from 19.01% to 19.03%.

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

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

	Assets HK$m	Liabilities HK$m	Equity HK$m	Revenue HK$m	Expenses HK$m	Profit HK$m
2010						
100%	**6,754,826**	**6,368,911**	**385,915**	**175,768**	**110,321**	**65,447**
Group's effective interest[1]	**1,053,418**	**991,097**	**62,321**	**29,268**	**18,717**	**10,551**
2009						
100%	5,283,305	5,020,983	262,322	129,484	82,826	46,658
Group's effective interest[1]	847,698	804,564	43,134	21,978	14,559	7,419

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

At 31 December 2010, the group's share of associates and joint ventures' contingent liabilities was HK$199,304m (2009: HK$150,105m).

Notes on the Financial Statements (continued)

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

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

Group

	2010		2009	
	Highest balance during the year[1] HK$m	**Balance at 31 December[1] HK$m**	Highest balance during the year[1] HK$m	Balance at 31 December[1] HK$m
Amounts due from associates				
– unsubordinated	**16,312**	**12,930**	8,686	8,176
Amounts due from joint ventures				
– subordinated	**39**	**39**	–	–
– unsubordinated	**1,493**	**699**	1,135	789
	1,532	**738**	1,135	789
Amounts due to associates	**5,293**	**4,042**	3,814	926
Amounts due to joint ventures	**1,140**	**1,013**	909	903

Bank

	2010		2009	
	Highest balance during the year[1] HK$m	**Balance at 31 December[1] HK$m**	Highest balance during the year[1] HK$m	Balance at 31 December[1] HK$m
Amounts due from associates				
– unsubordinated	**7,045**	**4,513**	2,858	2,349
Amounts due from joint ventures				
– unsubordinated	**1,293**	**608**	1,135	789
Amounts due to associates	**1,150**	**732**	1,210	746
Amounts due to joint ventures	**1,139**	**1,013**	908	902

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

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

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

	Place of incorporation	**Principal activity**	**Issued equity capital**	**Group's interest in equity capital**
Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited	India	Insurance manufacturing	INR7,000m	26.00%
Hana HSBC Life Insurance Co., Ltd	South Korea	Insurance manufacturing	KRW60,201m	49.99%

25 Goodwill and intangible assets

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

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Goodwill	**7,891**	7,519	**1,167**	1,104
Present value of in-force long-term insurance business	**14,767**	10,554	**–**	–
Other intangible assets	**7,032**	6,996	**3,546**	5,650
	29,690	25,069	**4,713**	6,754

a *Goodwill*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Cost at 1 January	**7,519**	2,523	**1,104**	1,020
Additions	**–**	4,418	**–**	–
Exchange and other movements	**372**	578	**63**	84
Net book value at 31 December	**7,891**	7,519	**1,167**	1,104

Segmental analysis of goodwill

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Hong Kong – Personal Financial Services	**12**	12	**–**	–
Hong Kong – Commercial Banking	**36**	36	**24**	24
Hong Kong – Global Banking and Markets	**755**	754	**498**	498
Rest of Asia-Pacific – Personal Financial Services	**1,598**	1,530	**78**	77
Rest of Asia-Pacific – Commercial Banking	**4,358**	4,148	**–**	4
Rest of Asia-Pacific – Global Banking and Markets	**1,132**	1,039	**567**	501
	7,891	7,519	**1,167**	1,104

During 2010 there was no impairment of goodwill (2009: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units (‘CGUs’), determined at 1 July 2010 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 and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of business units making up the CGUs. The discount rate used is based on the cost of capital HSBC allocates to investments in the countries in which the CGU operates.

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

25 Goodwill and intangible assets *(continued)*

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the nominal long-term growth rate. The discount rates used in the impairment test in 2010 were in the range of 10% to 11% (2009: 9% to 12%) across different CGUs. The nominal long-term growth rates used in the impairment test in 2010 for Hong Kong and Rest of Asia-Pacific were 5.3% and 6.9% respectively (2009: 4.7% and 6.5%).

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:

	2010	2009
Risk free rate	**3.10%**	2.58%
Risk adjusted discount rate	**11.0%**	11.0%
Expenses inflation	**3.0%**	3.0%
Lapse rate	**0%-20% for the first policy year and 0%-15% for renewal years**	0%-17% for the first policy year and 0%-15% for renewal years

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

	Group	
	2010	2009
	HK$m	HK$m
At 1 January	**10,554**	7,638
Addition from current year new business	**3,737**	2,684
Movement from in-force business	**369**	204
Exchange and other adjustments	**107**	28
At 31 December	**14,767**	10,554

25 Goodwill and intangible assets *(continued)*

c *Other intangible assets*

Group

	Computer software HK$m	**Customer/ merchant relationships HK$m**	**Other[1] HK$m**	**Total HK$m**
Cost at 1 January 2010	**6,866**	**1,743**	**2,090**	**10,699**
Additions	**1,345**	**–**	**28**	**1,373**
Disposals/amounts written-off	**(82)**	**–**	**–**	**(82)**
Exchange and other movements	**79**	**162**	**200**	**441**
At 31 December 2010	**8,208**	**1,905**	**2,318**	**12,431**
Accumulated amortisation and impairment				
At 1 January 2010	**3,203**	**479**	**21**	**3,703**
Amortisation charge for the year	**1,374**	**195**	**10**	**1,579**
Impairment	**85**	**–**	**–**	**85**
Disposals/amounts written-off	**(82)**	**–**	**–**	**(82)**
Exchange and other movements	**60**	**53**	**1**	**114**
At 31 December 2010	**4,640**	**727**	**32**	**5,399**
Net book value at 31 December 2010	**3,568**	**1,178**	**2,286**	**7,032**

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

Notes on the Financial Statements (continued)

25 Goodwill and intangible assets *(continued)*

Bank

	Computer software HK$m	Customer/ merchant relationships HK$m	Other[1] HK$m	Total HK$m
Cost at 1 January 2010	**5,557**	**1,135**	**1,975**	**8,667**
Additions	**1,071**	**–**	**2**	**1,073**
Disposals/amounts written-off	**(150)**	**–**	**–**	**(150)**
Exchange and other movements[2]	**(54)**	**134**	**(1,965)**	**(1,885)**
At 31 December 2010	**6,424**	**1,269**	**12**	**7,705**
Accumulated amortisation and impairment				
At 1 January 2010	**2,648**	**361**	**8**	**3,017**
Amortisation charge for the year	**1,115**	**95**	**–**	**1,210**
Disposals/amounts written-off	**(70)**	**–**	**–**	**(70)**
Exchange and other movements	**(46)**	**47**	**1**	**2**
At 31 December 2010	**3,647**	**503**	**9**	**4,159**
Net book value at 31 December 2010	**2,777**	**766**	**3**	**3,546**
Cost at 1 January 2009	4,602	896	1,924	7,422
Additions	964	–	–	964
Disposals/amounts written-off	(18)	–	–	(18)
Exchange and other movements	9	239	51	299
At 31 December 2009	5,557	1,135	1,975	8,667
Accumulated amortisation and impairment				
At 1 January 2009	1,856	214	4	2,074
Amortisation charge for the year	803	91	3	897
Disposals/amounts written-off	(18)	–	–	(18)
Exchange and other movements	7	56	1	64
At 31 December 2009	2,648	361	8	3,017
Net book value at 31 December 2009	2,909	774	1,967	5,650

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.*
2 *Other intangible assets arising from the acquisition of the assets, liabilities and operations of The Chinese Bank in Taiwan were transferred from Bank to Group following the local incorporation of HSBC Bank (Taiwan) Limited in 2010.*

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

An impairment test was carried out in respect of the operating licenses in Taiwan as at 1 July 2010. 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.

25 Goodwill and intangible assets *(continued)*

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

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

Two key assumptions upon which management has based its determination of the recoverable amount of the CGUs are the discount rate and the long-term growth rate. The discount rate used during 2010 was in the range of 11% to 12% (2009: 12%). The long-term growth rate used in the impairment testing during 2010 was 3% (2009: 3%).

26 Property, plant and equipment

a *Property, plant and equipment*

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

Notes on the Financial Statements (continued)

26 Property, plant and equipment *(continued)*

	Group			Bank		
	Land and buildings HK$m *Restated* [1]	Investment properties HK$m	Equipment HK$m	Land and buildings HK$m *Restated* [1]	Investment properties HK$m	Equipment HK$m
Cost or valuation as previously reported	27,376	2,824	16,385	17,269	125	11,497
Restatement for HKAS 17	19,260	–	–	12,533	–	–
Cost or valuation at 1 January 2009	46,636	2,824	16,385	29,802	125	11,497
Exchange and other adjustments	120	15	382	90	1	134
Additions	766	–	2,339	293	–	976
Disposals	(56)	–	(646)	(56)	–	(326)
Elimination of accumulated depreciation on revalued land and buildings	(1,146)	–	–	(678)	–	–
Surplus on revaluation	4,479	262	–	2,224	–	–
Reclassifications	(696)	13	–	(91)	–	–
At 31 December 2009	50,103	3,114	18,460	31,584	126	12,281
Accumulated depreciation at 1 January 2009	7	–	10,693	–	–	7,507
Exchange and other adjustments	(1)	–	269	–	–	97
Charge for the year	1,129	–	2,033	684	–	1,352
Acquisition of subsidiaries	28	–	460	–	–	–
Disposals	(5)	–	(599)	(5)	–	(306)
Elimination of accumulated depreciation on revalued land and buildings	(1,146)	–	–	(678)	–	–
Reclassifications	(1)	–	–	(1)	–	–
At 31 December 2009	11	–	12,856	–	–	8,650
Net book value at 31 December 2009	50,092	3,114	5,604	31,584	126	3,631
Total at 31 December 2009			58,810			35,341

b *The carrying amount of land and buildings, had they been stated at cost less accumulated depreciation, would have been as follows:*

	Group			Bank		
	2010 HK$m	2009 HK$m *Restated* [1]	2008 HK$m *Restated* [1]	**2010 HK$m**	2009 HK$m *Restated* [1]	2008 HK$m *Restated* [1]
Cost less accumulated depreciation	**19,475**	15,678	15,602	**14,507**	10,848	11,055

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

	Group			Bank		
	2010 HK$m	2009 HK$m *Restated* [1]	2008 HK$m *Restated* [1]	**2010 HK$m**	2009 HK$m *Restated* [1]	2008 HK$m *Restated* [1]
Land and buildings carried at valuation	**62,956**	49,929	46,472	**41,423**	31,584	29,802
Other land and buildings stated at cost	**192**	174	164	–	–	–
Land and buildings before deduction of accumulated depreciation	**63,148**	50,103	46,636	**41,423**	31,584	29,802

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

26 Property, plant and equipment *(continued)*

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

	Group			Bank		
	2010	2009	2008	**2010**	2009	2008
	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m
		Restated [1]	*Restated* [1]		*Restated* [1]	*Restated* [1]
In Hong Kong:						
Long leaseholds (over fifty years)	**28,263**	26,757	24,323	**24,626**	21,088	19,223
Medium-term leaseholds (between ten and fifty years)	**28,269**	21,412	20,535	**8,837**	7,134	7,120
Short leaseholds (less than ten years)	**136**	106	111	**100**	106	111
	56,668	48,275	44,969	**33,563**	28,328	26,454
Outside Hong Kong:						
Freeholds	**4,287**	3,741	3,394	**3,361**	3,126	3,213
Long leaseholds (over fifty years)	**125**	118	102	**82**	65	61
Medium-term leaseholds (between ten and fifty years)	**5,527**	972	958	**4,501**	154	169
Short leaseholds (less than ten years)	**42**	100	30	**42**	37	30
	9,981	4,931	4,484	**7,986**	3,382	3,473
Total	**66,649**	53,206	49,453	**41,549**	31,710	29,927
Analysed as follows:						
Land and buildings	**63,146**	50,092	46,629	**41,423**	31,584	29,802
Investment properties	**3,503**	3,114	2,824	**126**	126	125
Total	**66,649**	53,206	49,453	**41,549**	31,710	29,927

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

The group's land and buildings and investment properties were revalued at 30 November 2010 and updated for any material changes at 31 December 2010. The basis of valuation for land and buildings and investment properties was open market value, depreciated replacement cost or surrender value as noted in note 3(o). In determining the open market value of investment properties, expected future cash flows have been discounted to their present values. The net book value of 'Land and buildings' includes HK$8,931m (2009 restated: HK$7,935m) in respect of properties which were valued using the depreciated replacement cost method or surrender value.

The surplus on property revaluation was HK$10,521m (2009 restated: HK$4,741m). Amounts of HK$7,513m (2009 restated: HK$3,382m) and HK$585m (2009 restated: HK$153m) were credited to the property revaluation reserve and the income statement respectively. The amount credited to the property revaluation reserve of HK$7,513m (2009 restated: HK$3,382m) is stated after deduction of non-controlling interests of HK$796m (2009 restated: HK$558m) and deferred tax of HK$1,627m (2009 restated: HK$648m). The amount credited to the income statement comprises the surplus of HK$483m (2009 restated: HK$262m) on revaluation of investment properties, and HK$102m (2009 restated: HK$109m deficit) relating to the reversal of previous revaluation deficits that arose when the value of certain land and buildings fell below depreciated historical cost or surrender value, or when land and buildings were newly acquired with revaluation losses.

Land and buildings and investment properties in Hong Kong, the Macau SAR and mainland China, representing 95% by value of the group's properties subject to valuation, were valued by DTZ Debenham Tie Leung Limited who have recent experience in the location and type of properties. The valuations were carried out by qualified valuers who are members of the Hong Kong Institute of Surveyors. Properties in eleven countries, which represent 5% by value of the group's properties, were valued by different independent professionally qualified valuers.

Notes on the Financial Statements (continued)

26 Property, plant and equipment *(continued)*

e *Properties leased to customers*

The group's investment properties are rented out under operating leases. The leases typically run for a period of 2-3 years and may contain an option to renew and the terms will then be renegotiated. During the current year, HK$170m (2009: HK$169m) was recognised as rental income in the income statement in respect of operating leases.

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

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Within one year	**130**	120	**5**	6
After one but within five years	**93**	62	**–**	5
	223	182	**5**	11

27 Leasehold land and land use rights

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

	Group			Bank		
	2010	2009	2008	**2010**	2009	2008
	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m
		Restated [1]	*Restated* [1]		*Restated* [1]	*Restated* [1]
In Hong Kong:						
Medium-term leaseholds (between ten and fifty years)	**348**	366	370	**79**	82	84

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

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

28 Other assets

	Group			Bank		
	2010	2009	2008	**2010**	2009	2008
	HK$m	HK$m	HK$m	**HK$m**	HK$m	HK$m
		Restated [1]	*Restated* [1]		*Restated* [1]	*Restated* [1]
Current taxation recoverable	**335**	889	1,371	**208**	706	1,210
Assets held for sale	**257**	228	338	**6**	123	123
Prepayments and accrued income	**3,218**	2,564	3,030	**1,468**	1,173	2,602
Accrued interest receivable	**11,678**	9,948	12,493	**5,813**	5,621	7,262
Acceptances and endorsements	**25,892**	22,211	31,453	**17,041**	16,073	26,006
Other accounts	**19,527**	22,978	23,719	**7,337**	11,723	10,320
	60,907	58,818	72,404	**31,873**	35,419	47,523

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

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

29 Customer accounts

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Current accounts	**643,850**	536,350	**376,925**	352,151
Savings accounts	**1,765,835**	1,591,351	**1,204,293**	1,068,952
Other deposit accounts	**903,559**	816,838	**463,446**	481,468
	3,313,244	2,944,539	**2,044,664**	1,902,571

30 Trading liabilities

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit in issue	**2,694**	2,545	**1,667**	2,453
Other debt securities in issue	**17,919**	17,708	**14,710**	11,665
Short positions in securities	**51,089**	68,826	**31,665**	55,674
Deposits by banks	**11,103**	3,039	**10,428**	2,972
Customer accounts	**68,729**	62,248	**32,714**	30,692
	151,534	154,366	**91,184**	103,456

31 Financial liabilities designated at fair value

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Deposits by banks	**288**	253	**288**	253
Customer accounts	**1,688**	1,604	**1,688**	1,604
Subordinated liabilities (note 36)	**–**	1,003	**–**	–
Debt securities in issue	**4,605**	–	**4,605**	–
Liabilities to customers under investment contracts	**33,746**	33,849	**–**	–
	40,327	36,709	**6,581**	1,857

At 31 December 2010, the carrying amount of financial liabilities designated at fair value was HK$38m lower than the contractual amount at maturity (2009: the carrying amount was HK$37m higher than the contractual amount). At 31 December 2010, the accumulated loss in fair value attributable to changes in credit risk was HK$5m (2009: the accumulated gain was HK$46m).

32 Debt securities in issue

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Certificates of deposit	**36,222**	25,090	**30,368**	19,610
Other debt securities	**23,061**	18,306	**12,771**	8,640
	59,283	43,396	**43,139**	28,250

Notes on the Financial Statements (continued)

33 Other liabilities and provisions

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Accruals and deferred income	**22,502**	18,209	**13,757**	11,836
Provisions for liabilities and charges (note 35)	**1,359**	1,226	**858**	800
Acceptances and endorsements	**25,950**	22,232	**17,099**	16,094
Share based payment liability to HSBC Holdings plc	**1,812**	1,199	**1,413**	953
Other liabilities	**19,323**	13,116	**10,905**	8,346
	70,946	55,982	**44,032**	38,029

34 Liabilities under insurance contracts issued

	Gross	Reinsurance	Net
	HK$m	**HK$m**	**HK$m**
2010			
Non-life insurance liabilities			
Unearned premiums	**1,495**	**(158)**	**1,337**
Notified claims	**1,008**	**(219)**	**789**
Claims incurred but not reported	**295**	**(43)**	**252**
Other	**122**	**–**	**122**
	2,920	**(420)**	**2,500**
Life insurance liabilities to policyholders			
Life (non-linked)	**145,960**	**(161)**	**145,799**
Investment contracts with discretionary participation features	**170**	**–**	**170**
Life (linked)	**28,920**	**(5,567)**	**23,353**
	175,050	**(5,728)**	**169,322**
Total liabilities under insurance contracts	**177,970**	**(6,148)**	**171,822**
2009			
Non-life insurance liabilities			
Unearned premiums	1,233	(113)	1,120
Notified claims	953	(235)	718
Claims incurred but not reported	320	(38)	282
Provision for unexpired risk	8	–	8
Other	119	(1)	118
	2,633	(387)	2,246
Life insurance liabilities to policyholders			
Life (non-linked)	116,180	(67)	116,113
Investment contracts with discretionary participation features	269	–	269
Life (linked)	25,846	(6,237)	19,609
	142,295	(6,304)	135,991
Total liabilities under insurance contracts	144,928	(6,691)	138,237

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

34 Liabilities under insurance contracts issued *(continued)*

a *Movement of liabilities under insurance contracts*

(i) Non-life insurance

	Gross HK$m	Reinsurance HK$m	Net HK$m
2010			
Unearned premiums			
At 1 January	**1,233**	**(113)**	**1,120**
Gross written premiums	**3,166**	**(457)**	**2,709**
Gross earned premiums	**(2,931)**	**416**	**(2,515)**
Foreign exchange and other movements	**27**	**(4)**	**23**
At 31 December	**1,495**	**(158)**	**1,337**
Notified and incurred but not reported claims			
At 1 January	**1,273**	**(273)**	**1,000**
– Notified claims	**953**	**(235)**	**718**
– Claims incurred but not reported	**320**	**(38)**	**282**
Claims paid in current year	**(1,290)**	**160**	**(1,130)**
Claims incurred	**1,276**	**(140)**	**1,136**
Foreign exchange and other movements	**44**	**(9)**	**35**
At 31 December			
– Notified claims	**1,008**	**(219)**	**789**
– Claims incurred but not reported	**295**	**(43)**	**252**
Total at 31 December	**1,303**	**(262)**	**1,041**
2009			
Unearned premiums			
At 1 January	1,117	(78)	1,039
Gross written premiums	2,754	(394)	2,360
Gross earned premiums	(2,638)	361	(2,277)
Foreign exchange and other movements	–	(2)	(2)
At 31 December	1,233	(113)	1,120
Notified and incurred but not reported claims			
At 1 January	1,413	(282)	1,131
– Notified claims	1,024	(233)	791
– Claims incurred but not reported	389	(49)	340
Claims paid in current year	(1,227)	110	(1,117)
Claims incurred	1,084	(92)	992
Foreign exchange and other movements	3	(9)	(6)
At 31 December			
– Notified claims	953	(235)	718
– Claims incurred but not reported	320	(38)	282
Total at 31 December	1,273	(273)	1,000

Notes on the Financial Statements (continued)

34 Liabilities under insurance contracts issued *(continued)*

(ii) Life insurance liabilities to policyholders

	Gross HK$m	Reinsurance HK$m	Net HK$m
2010			
Life (non-linked)			
At 1 January	**116,180**	**(67)**	**116,113**
Benefits paid	**(4,030)**	**157**	**(3,873)**
Increase in liabilities to policyholders	**32,896**	**(154)**	**32,742**
Foreign exchange and other movements	**914**	**(97)**	**817**
At 31 December	**145,960**	**(161)**	**145,799**
Life (linked)			
At 1 January	**25,846**	**(6,237)**	**19,609**
Benefits paid	**(2,330)**	**298**	**(2,032)**
Increase in liabilities to policyholders	**5,002**	**960**	**5,962**
Foreign exchange and other movements	**402**	**(588)**	**(186)**
At 31 December	**28,920**	**(5,567)**	**23,353**
Investment contracts with discretionary participation features			
At 1 January	**269**	**–**	**269**
Benefits paid	**(122)**	**–**	**(122)**
Increase in liabilities to policyholders	**3**	**–**	**3**
Foreign exchange and other movements	**20**	**–**	**20**
At 31 December	**170**	**–**	**170**
Total policyholders' liabilities	**175,050**	**(5,728)**	**169,322**
2009			
Life (non-linked)			
At 1 January	90,383	(144)	90,239
Benefits paid	(3,001)	149	(2,852)
Increase in liabilities to policyholders	28,294	(57)	28,237
Foreign exchange and other movements	504	(15)	489
At 31 December	116,180	(67)	116,113
Life (linked)			
At 1 January	20,044	(7,334)	12,710
Benefits paid	(884)	95	(789)
Increase in liabilities to policyholders	6,590	1,310	7,900
Foreign exchange and other movements	96	(308)	(212)
At 31 December	25,846	(6,237)	19,609
Investment contracts with discretionary participation features			
At 1 January	260	–	260
Benefits paid	(2)	–	(2)
Increase in liabilities to policyholders	2	–	2
Foreign exchange and other movements	9	–	9
At 31 December	269	–	269
Total policyholders' liabilities	142,295	(6,304)	135,991

35 Provisions for liabilities and charges

Provisions for liabilities and charges

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
At 1 January	**1,226**	1,093	**800**	714
Additional provisions/increase in provisions	**195**	373	**184**	302
Provisions utilised	**(114)**	(225)	**(96)**	(144)
Amounts reversed	**(68)**	(103)	**(52)**	(93)
Exchange and other movements	**120**	88	**22**	21
At 31 December	**1,359**	1,226	**858**	800

36 Subordinated liabilities

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

		2010	2009
		HK$m	HK$m
Bank			
US$1,200m	Undated floating rate primary capital notes	**9,404**	9,393
TW$330m	Non-callable floating rate subordinated notes due 2010	**–**	80
TW$1,865m	Non-callable floating rate subordinated notes due 2010	**–**	452
		9,404	9,925
Group			
A$200m	Floating rate subordinated notes due 2016, callable from 2011[1]	**1,583**	1,396
A$42m	Floating rate subordinated notes due 2018, callable from 2013[2]	**332**	293
A$200m	Floating rate subordinated notes due 2020, callable from 2015	**1,583**	–
HK$1,500m	Floating rate subordinated notes due 2015, callable from 2010	**–**	1,499
US$450m	Floating rate subordinated notes due 2016, callable from 2011[3]	**3,495**	3,483
US$300m	Floating rate subordinated notes due 2017, callable from 2012[4]	**2,328**	2,321
RM500m	Fixed rate (4.35%) subordinated bonds due 2022, callable from 2017[5]	**1,263**	1,136
RM500m	Fixed rate (5.05%) subordinated bonds due 2027, callable from 2022[6]	**1,266**	1,128
		21,254	21,181

1 *The interest rate on the A$200m callable subordinated floating rate notes 2016 will increase by 0.5% from May 2011.*
2 *The interest rate on the A$42m callable subordinated floating rate notes 2018 will increase by 0.5% from March 2013.*
3 *The interest rate on the US$450m callable subordinated floating rate notes 2016 will increase by 0.5% from July 2011.*
4 *The interest rate on the US$300m callable subordinated floating rate notes 2017 will increase by 0.5% from July 2012.*
5 *The interest rate on the 4.35% callable subordinated bonds due 2022 will increase by 1% from June 2017.*
6 *The interest rate on the 5.05% callable subordinated bonds due 2027 will increase by 1% from November 2022.*

The following subordinated note was classified as 'Financial liabilities designated at fair value' (note 31):

		Group	
		2010	2009
		HK$m	HK$m
HK$1,000m	Callable fixed rate (4.125%) subordinated notes due 2015	**–**	1,003

37 Preference shares

Authorised

At 31 December 2010, the authorised preference share capital of the Bank was US$13,450,500,000 (2009: US$13,450,500,000) comprising 3,750,500,000 cumulative redeemable preference shares of US$1 each, 7,500,000,000 non-cumulative irredeemable preference shares of US$1 each and 2,200,000,000 cumulative irredeemable preference shares of US$1 each (2009: comprising 3,750,500,000 cumulative redeemable preference shares of US$1 each, 7,500,000,000 non-cumulative irredeemable preference shares of US$1 each and 2,200,000,000 cumulative irredeemable preference shares of US$1 each).

At a group level, there was an additional Rs.900,000,000 (2009: Rs.900,000,000) of authorised preference share capital comprising 9,000,000 compulsorily convertible preference shares of Rs.100 each in the share capital of a subsidiary.

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Issued and fully paid				
Redeemable preference shares	**29,153**	29,083	**29,153**	29,083
Irredeemable preference shares	**68,422**	68,252	**68,270**	68,107
Share premium	**3,883**	3,873	**3,883**	3,873
	101,458	101,208	**101,306**	101,063

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

400,000,000 cumulative redeemable preferences shares were issued in 2008, which have a mandatory redemption date of 29 March 2023 but may be redeemed at the Bank's option on or after 29 March 2018, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. 1,050,000,000 cumulative redeemable preferences shares were issued in 2009, which have a mandatory redemption date of 2 January 2024 but may be redeemed at the Bank's option on or after 2 January 2019, subject to the consent of the Hong Kong Monetary Authority. The shares are redeemable at the issue price of US$1 per share. The total number of issued cumulative redeemable preference shares at 31 December 2010 was 3,750,500,000 (2009: 3,750,500,000). No shares were issued during the year (2009: 1,050,000,000).

The non-cumulative irredeemable preference shares were issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. On redemption, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of redemption, subject to the Bank having sufficient distributable profits. The number of issued non-cumulative irredeemable preference shares at 31 December 2010 was 6,653,000,000 (2009: 6,653,000,000). No shares were issued during the year (2009: nil).

37 Preference shares *(continued)*

The cumulative irredeemable preference shares were issued at nominal value, and may be redeemed subject to 30 days' notice in writing to shareholders and with the prior consent of the Hong Kong Monetary Authority. On redemption, holders of the shares shall be entitled to receive the issue price of US$1 per share held together with any unpaid dividends for the period since the annual dividend payment date immediately preceding the date of redemption, subject to the Bank having sufficient distributable profits. The number of issued cumulative irredeemable preference shares at 31 December 2010 was 2,130,000,000 (2009: 2,130,000,000). No shares were issued during the year (2009: nil).

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

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

38 Share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2010 and 2009 was HK$30,000m divided into 12,000m ordinary shares of HK$2.50 each. No new shares were issued during 2010 (2009: nil).

Issued and fully paid

	Bank and group	
	2010	2009
	HK$m	HK$m
Ordinary share capital	**22,494**	22,494

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

39 Analysis of changes in equity

The Bank

	2010							
			Other reserves					
	Share capital HK$m	Retained profits and Proposed dividend HK$m	Property revaluation reserve HK$m	Available-for-sale investment reserve HK$m	Cash flow hedge reserve HK$m	Foreign exchange reserve HK$m	Other HK$m	Total equity HK$m
At 1 January 2010	22,494	88,837	13,595	39,050	763	(1,313)	1,485	164,911
Profit for the year	–	38,227	–	–	–	–	–	38,227
Other comprehensive income								
Available-for-sale investments:								
– fair value changes taken to equity	–	–	–	12,943	–	–	–	12,943
– fair value changes transferred to the income statement on disposal	–	–	–	(1,510)	–	–	–	(1,510)
– amounts transferred to the income statement on impairment	–	–	–	(3)	–	–	–	(3)
– fair value changes transferred to the income statement on hedged items due to hedged risk	–	–	–	(248)	–	–	–	(248)
– income taxes	–	–	–	357	–	–	–	357
Cash flow hedges:								
– fair value changes taken to equity	–	–	–	–	359	–	–	359
– fair value changes transferred to the income statement	–	–	–	–	(1,194)	–	–	(1,194)
– income taxes	–	–	–	–	141	–	–	141
Property revaluation:								
– fair value changes taken to equity	–	–	6,347	–	–	–	–	6,347
– income taxes	–	(53)	(1,156)	–	–	–	–	(1,209)
Actuarial losses on defined benefit plans:								
– before income taxes	–	(772)	–	–	–	–	–	(772)
– income taxes	–	148	–	–	–	–	–	148
Exchange differences	–	6	–	(40)	1	2,617	–	2,584
Other comprehensive income for the year, net of tax	–	(671)	5,191	11,499	(693)	2,617	–	17,943
Total comprehensive income	–	37,556	5,191	11,499	(693)	2,617	–	56,170
Dividends paid	–	(26,850)	–	–	–	–	–	(26,850)
Other movements and transfers	–	543	(349)	2	–	–	82	278
At 31 December 2010	22,494	100,086	18,437	50,551	70	1,304	1,567	194,509

39 Analysis of changes in equity *(continued)*

The Bank

	2009							
			Other reserves					
	Share capital HK$m	Retained profits and Proposed dividend HK$m	Property revaluation reserve HK$m	Available-for-sale investment reserve HK$m	Cash flow hedge reserve HK$m	Foreign exchange reserve HK$m	Other HK$m	Total equity HK$m
As previously reported	22,494	80,594	3,512	16,584	1,516	(4,174)	2,195	122,721
Restatement for HKAS 17	–	–	8,387	–	–	–	–	8,387
At 1 January 2009	22,494	80,594	11,899	16,584	1,516	(4,174)	2,195	131,108
Profit for the year	–	35,278	–	–	–	–	–	35,278
Other comprehensive income								
Available-for-sale investments:								
– fair value changes taken to equity	–	–	–	22,984	–	–	–	22,984
– fair value changes transferred to the income statement on disposal	–	–	–	(700)	–	–	–	(700)
– amounts transferred to the income statement on impairment	–	–	–	406	–	–	–	406
– fair value changes transferred to the income statement on hedged items due to hedged risk	–	–	–	363	–	–	–	363
– income taxes	–	–	–	(654)	–	–	–	(654)
Cash flow hedges:								
– fair value changes taken to equity	–	–	–	–	1,208	–	–	1,208
– fair value changes transferred to the income statement	–	–	–	–	(2,140)	–	–	(2,140)
– income taxes	–	–	–	–	139	–	–	139
Property revaluation:								
– fair value changes taken to equity	–	–	2,323	–	–	–	–	2,323
– income taxes	–	(55)	(301)	–	–	–	–	(356)
Actuarial gains on defined benefit plans:								
– before income taxes	–	1,463	–	–	–	–	–	1,463
– income taxes	–	(244)	–	–	–	–	–	(244)
Exchange differences	–	(4)	–	64	40	2,861	–	2,961
Other comprehensive income for the year, net of tax	–	1,160	2,022	22,463	(753)	2,861	–	27,753
Total comprehensive income	–	36,438	2,022	22,463	(753)	2,861	–	63,031
Dividends paid	–	(28,840)	–	–	–	–	–	(28,840)
Other movements and transfers	–	645	(326)	3	–	–	(710)	(388)
At 31 December 2009	22,494	88,837	13,595	39,050	763	(1,313)	1,485	164,911

39 Analysis of changes in equity *(continued)*

Regulatory reserve

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

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

At 31 December 2010, the effect of this requirement is to restrict the amount of reserves which can be distributed to shareholders by HK$7,702m (2009: HK$6,413m).

Retained profits

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

Property revaluation reserve

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

Available-for-sale investment reserve

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

Cash flow hedge reserve

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

Foreign exchange reserve

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

Other reserve

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

40 Maturity analysis of assets and liabilities

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

Group

2010	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	291,330	284,382	138,644	93,629	–	–	–	–	–	807,985
Items in the course of collection from other banks	–	16,878	–	–	–	–	–	–	–	16,878
Placings with banks maturing after one month	–	–	114,975	27,338	3,800	3,444	–	–	–	149,557
Certificates of deposit	–	7,874	14,583	42,371	5,459	2,917	43	–	–	73,247
Hong Kong Government certificates of indebtedness	148,134	–	–	–	–	–	–	–	–	148,134
Trading assets	–	–	–	–	–	–	–	390,208	–	390,208
Financial assets designated at fair value	–	395	371	1,947	10,625	4,588	36,678	–	–	54,604
Derivatives	–	–	–	–	–	–	–	301,304	1,318	302,622
Advances to customers	112,775	246,351	205,109	312,261	550,396	477,162	(12,994)	–	–	1,891,060
Financial investments	–	40,743	61,393	236,663	323,684	90,122	74,057	–	–	826,662
Amounts due from Group companies	23,727	39,922	8,494	13,577	7,884	3,632	–	40,397	–	137,633
Interests in associates and joint ventures	–	–	–	–	–	–	75,568	–	–	75,568
Goodwill and intangible assets	–	–	–	–	–	–	29,690	–	–	29,690
Property, plant and equipment	–	–	–	–	–	–	72,347	–	–	72,347
Deferred tax assets	–	–	–	–	–	–	2,515	–	–	2,515
Retirement benefits	–	–	–	–	–	–	301	–	–	301
Other assets	3,295	17,093	13,464	12,997	1,680	7,783	4,595	–	–	60,907
Total assets at 31 December 2010	579,261	653,638	557,033	740,783	903,528	589,648	282,800	731,909	1,318	5,039,918

Notes on the Financial Statements (continued)

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

Group

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2010										
Liabilities										
Hong Kong currency notes in circulation	148,134	–	–	–	–	–	–	–	–	148,134
Items in the course of transmission to other banks	–	26,495	–	–	–	–	–	–	–	26,495
Deposits by banks	80,553	79,196	5,694	1,384	699	301	–	–	–	167,827
Customer accounts	2,528,031	384,068	227,183	160,456	13,112	394	–	–	–	3,313,244
Trading liabilities	–	–	–	–	–	–	–	151,534	–	151,534
Financial liabilities designated at fair value	99	–	740	–	5,681	448	33,359	–	–	40,327
Derivatives	–	–	–	–	–	–	–	307,225	2,613	309,838
Debt securities in issue	1,933	15,438	16,902	14,559	5,806	4,645	–	–	–	59,283
Retirement benefit liabilities	–	–	–	–	–	–	4,713	–	–	4,713
Amounts due to Group companies	23,032	15,324	2,118	3,510	7,813	6,168	–	25,163	–	83,128
Other liabilities and provisions	5,121	18,072	24,764	16,020	2,825	196	3,948	–	–	70,946
Liabilities under insurance contracts issued	853	–	–	–	–	–	177,117	–	–	177,970
Current tax liabilities	1	590	650	3,178	–	–	–	–	–	4,419
Deferred tax liabilities	–	–	–	–	–	–	11,913	–	–	11,913
Subordinated liabilities	–	–	–	5,078	4,243	2,529	9,404	–	–	21,254
Preference shares	–	–	–	–	–	33,036	68,422	–	–	101,458
Total liabilities at 31 December 2010	2,787,757	539,183	278,051	204,185	40,179	47,717	308,876	483,922	2,613	4,692,483

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

Bank

2010	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	201,340	139,998	131,708	77,957	–	–	–	–	–	551,003
Items in the course of collection from other banks	–	12,143	–	–	–	–	–	–	–	12,143
Placings with banks maturing after one month	–	–	52,915	17,816	3,667	393	–	–	–	74,791
Certificates of deposit	–	4,229	7,014	15,243	1,402	–	–	–	–	27,888
Hong Kong Government certificates of indebtedness	148,134	–	–	–	–	–	–	–	–	148,134
Trading assets	–	–	–	–	–	–	–	297,929	–	297,929
Financial assets designated at fair value	–	–	149	233	1,704	–	–	–	–	2,086
Derivatives	–	–	–	–	–	–	–	294,739	740	295,479
Advances to customers	64,594	119,356	109,816	174,537	310,755	246,227	(8,973)	–	–	1,016,312
Financial investments	–	31,135	29,481	169,206	196,586	15,180	62,164	–	–	503,752
Amounts due from Group companies	33,748	54,700	11,981	21,085	16,469	16,999	–	43,340	–	198,322
Investments in subsidiaries	–	–	–	–	–	–	52,924	–	–	52,924
Interests in associates and joint ventures	–	–	–	–	–	–	28,139	–	–	28,139
Goodwill and intangible assets	–	–	–	–	–	–	4,713	–	–	4,713
Property, plant and equipment	–	–	–	–	–	–	45,061	–	–	45,061
Deferred tax assets	–	–	–	–	–	–	1,104	–	–	1,104
Retirement benefits	–	–	–	–	–	–	179	–	–	179
Other assets	1,727	10,685	7,635	6,856	1,030	488	3,452	–	–	31,873
Total assets at 31 December 2010	449,543	372,246	350,699	482,933	531,613	279,287	188,763	636,008	740	3,291,832

Notes on the Financial Statements (continued)

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

Bank

	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
2010										
Liabilities										
Hong Kong currency notes in circulation	148,134	–	–	–	–	–	–	–	–	148,134
Items in the course of transmission to other banks	–	17,951	–	–	–	–	–	–	–	17,951
Deposits by banks	59,636	63,872	4,762	1,322	583	301	–	–	–	130,476
Customer accounts	1,635,640	249,273	85,495	65,231	8,693	332	–	–	–	2,044,664
Trading liabilities	–	–	–	–	–	–	–	91,184	–	91,184
Financial liabilities designated at fair value	–	–	740	–	5,681	132	28	–	–	6,581
Derivatives	–	–	–	–	–	–	–	302,365	1,517	303,882
Debt securities in issue	1,933	15,257	13,972	8,789	1,370	1,818	–	–	–	43,139
Retirement benefit liabilities	–	–	–	–	–	–	2,465	–	–	2,465
Amounts due to Group companies	40,794	49,588	15,396	10,172	8,067	6,348	–	15,529	–	145,894
Other liabilities and provisions	2,957	11,287	16,460	8,831	2,124	169	2,204	–	–	44,032
Current tax liabilities	1	336	333	2,016	–	–	–	–	–	2,686
Deferred tax liabilities	–	–	–	–	–	–	5,525	–	–	5,525
Subordinated liabilities	–	–	–	–	–	–	9,404	–	–	9,404
Preference shares	–	–	–	–	–	33,036	68,270	–	–	101,306
Total liabilities at 31 December 2010	**1,889,095**	**407,564**	**137,158**	**96,361**	**26,518**	**42,136**	**87,896**	**409,078**	**1,517**	**3,097,323**

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

Group

2009[1]	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	90,775	524,948	220,718	55,734	–	–	–	–	–	892,175
Items in the course of collection from other banks	–	15,528	–	–	–	–	–	–	–	15,528
Placings with banks maturing after one month	–	–	83,555	19,697	3,758	60	–	–	–	107,070
Certificates of deposit	–	8,297	10,667	8,218	8,563	1,605	38	–	–	37,388
Hong Kong Government certificates of indebtedness	135,414	–	–	–	–	–	–	–	–	135,414
Trading assets	–	–	–	–	–	–	–	322,731	–	322,731
Financial assets designated at fair value	–	81	280	3,655	11,053	3,634	29,384	–	–	48,087
Derivatives	–	–	–	–	–	–	–	233,046	2,125	235,171
Advances to customers	87,084	151,698	135,083	192,583	424,029	374,447	(14,280)	–	–	1,350,644
Financial investments	–	41,444	56,333	164,777	490,111	70,241	59,783	–	–	882,689
Amounts due from Group companies	23,157	47,392	7,654	9,029	5,804	12	–	41,463	–	134,511
Interests in associates and joint ventures	–	–	–	–	–	–	53,683	–	–	53,683
Goodwill and intangible assets	–	–	–	–	–	–	25,069	–	–	25,069
Property, plant and equipment	–	–	–	–	–	–	58,810	–	–	58,810
Deferred tax assets	–	–	–	–	–	–	2,668	–	–	2,668
Retirement benefits	–	–	–	–	–	–	292	–	–	292
Other assets	319	16,904	14,829	10,256	5,822	6,805	3,883	–	–	58,818
Total assets at 31 December 2009	336,749	806,292	529,119	463,949	949,140	456,804	219,330	597,240	2,125	4,360,748

Notes on the Financial Statements (continued)

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

Group

2009[1]	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
Liabilities										
Hong Kong currency notes in circulation	135,414	–	–	–	–	–	–	–	–	135,414
Items in the course of transmission to other banks	–	22,960	–	–	–	–	–	–	–	22,960
Deposits by banks	57,386	46,724	2,517	3,135	1,234	210	–	–	–	111,206
Customer accounts	2,215,921	299,215	272,083	126,854	29,544	922	–	–	–	2,944,539
Trading liabilities	–	–	–	–	–	–	–	154,366	–	154,366
Financial liabilities designated at fair value	129	50	159	1,050	1,343	733	33,245	–	–	36,709
Derivatives	–	–	–	–	–	–	–	230,084	2,762	232,846
Debt securities in issue	958	8,487	7,077	13,696	9,956	3,222	–	–	–	43,396
Retirement benefit liabilities	–	–	–	–	–	–	3,922	–	–	3,922
Amounts due to Group companies	25,894	5,770	5,048	1,209	9	2,101	–	10,811	–	50,842
Other liabilities and provisions	4,240	14,522	20,944	9,810	2,611	194	3,661	–	–	55,982
Liabilities under insurance contracts issued	680	–	–	–	–	–	144,248	–	–	144,928
Current tax liabilities	–	434	855	2,830	–	–	–	–	–	4,119
Deferred tax liabilities	–	–	–	–	–	–	10,503	–	–	10,503
Subordinated liabilities	–	–	–	2,031	7,493	2,264	9,393	–	–	21,181
Preference shares	–	–	–	–	–	32,956	68,252	–	–	101,208
Total liabilities at 31 December 2009	2,440,622	398,162	308,683	160,615	52,190	42,602	273,224	395,261	2,762	4,074,121

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

Bank

2009[1]	On demand HK$m	Due within 1 month HK$m	Due between 1 and 3 months HK$m	Due between 3 and 12 months HK$m	Due between 1 and 5 years HK$m	Due after 5 years HK$m	No contractual maturity HK$m	Trading instruments HK$m	Non-trading derivatives HK$m	Total HK$m
Assets										
Cash and short-term funds	85,821	337,108	206,479	28,357	–	–	–	–	–	657,765
Items in the course of collection from other banks	–	11,151	–	–	–	–	–	–	–	11,151
Placings with banks maturing after one month	–	–	46,484	17,735	3,020	60	–	–	–	67,299
Certificates of deposit	–	7,041	6,712	5,000	1,739	–	–	–	–	20,492
Hong Kong Government certificates of indebtedness	135,414	–	–	–	–	–	–	–	–	135,414
Trading assets	–	–	–	–	–	–	–	216,480	–	216,480
Financial assets designated at fair value	–	–	–	76	1,725	–	–	–	–	1,801
Derivatives	–	–	–	–	–	–	–	229,352	1,646	230,998
Advances to customers	54,152	85,728	71,655	98,677	241,786	210,427	(9,851)	–	–	752,574
Financial investments	–	34,860	35,233	121,141	312,386	11,160	49,958	–	–	564,738
Amounts due from Group companies	14,042	58,140	10,430	19,708	3,473	8,400	–	47,562	–	161,755
Investments in subsidiaries	–	–	–	–	–	–	39,606	–	–	39,606
Interests in associates and joint ventures	–	–	–	–	–	–	21,132	–	–	21,132
Goodwill and intangible assets	–	–	–	–	–	–	6,754	–	–	6,754
Property, plant and equipment	–	–	–	–	–	–	35,341	–	–	35,341
Deferred tax assets	–	–	–	–	–	–	1,436	–	–	1,436
Retirement benefits	–	–	–	–	–	–	176	–	–	176
Other assets	217	11,249	10,145	6,780	3,903	386	2,739	–	–	35,419
Total assets at 31 December 2009	289,646	545,277	387,138	297,474	568,032	230,433	147,291	493,394	1,646	2,960,331

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

Bank

2009[1]	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
Liabilities										
Hong Kong currency notes in circulation	135,414	–	–	–	–	–	–	–	–	135,414
Items in the course of transmission to other banks	–	15,796	–	–	–	–	–	–	–	15,796
Deposits by banks	44,229	45,433	1,299	3,094	596	210	–	–	–	94,861
Customer accounts	1,468,558	182,008	163,704	63,642	23,930	729	–	–	–	1,902,571
Trading liabilities	–	–	–	–	–	–	–	103,456	–	103,456
Financial liabilities designated at fair value	–	50	42	–	1,343	388	34	–	–	1,857
Derivatives	–	–	–	–	–	–	–	228,223	1,920	230,143
Debt securities in issue	958	7,798	6,883	9,684	2,927	–	–	–	–	28,250
Retirement benefit liabilities	–	–	–	–	–	–	1,986	–	–	1,986
Amounts due to Group companies	39,815	36,327	12,466	5,762	38	2,103	–	26,691	–	123,202
Other liabilities and provisions	2,830	9,819	15,465	6,395	1,563	78	1,879	–	–	38,029
Current tax liabilities	–	355	782	2,319	–	–	–	–	–	3,456
Deferred tax liabilities	–	–	–	–	–	–	5,411	–	–	5,411
Subordinated liabilities	–	–	–	532	–	–	9,393	–	–	9,925
Preference shares	–	–	–	–	–	32,956	68,107	–	–	101,063
Total liabilities at 31 December 2009	1,691,804	297,586	200,641	91,428	30,397	36,464	86,810	358,370	1,920	2,795,420

1 *Restated for the amendment of HKAS17 'Leases'. See note 1 for further information.*

41 Analysis of cash flows payable under financial liabilities by remaining contractual maturities

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 2010						
Hong Kong currency notes in circulation	**148,134**	**–**	**–**	**–**	**–**	**148,134**
Items in the course of transmission to other banks	**–**	**26,495**	**–**	**–**	**–**	**26,495**
Deposits by banks	**80,558**	**84,971**	**1,399**	**741**	**344**	**168,013**
Customer accounts	**2,528,174**	**614,212**	**165,007**	**14,834**	**486**	**3,322,713**
Trading liabilities	**151,534**	**–**	**–**	**–**	**–**	**151,534**
Financial liabilities designated at fair value	**99**	**803**	**205**	**6,128**	**33,795**	**41,030**
Derivatives	**307,286**	**334**	**953**	**1,163**	**124**	**309,860**
Debt securities in issue	**1,933**	**32,676**	**15,144**	**6,713**	**6,382**	**62,848**
Amounts due to Group companies	**48,200**	**17,453**	**3,532**	**7,837**	**6,201**	**83,223**
Other financial liabilities	**4,542**	**38,925**	**15,034**	**2,253**	**191**	**60,945**
Subordinated liabilities	**–**	**211**	**5,508**	**6,475**	**16,078**	**28,272**
Preference shares	**–**	**919**	**1,499**	**9,670**	**122,519**	**134,607**
	3,270,460	**816,999**	**208,281**	**55,814**	**186,120**	**4,537,674**
Loan commitments	**1,044,586**	**289,498**	**25,961**	**11,050**	**19**	**1,371,114**
Financial guarantee contracts	**40,752**	**–**	**–**	**–**	**–**	**40,752**
	4,355,798	**1,106,497**	**234,242**	**66,864**	**186,139**	**5,949,540**
At 31 December 2009						
Hong Kong currency notes in circulation	135,414	–	–	–	–	135,414
Items in the course of transmission to other banks	–	22,960	–	–	–	22,960
Deposits by banks	57,404	49,295	3,215	1,244	211	111,369
Customer accounts	2,216,572	573,658	129,540	32,608	1,243	2,953,621
Trading liabilities	154,366	–	–	–	–	154,366
Financial liabilities designated at fair value	129	220	1,080	1,408	33,955	36,792
Derivatives	230,288	509	1,345	721	52	232,915
Debt securities in issue	958	15,745	14,127	10,849	4,558	46,237
Amounts due to Group companies	36,705	10,820	1,222	73	2,169	50,989
Other financial liabilities	3,381	34,524	8,200	2,240	276	48,621
Subordinated liabilities	–	172	2,398	9,259	15,700	27,529
Preference shares	–	1,300	1,816	12,462	129,244	144,822
	2,835,217	709,203	162,943	70,864	187,408	3,965,635
Loan commitments	908,223	213,095	7,102	7,055	–	1,135,475
Financial guarantee contracts	37,261	18	209	–	–	37,488
	3,780,701	922,316	170,254	77,919	187,408	5,138,598

Notes on the Financial Statements (continued)

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

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 2010						
Hong Kong currency notes in circulation	**148,134**	**–**	**–**	**–**	**–**	**148,134**
Items in the course of transmission to other banks	**–**	**17,951**	**–**	**–**	**–**	**17,951**
Deposits by banks	**59,640**	**68,678**	**1,336**	**623**	**344**	**130,621**
Customer accounts	**1,635,681**	**335,626**	**66,849**	**9,679**	**396**	**2,048,231**
Trading liabilities	**91,184**	**–**	**–**	**–**	**–**	**91,184**
Financial liabilities designated at fair value	**–**	**803**	**205**	**6,128**	**148**	**7,284**
Derivatives	**302,368**	**210**	**583**	**586**	**145**	**303,892**
Debt securities in issue	**1,933**	**29,392**	**8,993**	**1,541**	**2,142**	**44,001**
Amounts due to Group companies	**56,328**	**65,001**	**10,187**	**8,091**	**6,404**	**146,011**
Other financial liabilities	**2,708**	**25,256**	**8,398**	**1,660**	**158**	**38,180**
Subordinated liabilities	**–**	**120**	**205**	**1,298**	**12,573**	**14,196**
Preference shares	**–**	**919**	**1,499**	**9,670**	**122,368**	**134,456**
	2,297,976	**543,956**	**98,255**	**39,276**	**144,678**	**3,124,141**
Loan commitments	**640,773**	**213,000**	**7,665**	**6,537**	**19**	**867,994**
Financial guarantee contracts	**23,353**	**–**	**–**	**–**	**–**	**23,353**
	2,962,102	**756,956**	**105,920**	**45,813**	**144,697**	**4,015,488**
At 31 December 2009						
Hong Kong currency notes in circulation	135,414	–	–	–	–	135,414
Items in the course of transmission to other banks	–	15,796	–	–	–	15,796
Deposits by banks	44,230	46,773	3,152	603	211	94,969
Customer accounts	1,468,883	346,576	64,533	26,037	973	1,907,002
Trading liabilities	103,456	–	–	–	–	103,456
Financial liabilities designated at fair value	–	94	20	1,408	401	1,923
Derivatives	228,359	397	941	387	60	230,144
Debt securities in issue	958	14,708	9,753	2,985	–	28,404
Amounts due to Group companies	66,506	48,796	5,775	102	2,171	123,350
Other financial liabilities	2,373	24,310	5,622	1,139	48	33,492
Subordinated liabilities	–	120	746	1,295	12,543	14,704
Preference shares	–	1,300	1,816	12,462	129,099	144,677
	2,050,179	498,870	92,358	46,418	145,506	2,833,331
Loan commitments	621,718	148,314	2,146	2,429	–	774,607
Financial guarantee contracts	25,607	18	209	–	–	25,834
	2,697,504	647,202	94,713	48,847	145,506	3,633,772

The balances in the above tables will not agree directly with the balances in the consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan commitments and financial guarantee contracts are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows payable under hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under loan commitments and financial guarantee contracts are classified on the basis of the earliest date they can be called.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. In practice, however, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments and guarantee contracts expire without being drawn upon. The group's approach to managing liquidity risk is set out in note 52.

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

	2010 HK$m	2009 HK$m *Restated*[1]
Operating profit	**66,703**	54,352
Net interest income	**(61,876)**	(58,432)
Dividend income	**(564)**	(364)
Depreciation and amortisation	**5,089**	4,339
Amortisation of prepaid operating lease payments	**18**	18
Loan impairment charges and other credit risk provisions	**4,619**	11,235
Advances written off net of recoveries	**(5,557)**	(8,081)
Other provisions for liabilities and charges	**161**	116
Provisions utilised	**(114)**	(225)
(Surplus)/Deficit arising on property revaluation	**(102)**	109
Gains on investment properties	**(483)**	(262)
Profit on disposal of property, plant and equipment and assets held for sale	**(13)**	(410)
(Profit)/Loss on disposal of subsidiaries, associates and business portfolios	**(603)**	6
Gains less losses from financial investments	**(2,016)**	131
Share based payments granted cost free	**1,427**	1,105
Interest received	**70,449**	68,481
Interest paid	**(19,535)**	(22,117)
Operating profit before changes in working capital	**57,603**	50,001
Change in treasury bills with original term to maturity of more than three months	**56,186**	(226,872)
Change in placings with banks maturing after one month	**(42,482)**	(49,381)
Change in certificates of deposit with original term to maturity of more than three months	**(35,189)**	14,664
Change in trading assets	**(94,985)**	132,978
Change in trading liabilities	**(2,832)**	(61,745)
Change in financial assets designated as fair value	**(6,517)**	(7,534)
Change in financial liabilities designated as fair value	**3,618**	(3,217)
Change in derivative assets	**(67,451)**	221,419
Change in derivative liabilities	**76,992**	(235,528)
Change in financial investments held for backing liabilities to long-term policyholders	**18,682**	(31,037)
Change in advances to customers	**(539,117)**	5,811
Change in amounts due from Group companies	**(3,045)**	247,848
Change in other assets	**(24,354)**	(125,686)
Change in deposits by banks	**56,620**	(88,548)
Change in customer accounts	**368,701**	264,655
Change in amounts due to Group companies	**32,735**	(3,313)
Change in debt securities in issue	**15,887**	(6,906)
Change in liabilities under insurance contracts issued	**33,042**	31,497
Change in other liabilities	**(3,465)**	(10,784)
Exchange adjustments	**(8,553)**	5,467
Cash (used in)/generated from operations	**(107,924)**	123,789

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*

Notes on the Financial Statements (continued)

43 Analysis of cash and cash equivalents

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

	2010 HK$m	2009 HK$m
Balance at 1 January	**675,234**	650,885
Net cash (outflow)/inflow before the effect of foreign exchange movements	**(85,858)**	5,155
Effect of foreign exchange movements	**28,823**	19,194
Balance at 31 December	**618,199**	675,234

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

	2010 HK$m	2009 HK$m
Cash in hand and sight balances with central banks	**81,381**	90,775
Items in the course of collection from other banks	**16,878**	15,528
Placings with banks	**472,774**	461,645
Treasury bills	**60,149**	108,736
Certificates of deposit	**12,331**	20,206
Other eligible bills	**1,181**	1,304
Less: items in the course of transmission to other banks	**(26,495)**	(22,960)
	618,199	675,234

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

	2010 HK$m	2009 HK$m
Cash consideration	**(188)**	(13,927)
Cash and cash equivalents acquired	**61**	29,198
	(127)	15,271

d *Analysis of net outflow of cash and cash equivalents in respect of the sale of subsidiaries*

	2010 HK$m	2009 HK$m
Sale proceeds	**7**	–
Cash and cash equivalents transferred	**(20)**	–
	(13)	–

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

	2010 HK$m	2009 HK$m
Sale proceeds	**–**	251
Cash and cash equivalents transferred	**–**	–
	–	251

44 Contingent liabilities and commitments

a *Off-balance sheet contingent liabilities and commitments*

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security	**164,145**	142,469	**118,568**	110,053
Other contingent liabilities	**213**	191	**386**	178
	164,358	142,660	**118,954**	110,231
Commitments				
Documentary credits and short-term trade-related transactions	**45,572**	32,079	**33,476**	21,004
Forward asset purchases and forward forward deposits placed	**1,299**	1,308	**–**	823
Undrawn formal standby facilities, credit lines and other commitments to lend	**1,324,243**	1,102,088	**834,518**	752,780
	1,371,114	1,135,475	**867,994**	774,607

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

Notes on the Financial Statements (continued)

44 Contingent liabilities and commitments *(continued)*

b *Guarantees (including financial guarantee contracts)*

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December 2010, were as follows:

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Guarantees in favour of third parties				
Financial guarantee contracts[1]	**23,538**	20,561	**12,970**	12,993
Standby letters of credit which are financial guarantee contracts[2]	**17,374**	15,670	**9,960**	11,589
Other direct credit substitutes[3]	**36,798**	27,260	**30,782**	22,845
Performance bonds[4]	**46,116**	41,105	**35,479**	31,086
Bid bonds[4]	**1,911**	1,454	**1,539**	1,164
Standby letters of credit related to particular transactions[4]	**8,653**	3,699	**4,872**	2,343
Other transaction-related guarantees[4]	**25,034**	25,521	**16,636**	19,529
	159,424	135,270	**112,238**	101,549
Guarantees in favour of other HSBC Group entities	**4,721**	7,199	**6,330**	8,504
	164,145	142,469	**118,568**	110,053

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

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

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

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

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

c *Contingencies*

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

45 Assets pledged as security for liabilities

Liabilities of the group amounting to HK$64,772m (2009: HK$52,888m) and of the Bank amounting to HK$45,264m (2009: HK$45,668m) are secured by the deposit of assets, including assets pledged in respect of sale and repurchase agreements, to cover short positions and to facilitate settlement processes with clearing houses. The amount of assets pledged by the group to secure these liabilities is HK$73,002m (2009: HK$57,126m) and by the Bank is HK$54,890m (2009: HK$39,915m). These assets comprise treasury bills, debt securities, equities, and deposits.

In respect of reverse repo and stock borrowing transactions, the fair value of collateral held by the group which was permitted to be sold or repledged amounted to HK$151,012m (2009: HK$124,922m), and by the Bank of HK$101,438m (2009: HK$106,365m). The fair value of such collateral actually sold or repledged by the group amounted to HK$26,242m (2009: HK$7,944m) and by the Bank of HK$7,792m (2009: HK$7,028m).

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

46 Capital commitments

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Expenditure contracted for	**1,011**	4,174	**913**	1,800
Expenditure authorised by the Directors but not contracted for	**42**	360	**–**	354
	1,053	4,534	**913**	2,154

The capital commitments mainly relate to the commitment to purchase premises and equipment.

47 Lease commitments

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

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Premises				
Amounts payable within				
– one year or less	**2,652**	2,351	**1,446**	1,257
– five years or less but over one year	**4,161**	2,889	**2,067**	1,871
– over five years	**659**	220	**254**	182
	7,472	5,460	**3,767**	3,310
Equipment				
Amounts payable within				
– one year or less	**67**	51	**4**	25
– five years or less but over one year	**113**	43	**2**	34
	180	94	**6**	59

48 Segmental analysis

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

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

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

Products and services

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

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

48 Segmental analysis *(continued)*

Total assets:

	2010		2009	
	HK$m	**%**	HK$m *Restated* [1]	% *Restated* [1]
Hong Kong	**3,276,432**	**65.0**	2,971,308	68.1
Rest of Asia-Pacific	**2,117,894**	**42.0**	1,714,579	39.3
Intra region	**(354,408)**	**(7.0)**	(325,139)	(7.4)
	5,039,918	**100.0**	4,360,748	100.0

Total liabilities:

	2010		2009	
	HK$m	**%**	HK$m *Restated* [1]	% *Restated* [1]
Hong Kong	**3,130,937**	**66.7**	2,833,184	69.6
Rest of Asia-Pacific	**1,915,954**	**40.8**	1,566,076	38.4
Intra region	**(354,408)**	**(7.5)**	(325,139)	(8.0)
	4,692,483	**100.0**	4,074,121	100.0

Interests in associates and joint ventures:

	2010		2009	
	HK$m	**%**	HK$m	%
Hong Kong	**1,607**	**2.1**	1,215	2.3
Rest of Asia-Pacific	**73,961**	**97.9**	52,468	97.7
	75,568	**100.0**	53,683	100.0

Credit commitments (contract amounts):

	2010		2009	
	HK$m	**%**	HK$m	%
Hong Kong	**743,732**	**48.4**	618,975	48.4
Rest of Asia-Pacific	**791,740**	**51.6**	659,160	51.6
	1,535,472	**100.0**	1,278,135	100.0

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

	2010		2009	
	HK$m	**%**	HK$m	%
Hong Kong	**2,590**	**41.9**	1,115	14.0
Rest of Asia-Pacific	**3,596**	**58.1**	6,859	86.0
	6,186	**100.0**	7,974	100.0

Notes on the Financial Statements (continued)

48 Segmental analysis *(continued)*

Consolidated income statement:

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

48 Segmental analysis *(continued)*

	Hong Kong HK$m *Restated*[1]	Rest of Asia-Pacific HK$m *Restated*[1]	Intra-segment elimination HK$m	Total HK$m *Restated*[1]
2009				
Interest income	39,291	45,667	(2,408)	82,550
Interest expense	(8,356)	(18,183)	2,421	(24,118)
Net interest income	30,935	27,484	13	58,432
Fee income	22,552	14,233	(1,202)	35,583
Fee expense	(3,433)	(3,074)	1,202	(5,305)
Net trading income	8,427	12,112	(13)	20,526
Net income from financial instruments designated at fair value	6,391	868	–	7,259
Gains less losses from financial investments	117	(248)	–	(131)
Dividend income	245	119	–	364
Net earned insurance premiums	28,566	2,829	–	31,395
Other operating income	9,539	1,746	(4,279)	7,006
Total operating income	103,339	56,069	(4,279)	155,129
Net insurance claims incurred and movement in policyholders' liabilities	(34,070)	(3,061)	–	(37,131)
Net operating income before loan impairment charges and other credit risk provisions	69,269	53,008	(4,279)	117,998
Loan impairment charges and other credit risk provisions	(3,875)	(7,360)	–	(11,235)
Net operating income	65,394	45,648	(4,279)	106,763
Operating expenses	(29,135)	(27,555)	4,279	(52,411)
Operating profit	36,259	18,093	–	54,352
Share of profit in associates and joint ventures	59	7,682	–	7,741
Profit before tax	36,318	25,775	–	62,093
Tax expense	(6,365)	(5,518)	–	(11,883)
Profit for the year	29,953	20,257	–	50,210
Profit attributable to shareholders	25,991	19,405	–	45,396
Profit attributable to non-controlling interests	3,962	852	–	4,814
Net operating income				
– external	61,245	45,930	–	107,175
– inter-company/inter-segment	4,149	(282)	(4,279)	(412)
Depreciation and amortisation included in operating expenses	(3,127)	(1,212)	–	(4,339)

Notes on the Financial Statements (continued)

48 Segmental analysis *(continued)*

Net operating income by customer group and global business

	Personal Financial Services HK$m	Commercial Banking HK$m	Global Banking & Markets HK$m	Private Banking HK$m	Other HK$m	Inter-Segment HK$m	Total HK$m
Year ended 31 December 2010							
External	**43,394**	**25,910**	**54,783**	**(20)**	**1,780**	**–**	**125,847**
Inter-segment	**9,545**	**2,012**	**(9,414)**	**343**	**5,986**	**(7,372)**	**1,100**
Year ended 31 December 2009[1]							
External	35,552	19,582	51,739	(50)	352	–	107,175
Inter-segment	10,093	634	(8,913)	336	3,805	(6,367)	(412)

Information by country

	Net external operating income[2]		Non-current assets[3]	
	2010 HK$m	2009 HK$m *Restated*[1]	**2010 HK$m**	2009 HK$m *Restated*[1]
Hong Kong	**68,348**	61,245	**67,424**	58,531
Mainland China	**6,069**	4,791	**75,410**	51,523
Australia	**6,020**	4,283	**1,652**	1,532
India	**8,445**	5,665	**2,901**	2,659
Indonesia	**4,045**	2,981	**5,532**	5,327
Malaysia	**5,784**	4,450	**982**	800
Singapore	**6,774**	6,346	**830**	719
South Korea	**4,320**	4,429	**1,487**	1,296
Taiwan	**3,165**	2,706	**2,619**	2,292
Vietnam	**1,288**	1,095	**282**	244
Other	**11,589**	9,184	**5,989**	3,940
Total	**125,847**	107,175	**165,108**	128,863

1 *Restated for the amendment of HKAS 17 'Leases'. See note 1 for further information.*
2 *Net external operating income is attributable to countries based on the location of the principal operations of the subsidiary or branch.*
3 *Non-current assets consist of property, plant and equipment, goodwill, other intangible assets, interests in associates and joint ventures and certain other assets expected to be recovered more than 12 months after the reporting date.*

49 Related-party transactions

a *Immediate and ultimate holding company*

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

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for the benefit of the group's employees, key management personnel, close family members of key management personnel and entities which are controlled, jointly controlled or significantly influenced by key management personnel or their close family members.

Transactions with the immediate holding company included the payment of interest on preference shares. As at 31 December 2010, the Bank has issued HK$101,306m of preference shares to its immediate holding company (2009: HK$101,063m). These are classified as liabilities on the balance sheet.

Transactions with the ultimate holding company included the issuance of subordinated liabilities and the payment of interest on subordinated liabilities. As at 31 December 2010, the Bank has issued HK$6,106m of subordinated liabilities to its ultimate holding company (2009: HK$2,101m). These are classified as liabilities on the balance sheet.

Income and expenses for the year

	Immediate holding company		Ultimate holding company	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Interest expense[1]	**2,659**	3,937	**23**	31
Other operating income	**–**	–	**252**	62
Other operating expenses	**28**	33	**1,341**	1,450

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

Information relating to preference shares can be found in the 'Notes on the Financial Statements' where the following are disclosed: interest expense on preference shares (note 4(b)) and preference shares issued (note 37).

Balances at 31 December

Group

	Immediate holding company		Ultimate holding company	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**319**	–
Amounts due to[2]	**102,669**	102,889	**6,351**	2,464

Bank

	Immediate holding company		Ultimate holding company	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from[1]	**–**	–	**319**	–
Amounts due to[2]	**102,669**	102,889	**6,287**	2,390

1 *Amounts due from the ultimate holding company are mainly IT cost recoveries.*
2 *Amounts due to the immediate holding company included preference shares of HK$101,306m (2009: HK$101,063m). Amounts due to the ultimate holding company included subordinated liabilities of HK$6,106m (2009: HK$2,101m).*

Guarantees made by the ultimate holding company to and on behalf of the group amounted to HK$353m (2009: HK$5,646m).

49 Related-party transactions *(continued)*

Share option and share award schemes

The group participates in various share option and share plans operated by HSBC Holdings plc whereby share options or shares of HSBC Holdings plc are granted to employees of the group. As disclosed in note 50, the group recognises an expense in respect of these share options and share awards. The cost borne by the ultimate holding company in respect of these share options and share awards is treated as a capital contribution and is recorded under 'Other reserves'. The group recognises a liability due to the ultimate holding company and a corresponding reduction in capital contribution on a straight-line basis over the vesting period for the amount of shares expected to vest. The liability is measured at the fair value of the shares at each reporting date. The balances of the capital contribution and the liability as at 31 December 2010 amounted to HK$2,223m and HK$1,812m respectively (2009: HK$2,006m and HK$1,199m respectively).

b *Subsidiaries and fellow subsidiaries*

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

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

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

Income and expenses for the year

	Fellow subsidiaries	
	2010	2009
	HK$m	HK$m
Interest income	**547**	1,156
Interest expense	**488**	364
Fee income	**1,969**	1,596
Fee expense	**1,065**	862
Other operating income	**2,576**	1,925
Other operating expenses[1]	**4,002**	3,443

1 *2010 included payment of HK$922m (2009: HK$810m) of software costs which were capitalised as intangible assets in the balance sheet of the group.*

Balances at 31 December

Group

	Fellow subsidiaries	
	2010	2009
	HK$m	HK$m
Amounts due from	**137,314**	134,511
Amounts due to	**75,566**	46,696

Bank

	Subsidiaries		Fellow subsidiaries	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Amounts due from	**81,793**	48,029	**116,210**	113,726
Amounts due to	**85,736**	76,438	**52,508**	42,547

49 Related-party transactions *(continued)*

c *Associates and joint ventures*

Information relating to associates and joint venture can be found in note 24 where the following are disclosed:

– interests in associates and joint ventures;

– amounts due from/to associates and joint ventures; and

– principal associates.

The group has entered into Technical Support and Assistance Agreements with Bank of Communications ('BoCom'), Industrial Bank, Vietnam Technological and Commercial Joint Stock Bank, Bao Viet Holdings, Hana HSBC Life Insurance and Canara HSBC Oriental Bank of Commerce Life Insurance to provide technical support and assistance in relation to their banking and insurance business.

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

d *Key management personnel*

Key management personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of The Hongkong and Shanghai Banking Corporation Ltd and the group. It includes members of the Board of Directors and Executive Committee of The Hongkong and Shanghai Banking Corporation Ltd 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:

	2010 HK$m	2009 HK$m
Salaries and other short term benefits	**207**	187
Retirement benefits		
– Defined contribution plans	**12**	10
– Defined benefit plans	**1**	2
Share-based payments	**118**	79
	338	278

Notes on the Financial Statements (continued)

49 Related-party transactions *(continued)*

Transactions, arrangements and agreements involving key management personnel

Transactions, arrangements and agreements are entered into by the group with companies that may be directly or indirectly influenced or controlled by certain directors of the group and their immediate relatives. These transactions are primarily loans and deposits, the average balances of which during the year were:

	2010	2009
	HK$m	HK$m
Average assets	**17,282**	24,043
Average liabilities	**24,206**	17,893

The aggregate contribution to the group's profit before tax from such transactions in 2010 was HK$439m (2009: HK$460m). As at the balance sheet date, guarantees made on behalf of such companies were HK$2,487m (2009: HK$1,224m).

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

The group adheres to Hong Kong Banking Ordinance Section 83 regarding lending to related parties; this includes unsecured lending to key management personnel, their relatives and companies that may be directly or indirectly influenced or controlled by such individuals.

No impairment losses have been recorded against balances outstanding during the year with key management personnel, and there are no specific impairment allowances on balances with key management personnel at the year end.

Loans to officers

Officers are defined as the Board of Directors, Executive Committee members and the Secretary of The Hongkong and Shanghai Banking Corporation Ltd and the Boards of Directors of the ultimate holding company, HSBC Holdings plc, and intermediate holding companies.

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

	Aggregate amount of loans outstanding at 31 December		Maximum aggregate amount of loans outstanding during the year	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
By the Bank	**70**	61	**117**	95
By subsidiaries	**4**	1	**22**	2
	74	62	**139**	97

e *Pension funds*

At 31 December 2010, HK$13.4bn (2009: HK$11.8bn) 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$49m for the year (2009: HK$42m).

50 Share-based payments

During 2010, HK$1,427m was charged to the income statement in respect of share-based payment transactions settled in equity (2009: HK$1,105m). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the HSBC Group's reward structures.

In April 2009, HSBC Holdings completed a rights issue. The terms of the share plans have been adjusted based on the theoretical ex-rights price, which was considered to be the most appropriate methodology to reflect the rights issue. These adjustments are set out in the tables below.

50 Share-based payments *(continued)*

Calculation of fair value

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

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

The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair value calculated is inherently subjective and uncertain due to the assumptions made and the limitations of the model used. Expected dividends are incorporated into the valuation model for share options and awards where applicable.

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

	1-year Savings-Related Share Option Schemes	3-year Savings-Related Share Option Schemes	5-year Savings-Related Share Option Schemes
2010			
Risk-free interest rate[1] (%)	**0.7**	**1.9**	**2.9**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**30**	**30**	**30**
Share price at grant date (£)	**6.82**	**6.82**	**6.82**
2009			
Risk-free interest rate[1] (%)	0.7	2.1	2.4
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	50	35	30
Share price at grant date (£)	4.65	4.65	4.65

1 *The risk-free rate was determined from the UK gilts yield curve.*
2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*
3 *Expected volatility is estimated by considering both historical average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

Share Option Schemes

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

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

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

The ESOS ran from October 1993 until April 2000, after which it was replaced by the GSOP due to a change in UK legislation. In broad terms, the ESOS and GSOP were similar, in that:

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

50 Share-based payments *(continued)*

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

Group

	2010		2009	
	Number (000s)	**Weighted average exercise price £**	Number (000s)	Weighted average exercise price £
Outstanding at 1 January	**22,379**	**7.03**	21,194	7.93
Exercised in the year	**(1,226)**	**6.43**	(302)	6.44
Transferred in the year	**47**	**6.92**	1,040	7.83
Lapsed in the year	**(1,305)**	**6.89**	(2,836)	6.09
Adjustment for rights issue	**–**	**–**	3,283	7.93
Outstanding at 31 December	**19,895**	**7.07**	22,379	7.03
Exercisable at 31 December	**19,895**	**7.07**	22,379	7.03

Bank

	2010		2009	
	Number (000s)	**Weighted average exercise price £**	Number (000s)	Weighted average exercise price £
Outstanding at 1 January	**16,180**	**7.02**	16,492	7.92
Exercised in the year	**(893)**	**6.44**	(171)	6.41
Transferred in the year	**(939)**	**7.01**	(244)	7.24
Lapsed in the year	**(869)**	**6.93**	(2,290)	6.14
Adjustment for rights issue	**–**	**–**	2,393	7.92
Outstanding at 31 December	**13,479**	**7.08**	16,180	7.02
Exercisable at 31 December	**13,479**	**7.08**	16,180	7.02

The options outstanding at the year end had an exercise price in the range of £6.02 to £7.96 (2009: £6.02 to £7.96), and a weighted average remaining contractual life of 2.15 years (2009: 2.94 years).

The weighted average share price during the year was £6.65 (2009: £5.86). No awards have been made under this plan since 2005. This plan was effectively superseded by the HSBC Share Plan.

b *Savings-Related Share Option Schemes*

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

The options are generally exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contracts, respectively. The exercise price is set at a 20% (2009: 20%) discount to the market value immediately preceding the date of invitation, save for the US sub plan one year savings contract where the discount to market value is 15% (2009: 15%).

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

50 Share-based payments *(continued)*

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

Group

	2010		2009	
	Number (000s)	**Weighted average exercise price £**	Number (000s)	Weighted average exercise price £
Outstanding at 1 January	**16,151**	**3.67**	8,193	6.82
Granted in the year	**3,755**	**5.46**	14,318	3.31
Forfeited/expired in the year	**(1,734)**	**4.32**	(8,315)	6.25
Exercised in the year	**(2,859)**	**3.91**	(764)	5.88
Transferred in the year	**91**	**3.87**	1,783	6.10
Adjustment for rights issue	**–**	**–**	936	6.92
Outstanding at 31 December	**15,404**	**3.99**	16,151	3.67
Exercisable at 31 December	**233**	**6.09**	422	6.28

Bank

	2010		2009	
	Number (000s)	**Weighted average exercise price £**	Number (000s)	Weighted average exercise price £
Outstanding at 1 January	**9,359**	**3.77**	6,648	6.83
Granted in the year	**1,315**	**5.46**	7,918	3.31
Forfeited/expired in the year	**(976)**	**4.59**	(5,372)	6.21
Exercised in the year	**(1,452)**	**4.10**	(503)	5.89
Transferred in the year	**(2,091)**	**3.83**	35	4.36
Adjustment for rights issue	**–**	**–**	633	6.91
Outstanding at 31 December	**6,155**	**3.91**	9,359	3.77
Exercisable at 31 December	**161**	**6.07**	330	6.28

The options outstanding at the year end had an exercise price in the range of £3.31 to £6.69 (2009: £3.31 to £6.69), and a weighted average remaining contractual life of 2.45 years (2009: 3.06 years).

The weighted average share price at the date of exercise for share options exercised during the year was £6.53 (2009: £6.56). The weighted average fair value of options granted during the year was £1.48 (2009: £1.40).

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

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

Group

	2010		2009	
	Number (000s)	Weighted average exercise price HK$	Number (000s)	Weighted average exercise price HK$
Outstanding at 1 January	**48,513**	**38.49**	14,404	106.14
Granted in the year	**4,796**	**62.98**	48,632	37.88
Forfeited/expired in the year	**(3,116)**	**44.10**	(15,096)	97.42
Exercised in the year	**(4,847)**	**38.26**	(19)	73.51
Transferred in the year	**(40)**	**49.10**	(1)	63.47
Adjustment for rights issue	**–**	**–**	593	105.87
Outstanding at 31 December	**45,306**	**40.72**	48,513	38.49
Exercisable at 31 December	**69**	**94.51**	148	90.14

Bank

	2010		2009	
	Number (000s)	Weighted average exercise price HK$	Number (000s)	Weighted average exercise price HK$
Outstanding at 1 January	**33,017**	**38.47**	9,242	106.10
Granted in the year	**2,843**	**62.98**	33,141	37.88
Forfeited/expired in the year	**(2,054)**	**43.75**	(9,773)	98.69
Exercised in the year	**(2,754)**	**38.35**	(13)	69.03
Transferred in the year	**(54)**	**50.64**	3	72.32
Adjustment for rights issue	**–**	**–**	417	105.84
Outstanding at 31 December	**30,998**	**40.36**	33,017	38.47
Exercisable at 31 December	**45**	**94.51**	110	90.14

The options outstanding at the year end had an exercise price in the range of HK$37.88 to HK$94.51 (2009: HK$37.88 to HK$94.51), and a weighted average remaining contractual life of 2.89 years (2009: 3.67 years).

The weighted average share price at the date of exercise for share options exercised during the year was HK$79.38 (2009: HK$88.33).

The weighted average fair value of options granted during the year was HK$19.02 (2009: HK$15.65).

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

HSBC Share Plan

The HSBC Share Plan was adopted by HSBC in 2005. Under this plan, Performance Share awards, Restricted Share awards and Achievement Share awards may be made. The aim of the share plan is to align the interests of executives to the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

50 Share-based payments *(continued)*

c *Performance Share Awards*

Performance Shares are awarded to executive Directors and other senior executives after taking into account individual performance in the previous year. For awards made prior to 2008, each award is divided into two equal parts for testing attainment against pre-determined benchmarks. One half of the award is subject to a Total Shareholder Return ('TSR') measure, based on HSBC's ranking against a comparator group of major banks; the other half is subject to an earnings per share target. For each element of the award, shares are released to the employee on a sliding scale from 30 to 100% of the award, depending on the scale of achievement against the benchmarks, providing that the minimum criteria for each performance measure has been met.

For awards made during 2008 and prospectively, each award is divided into three parts for testing attainment against pre-determined benchmarks. 40% of the award is subject to a TSR measure, based on HSBC's ranking against a comparator group of major banks; 40% is subject to an economic profit measure, calculated as the average annual difference between return on invested capital and HSBC's benchmark cost of capital; and 20% is subject to an earnings per share target. For the TSR and EPS elements of the awards, shares are released to the employee on a sliding scale from 20 to 100% of the award, depending on the scale of achievement against the benchmarks. For the economic profit element of the awards, shares are released to the employee on a sliding scale from zero to 100%, depending on the scale of achievement against the benchmark. In all cases, shares are only released when the minimum criteria for each performance measure has been met. The performance conditions are measured over a three year performance period and awards forfeited to the extent they have not been met.

In addition to the performance conditions mentioned above, before an award can vest, the Remuneration Committee needs to be satisfied that the HSBC Group has shown a sustained improvement in the period since the award was made. In determining whether HSBC Holdings has achieved such sustained improvement the Remuneration Committee will take account of all relevant factors, in particular, comparisons against the TSR comparator group in areas such as revenue growth and mix, cost efficiency, credit performance as measured by risk-adjusted revenues, cash return on cash invested, dividend performance and TSR.

	Group		Bank	
	2010 Number (000s)	2009 Number (000s)	**2010 Number (000s)**	2009 Number (000s)
Outstanding at 1 January	**676**	1,192	**676**	1,121
Additions during the year	**17**	31	**13**	30
Released in the year	**(140)**	(179)	**(140)**	(157)
Transferred in the year	**(37)**	28	**(197)**	14
Lapsed in the year	**(233)**	(566)	**(233)**	(492)
Adjustment for rights issue	**–**	170	**–**	160
Outstanding at 31 December	**283**	676	**119**	676

The weighted average remaining vesting period was 0.23 years (2009: 0.70 years).

No shares were granted in 2010. Additions during the year comprised reinvested scrip dividends.

Notes on the Financial Statements (continued)

50 Share-based payments *(continued)*

d *Restricted Share Awards*

Restricted share awards are made to eligible employees for recruitment purposes or as part of deferral of annual bonus. The awards vest over a period of up to three years from the date of the award.

	Group		Bank	
	2010 Number (000s)	2009 Number (000s)	**2010 Number (000s)**	2009 Number (000s)
Outstanding at 1 January	**21,759**	9,997	**19,426**	8,433
Additions during the year	**23,912**	15,459	**19,888**	13,693
Released in the year	**(4,554)**	(4,411)	**(3,588)**	(3,657)
Transferred in the year	**340**	(18)	**(2,071)**	(77)
Lapsed in the year	**(2,981)**	(2,145)	**(2,903)**	(1,465)
Adjustment for rights issue	**–**	2,877	**–**	2,499
Outstanding at 31 December	**38,476**	21,759	**30,752**	19,426

The weighted average remaining vesting period as at year end was 1.30 years (2009: 1.82 years). The closing price of HSBC Holdings shares on 31 December 2010 was £6.51 (31 December 2009: £7.09).

e *Achievement Share Awards*

Achievement shares, a type of Restricted Share Award, were launched in 2005 and were utilised to promote widespread interest in HSBC shares amongst employees and are awarded to eligible employees after taking into account the employee's performance in the prior year. High-performing and/or high-potential senior and middle managers are normally eligible to receive achievement shares as part of the annual pay review process. Shares are awarded without corporate performance conditions and are released to employees after three years provided the employees have remained employed by the HSBC Group for this period.

Additional awards are made during the 3-year vesting period. At the end of three years, the original award together with the additional share awards will be released.

	Group		Bank	
	2010 Number (000s)	2009 Number (000s)	**2010 Number (000s)**	2009 Number (000s)
Outstanding at 1 January	**5,203**	5,532	**3,864**	4,466
Additions during the year	**123**	423	**84**	315
Released in the year	**(2,103)**	(1,452)	**(1,499)**	(1,216)
Transferred in the year	**(50)**	404	**(389)**	86
Lapsed in the year	**(262)**	(557)	**(147)**	(425)
Adjustment for rights issue	**–**	853	**–**	638
Outstanding at 31 December	**2,911**	5,203	**1,913**	3,864

The weighted average remaining vesting period as at year end was 0.25 years (2009: 0.67 years).

51 Fair value of financial instruments

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

Financial instruments measured at fair value on an ongoing basis include trading assets and liabilities, instruments designated at fair value through profit or loss, derivatives, and financial instruments classified as available-for-sale (including treasury and other eligible bills, debt securities and equity securities).

51 Fair value of financial instruments *(continued)*

Control framework

Fair values are subject to a control framework that aims to ensure that they are either determined, or validated, by a function independent of the risk taker. To this end, ultimate responsibility for the determination of fair values lies within the Finance function, which reports functionally to the group Chief Financial Officer. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of valuation models, independent determination or validation of valuation model inputs, independent determination or validation of any adjustments required outside of the valuation model, and, where possible, independent validation of model outputs. For fair values determined without a valuation model, there is independent price determination or validation. The results of independent validation processes are reported to senior management, and adjustments to the fair values made as appropriate.

Determination of fair value of financial instruments carried at fair value

Fair values are determined according to the following hierarchy:

(a) Quoted market price – Level 1

Financial instruments with quoted prices for identical instruments in active markets.

(b) Valuation technique using observable inputs – Level 2

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(c) Valuation technique with significant non-observable inputs – Level 3

Financial instruments valued using models where one or more significant inputs are not observable.

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. For these instruments, the fair value measurement derived is more judgemental. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would likely occur, but it generally does not mean that there is absolutely no market data available upon which to base a determination of fair value (historical data may, for example, be used). Furthermore, the assessment of hierarchy level is based on the lowest level of input that is significant to the fair value of the financial instrument. Consequently, the level of uncertainty in the determination of the unobservable inputs will generally give rise to valuation uncertainty that is less than the fair value itself.

In certain circumstances, the group applies the fair value option to own debt in issue. Where available, the fair value will be based upon quoted prices in an active market for the specific instrument concerned. Where not available, the fair value will either be based upon quoted prices in an inactive market for the specific instrument concerned, or estimated by comparison with quoted prices in an active market for similar instruments. The fair value of these instruments therefore includes the effect of own credit spread. Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt.

Issued structured notes and certain other hybrid instrument liabilities are included within trading liabilities, and marked at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes. Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

51 Fair value of financial instruments *(continued)*

All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer price as appropriate. Long positions are marked at bid price; short positions are marked at offer price.

The fair values of large holdings of non-derivative financial instruments are based on a multiple of the value of a single instrument, and do not include block adjustments for the size of the holding.

The valuation models used where quoted market prices are not available incorporate certain assumptions that the group anticipates would be used by a market participant to establish fair value. Where the group anticipates that there are additional considerations not included within the valuation model, adjustments may be adopted outside the model.

Examples of such adjustments are:

- Credit risk adjustment: an adjustment to reflect the credit worthiness of over-the-counter derivative counterparties.
- Market data/model uncertainty: an adjustment to reflect uncertainties in fair values based on uncertain market data inputs (e.g. as a result of illiquidity) or in areas where the choice of valuation model is particularly subjective.
- Inception profit ('day 1 P&L reserves'): for financial instruments valued, at inception, on the basis of one or more significant unobservable inputs, the difference between transaction price and model value (as adjusted) at inception is not recognised in the consolidated income statement, but is deferred and included as part of the fair value.

Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage, fee expense, and post-trade costs are included in operating expenses. The future cost of administering the over-the-counter derivative portfolio is also not included in fair value, but is expensed as incurred.

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

Loans

Loans are valued from broker quotes and/or market data consensus providers where available. Where unavailable, fair value will be determined based on an appropriate credit spread derived from other market instruments issued by the same or comparable entities.

Debt securities, Treasury and eligible bills, and Equities

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

Derivatives

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

51 Fair value of financial instruments *(continued)*

Analysis of fair value determination

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

Group

		Valuation techniques				
	Quoted market price HK$m	using observable inputs HK$m	with significant non-observable inputs HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2010						
Assets						
Trading assets	**263,579**	**124,594**	**2,035**	**390,208**	**–**	**390,208**
Financial assets designated at fair value	**38,300**	**13,867**	**2,437**	**54,604**	**–**	**54,604**
Derivatives	**2,533**	**236,479**	**1,372**	**240,384**	**62,238**	**302,622**
Available-for-sale investments[1]	**494,178**	**534,623**	**22,155**	**1,050,956**	**–**	**1,050,956**
Liabilities						
Trading liabilities	**56,846**	**80,174**	**14,514**	**151,534**	**–**	**151,534**
Financial liabilities designated at fair value	**–**	**40,327**	**–**	**40,327**	**–**	**40,327**
Derivatives	**2,617**	**234,996**	**1,612**	**239,225**	**70,613**	**309,838**
At 31 December 2009						
Assets						
Trading assets	237,253	82,887	2,591	322,731	–	322,731
Financial assets designated at fair value	31,185	11,012	5,890	48,087	–	48,087
Derivatives	1,877	182,463	1,891	186,231	48,940	235,171
Available-for-sale investments[1]	560,980	583,753	24,161	1,168,894	–	1,168,894
Liabilities						
Trading liabilities	72,870	70,139	11,357	154,366	–	154,366
Financial liabilities designated at fair value	–	36,709	–	36,709	–	36,709
Derivatives	1,838	177,084	2,981	181,903	50,943	232,846

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Bank

		Valuation techniques				
	Quoted market price HK$m	using observable inputs HK$m	with significant non-observable inputs HK$m	Third party total HK$m	Amounts with HSBC entities HK$m	Total HK$m
At 31 December 2010						
Assets						
Trading assets	**230,705**	**65,256**	**1,968**	**297,929**	**–**	**297,929**
Financial assets designated at fair value	**–**	**1,974**	**112**	**2,086**	**–**	**2,086**
Derivatives	**1,753**	**227,519**	**1,075**	**230,347**	**65,132**	**295,479**
Available-for-sale investments[1]	**449,296**	**317,363**	**17,708**	**784,367**	**–**	**784,367**
Liabilities						
Trading liabilities	**37,123**	**46,270**	**7,791**	**91,184**	**–**	**91,184**
Financial liabilities designated at fair value	**–**	**6,581**	**–**	**6,581**	**–**	**6,581**
Derivatives	**2,332**	**226,901**	**1,495**	**230,728**	**73,154**	**303,882**
At 31 December 2009						
Assets						
Trading assets	160,998	53,749	1,733	216,480	–	216,480
Financial assets designated at fair value	–	1,634	167	1,801	–	1,801
Derivatives	1,356	175,846	1,759	178,961	52,037	230,998
Available-for-sale investments[1]	471,682	388,243	21,711	881,636	–	881,636
Liabilities						
Trading liabilities	59,676	38,921	4,859	103,456	–	103,456
Financial liabilities designated at fair value	–	1,857	–	1,857	–	1,857
Derivatives	1,727	172,561	2,911	177,199	52,944	230,143

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

51 Fair value of financial instruments *(continued)*

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

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

Group

	Assets				Liabilities		
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m
At 1 January 2010	**24,161**	**2,591**	**5,890**	**1,891**	**11,357**	**–**	**2,981**
Total gains or losses recognised in profit or loss	**308**	**371**	**492**	**184**	**35**	**–**	**(192)**
Total gains or losses recognised in other comprehensive income	**1,878**	**15**	**12**	**34**	**506**	**–**	**16**
Purchases	**3,367**	**279**	**460**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**2,827**	**–**	**–**
Sales	**(1,347)**	**(2,045)**	**(216)**	**–**	**–**	**–**	**–**
Settlements	**(539)**	**475**	**(170)**	**1,421**	**127**	**–**	**772**
Transfers out	**(17,961)**	**(2,171)**	**(5,423)**	**(2,462)**	**(2,952)**	**–**	**(2,351)**
Transfers in	**12,288**	**2,520**	**1,392**	**304**	**2,614**	**–**	**386**
At 31 December 2010	**22,155**	**2,035**	**2,437**	**1,372**	**14,514**	**–**	**1,612**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[2]	**63**	**58**	**190**	**97**	**(114)**	**–**	**(78)**
At 1 January 2009	14,461	6,300	1,971	4,642	12,152	–	5,410
Total gains or losses recognised in profit or loss	(1,049)	368	755	(448)	1,056	–	3
Total gains or losses recognised in other comprehensive income	1,064	(60)	3	1	217	–	18
Purchases	6,076	658	564	–	–	–	–
Issues	–	–	–	–	797	–	–
Sales	(652)	(4,185)	(59)	–	–	–	–
Settlements	(3,866)	(79)	(46)	(450)	(1,267)	–	(516)
Transfers out	(8,734)	(1,795)	(1)	(2,850)	(2,817)	–	(2,717)
Transfers in	16,861	1,384	2,703	996	1,219	–	783
At 31 December 2009	24,161	2,591	5,890	1,891	11,357	–	2,981
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[2]	(732)	169	782	(240)	25	–	(161)

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Bank

	Assets				Liabilities		
	Available-for-sale HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m	Held for trading HK$m	Designated at fair value through profit or loss HK$m	Derivatives HK$m
At 1 January 2010	**21,711**	**1,733**	**167**	**1,759**	**4,859**	**–**	**2,911**
Total gains or losses recognised in profit or loss	**640**	**2**	**21**	**77**	**119**	**–**	**(300)**
Total gains or losses recognised in other comprehensive income	**1,025**	**13**	**–**	**33**	**93**	**–**	**15**
Purchases	**2,959**	**278**	**–**	**–**	**–**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**2,220**	**–**	**–**
Sales	**(1,338)**	**(1,445)**	**–**	**–**	**–**	**–**	**–**
Settlements	**(241)**	**475**	**–**	**1,283**	**708**	**–**	**786**
Transfers out	**(16,800)**	**(1,542)**	**(76)**	**(2,381)**	**(862)**	**–**	**(2,303)**
Transfers in	**9,752**	**2,454**	**–**	**304**	**654**	**–**	**386**
At 31 December 2010	**17,708**	**1,968**	**112**	**1,075**	**7,791**	**–**	**1,495**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[2]	**140**	**58**	**21**	**52**	**(60)**	**–**	**34**
At 1 January 2009	11,485	4,605	225	4,372	5,406	–	5,410
Total gains or losses recognised in profit or loss	8	190	18	(249)	720	–	(84)
Total gains or losses recognised in other comprehensive income	744	1	–	1	98	–	16
Purchases	5,781	590	–	–	–	–	–
Issues	–	–	–	–	791	–	–
Sales	(566)	(3,630)	(38)	–	–	–	–
Settlements	(3,781)	(72)	(38)	(450)	(591)	–	(512)
Transfers out	(8,734)	(725)	–	(2,808)	(1,681)	–	(2,686)
Transfers in	16,774	774	–	893	116	–	767
At 31 December 2009	21,711	1,733	167	1,759	4,859	–	2,911
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period[2]	273	109	22	(281)	48	–	(72)

2 *The amount has been reported on a net basis, after taking into consideration the total gains or losses arising from those transactions where the risk has been backed out to other HSBC entities.*

51 Fair value of financial instruments *(continued)*

For available-for sale securities, the unobservability of valuations of certain equity shares resulted in these assets being transferred into level 3 during the year. Transfers out of level 3 occurred in respect of certain debt securities as valuations in these assets becoming observable during the year.

For held-for-trading assets, the unobservability of valuations of certain debt securities resulted in these assets being transferred into level 3 during the year. Transfers out of level 3 also occurred in respect of certain debt securities as valuations in these assets became observable during the year.

For assets designated at fair value through profit or loss, the observability of valuations of certain debt securities and the deconsolidation of The HSBC Private Equity Fund 3 resulted in certain assets being transferred out of level 3 during the year. Transferred into level 3 resulted from the valuations of certain debt securities becoming unobservable during the year.

For derivative assets and liabilities, an increase in the observability of equity volatilities and correlations during the year resulted in transfers out of level 3. In addition, the unobservability of specific asset prices underlying derivative structures resulted in derivative liabilities being transferred into level 3.

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

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under 'Net trading income'.

Fair value changes on assets and liabilities designated at fair value are presented in the income statement under 'Net income/(loss) from financial instruments designated at fair value'.

Realised gains and losses from available-for-sale securities are presented under 'Gains less losses from financial investments' in the income statement while unrealised gains and losses are presented in 'Fair value changes taken to equity' within 'Available-for-sale investments' in other comprehensive income.

Effects of changes in significant non-observable assumptions to reasonably possible alternatives:

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation models that incorporate assumptions that are not supported by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions.

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

Group

	Reflected in income statement		Reflected in equity	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable changes HK$m
At 31 December 2010				
Derivatives/trading assets/trading liabilities	**492**	**(494)**	**–**	**–**
Financial assets/liabilities designated at fair value	**234**	**(234)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**2,073**	**(2,073)**
At 31 December 2009				
Derivatives/trading assets/trading liabilities	413	(408)	–	–
Financial assets/liabilities designated at fair value	573	(573)	–	–
Financial investments: available-for-sale	–	–	964	(958)

Bank

	Reflected in income statement		Reflected in equity	
	Favourable changes HK$m	Unfavourable changes HK$m	Favourable changes HK$m	Unfavourable changes HK$m
At 31 December 2010				
Derivatives/trading assets/trading liabilities	**444**	**(445)**	**–**	**–**
Financial assets/liabilities designated at fair value	**2**	**(2)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**1,632**	**(1,632)**
At 31 December 2009				
Derivatives/trading assets/trading liabilities	277	(272)	–	–
Financial assets/liabilities designated at fair value	–	–	–	–
Financial investments: available-for-sale	–	–	719	(719)

Changes in fair value recorded in the income statement

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

- the table details the total change in fair value of these instruments; it does not isolate that component of the change that is attributable to the non-observable component;
- instruments valued with significant non-observable inputs are frequently dynamically hedged with instruments valued using observable inputs; the table does not include any changes in fair value of these hedges; and
- there were significant assets and liabilities valued using observable inputs at 31 December 2009 that became valued with significant unobservable inputs during 2010; the table reflects the full change in fair value of those instruments during 2010, not just that element arising following the category change.

Group

	Recorded in the income statement	
	2010 HK$m	2009 HK$m
At 31 December		
Derivatives/trading assets/trading liabilities	**(37)**	(207)
Financial assets/liabilities designated at fair value	**190**	782

Bank

	Recorded in the income statement	
	2010 HK$m	2009 HK$m
At 31 December		
Derivatives/trading assets/trading liabilities	**84**	(196)
Financial assets/liabilities designated at fair value	**21**	22

51 Fair value of financial instruments *(continued)*

Fair value of financial instruments not carried at fair value

The fair values of financial instruments that are not recognised at fair value on the balance sheet are calculated as described below.

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

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

Advances to customers

The fair value of advances to customers is estimated using discounted cash flow models using an estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

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

Financial investments

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration either the prices of, or future earning streams of, equivalent quoted securities.

Deposits and customer accounts

The fair value of deposits and customer accounts is estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of deposits repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

Debt securities in issue and subordinated liabilities

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

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

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

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

Notes on the Financial Statements (continued)

51 Fair value of financial instruments *(continued)*

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

Assets	Liabilities
Cash and balances at central banks	Items in the course of transmission to other banks
Items in the course of collection from other banks	Endorsements and acceptances
Endorsements and acceptances	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals
Accrued income	

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

Group

	31 December 2010		31 December 2009	
	Carrying value HK$m	**Fair value HK$m**	Carrying value HK$m	Fair value HK$m
Assets				
Placings with banks	**597,081**	**597,144**	548,932	549,009
Loans and advances to customers	**1,891,060**	**1,889,974**	1,350,644	1,352,528
Debt securities	**128,033**	**132,832**	110,721	113,288
Liabilities				
Deposits by banks	**167,827**	**167,832**	111,206	111,205
Customer accounts	**3,313,244**	**3,313,148**	2,944,539	2,944,629
Debt securities in issue	**59,283**	**59,343**	43,396	43,433
Subordinated liabilities	**21,254**	**19,771**	21,181	19,124
Preference shares	**101,458**	**93,232**	101,208	89,482

Bank

	31 December 2010		31 December 2009	
	Carrying value HK$m	**Fair value HK$m**	Carrying value HK$m	Fair value HK$m
Assets				
Placings with banks	**318,912**	**318,983**	342,837	342,904
Loans and advances to customers	**1,016,312**	**1,015,787**	752,574	752,589
Liabilities				
Deposits by banks	**130,476**	**130,475**	94,861	94,862
Customer accounts	**2,044,664**	**2,044,807**	1,902,571	1,902,672
Debt securities in issue	**43,139**	**43,160**	28,250	28,275
Subordinated liabilities	**9,404**	**7,992**	9,925	8,054
Preference shares	**101,306**	**93,081**	101,063	89,338

52 Risk Management

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

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

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

a *Credit risk*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from lending, trade finance, treasury and leasing business, but also from off-balance sheet products such as guarantees and credit derivatives, and from the group's holding of debt securities. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities. The group's principal credit risk management procedures and policies, which follow policies established by HSBC Group Head Office, include the following:

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

52 Risk Management *(continued)*

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

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

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

The Audit Committee ('AC') also has responsibility for oversight and advice to the Board on risk matters. The key responsibilities of the AC 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 AC 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 AC approves the appointment and removal of the group Chief Risk Officer.

Credit quality

The group's credit risk rating system differentiates exposures in order to highlight those with greater risk factors and higher potential severity of loss.

The group's credit rating system is based on a sophisticated and granular methodology, using probability of default and loss estimates, which is compliant with an internal ratings based ('IRB') approach required to support the Basel II framework for calculating the group's minimum capital requirement. The integration of this framework into the group's reporting structure enables reporting to internal management in accordance with the group's IRB obligations.

Collateral and other credit enhancements

Loans and advances

The group has guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and the determination of valuation parameters. Such parameters are expected to be conservative, reviewed regularly and supported by empirical evidence. The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

52 Risk Management *(continued)*

The group obtained assets by taking possession of collateral held as security, or calling other credit enhancements.

The carrying amount outstanding as at the year end was as follows:

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Residential properties	**37**	116	**4**	23
Commercial and industrial properties	**12**	24	**2**	15
Other assets	**2**	3	**–**	–
	51	143	**6**	38

Repossessed assets are non-financial assets acquired in exchange for loans in order to achieve an orderly realisation, and are reported in the balance sheet within 'Other assets' at the lower of fair value (less costs to sell) and the carrying amount of the loan (net of any impairment allowance). If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The group does not generally occupy repossessed properties for its own business use.

Other financial assets

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured with the exception of asset-backed securities and similar instruments, which are secured by pools of financial assets.

The ISDA Master Agreement is the group's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter ('OTC') products is conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement, if either party defaults or other pre-agreed termination events occur. It is also common, and the group's preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market contingent counterparty risk inherent in the outstanding positions.

Daily Settlement Limits are established for each counterparty, to cover the aggregate of all settlement risk arising from the group's investment banking and markets transactions on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated when effected via Assured Payment Systems, or on a delivery versus payment basis.

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Maximum exposure to credit risk

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

Group

	2010 HK$m	2009 HK$m
Cash and short-term funds	**807,985**	892,175
Items in the course of collection from other banks	**16,878**	15,528
Placings with banks maturing after one month	**149,557**	107,070
Certificates of deposit	**73,247**	37,388
Hong Kong Government certificates of indebtedness	**148,134**	135,414
Trading assets	**372,410**	308,951
Debt securities	**200,379**	138,020
Treasury bills and other eligible bills	**140,873**	145,676
Other	**31,158**	25,255
Financial assets designated at fair value	**17,930**	18,695
Debt securities	**17,299**	18,300
Other	**631**	395
Derivatives	**302,622**	235,171
Advances to customers	**1,891,060**	1,350,644
Financial investments: Debt securities	**753,827**	824,458
Amounts due from Group companies	**137,633**	134,511
Other assets	**56,452**	54,744
Acceptances and endorsements	**25,892**	22,211
Other	**30,560**	32,533
Financial guarantees and other credit-related contingent liabilities	**104,927**	93,636
Loan commitments and other credit-related commitments	**1,543,697**	1,295,126
At 31 December	**6,376,359**	5,503,511

Bank

	2010 HK$m	2009 HK$m
Cash and short-term funds	**551,003**	657,765
Items in the course of collection from other banks	**12,143**	11,151
Placings with banks maturing after one month	**74,791**	67,299
Certificates of deposit	**27,888**	20,492
Hong Kong Government certificates of indebtedness	**148,134**	135,414
Trading assets	**280,309**	203,403
Debt securities	**155,174**	104,158
Treasury bills and other eligible bills	**112,602**	82,680
Other	**12,533**	16,565
Financial assets designated at fair value: debt securities	**2,086**	1,801
Derivatives	**295,479**	230,998
Advances to customers	**1,016,312**	752,574
Financial investments: Debt securities	**442,336**	515,923
Amounts due from group companies	**198,322**	161,755
Other assets	**28,980**	32,469
Acceptances and endorsements	**17,041**	16,073
Other	**11,939**	16,396
Financial guarantees and other credit-related contingent liabilities	**72,938**	72,006
Loan commitments and other credit-related commitments	**948,987**	846,106
At 31 December	**4,099,708**	3,709,156

Note 18(b) shows the analysis of advances to customers by industry sector and by geographical region.

52 Risk Management *(continued)*

Credit quality of financial instruments

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

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

Quality Classification	Wholesale lending and Derivatives	Retail lending	Debt securities/other
Strong	CRR 1 to CRR 2	EL 1 to EL 2	A– and above
Medium	CRR 3 to CRR 5	EL 3 to EL 5	B+ to BBB+, and unrated
Sub-standard	CRR 6 to CRR 8	EL 6 to EL 8	B and below
Impaired	CRR 9 to CRR 10	EL 9 to EL 10	Impaired

Quality classification definitions

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

The group's policy in respect of impairment on loans and advances and debt securities is set out in notes 3(d) and 3(g) on the Financial Statements. Analysis of impairment allowances as at 31 December 2010 and the movement of such allowances during the year are disclosed in note 19.

Granular risk rating scales

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

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

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

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Distribution of financial instruments by credit quality

Group

	Neither past due nor impaired						
31 December 2010	**Strong HK$m**	**Medium[1] HK$m**	**Sub-standard HK$m**	**Past due not impaired HK$m**	**Impaired HK$m**	**Impairment allowances HK$m**	**Total HK$m**
Items in the course of collection from other banks	15,294	1,584	–	–	–	–	16,878
Trading assets	319,851	51,858	701	–	–	–	372,410
– treasury and other eligible bills	133,799	7,074	–	–	–	–	140,873
– debt securities	160,916	39,306	157	–	–	–	200,379
– loans and advances to banks	24,140	1,509	471	–	–	–	26,120
– loans and advances to customers	996	3,969	73	–	–	–	5,038
Financial assets designated at fair value	15,994	1,936	–	–	–	–	17,930
– debt securities	15,363	1,936	–	–	–	–	17,299
– loans and advances to customers	631	–	–	–	–	–	631
Derivatives	264,605	37,114	903	–	–	–	302,622
Loans and advances held at amortised cost	1,577,126	847,090	35,382	25,256	16,281	(12,994)	2,488,141
– loans and advances to banks	537,729	56,777	1,739	836	–	–	597,081
– loans and advances to customers	1,039,397	790,313	33,643	24,420	16,281	(12,994)	1,891,060
Financial investments	1,017,926	87,053	993	121	61	–	1,106,154
– treasury and other eligible bills	259,134	19,946	–	–	–	–	279,080
– debt securities[2]	758,792	67,107	993	121	61	–	827,074
Other assets	18,565	36,409	903	501	74	–	56,452
– endorsements and acceptances	6,481	18,617	694	41	59	–	25,892
– other	12,084	17,792	209	460	15	–	30,560

1 *Includes HK$78,778m (31 December 2009: HK$62,029m) of treasury and eligible bills and debt securities that have been classified as BBB– to BBB+ using the ratings of Standard & Poor's.*
2 *Includes HK$26m of impaired debt securities overdue for between 6 months and 1 year.*

52 Risk Management *(continued)*

31 December 2009	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	13,831	1,696	1	–	–	–	15,528
Trading assets	276,294	30,076	2,581	–	–	–	308,951
– treasury and other eligible bills	142,907	1,880	889	–	–	–	145,676
– debt securities	114,097	23,349	574	–	–	–	138,020
– loans and advances to banks	18,272	1,076	1,118	–	–	–	20,466
– loans and advances to customers	1,018	3,771	–	–	–	–	4,789
Financial assets designated at fair value	17,387	1,288	20	–	–	–	18,695
– debt securities	16,992	1,288	20	–	–	–	18,300
– loans and advances to customers	395	–	–	–	–	–	395
Derivatives	179,579	53,212	2,380	–	–	–	235,171
Loans and advances held at amortised cost	1,154,942	680,483	37,734	24,501	16,196	(14,280)	1,899,576
– loans and advances to banks	452,387	94,425	2,027	93	–	–	548,932
– loans and advances to customers	702,555	586,058	35,707	24,408	16,196	(14,280)	1,350,644
Financial investments	1,135,488	84,012	1,838	–	46	–	1,221,384
– treasury and other eligible bills	344,172	14,297	1,069	–	–	–	359,538
– debt securities	791,316	69,715	769	–	46	–	861,846
Other assets	15,438	37,379	1,544	296	87	–	54,744
– endorsements and acceptances	3,788	17,097	1,258	14	54	–	22,211
– other	11,650	20,282	286	282	33	–	32,533

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Bank

	Neither past due nor impaired						
31 December 2010	**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	10,649	1,494	–	–	–	–	12,143
Trading assets	235,598	44,010	701	–	–	–	280,309
– treasury and other eligible bills	105,596	7,006	–	–	–	–	112,602
– debt securities	122,531	32,486	157	–	–	–	155,174
– loans and advances to banks	6,500	1,509	471	–	–	–	8,480
– loans and advances to customers	971	3,009	73	–	–	–	4,053
Financial assets designated at fair value: debt securities	863	1,223	–	–	–	–	2,086
Derivatives	260,596	34,171	712	–	–	–	295,479
Loans and advances held at amortised cost	858,392	449,484	14,290	11,435	10,596	(8,973)	1,335,224
– loans and advances to banks	296,100	21,119	860	833	–	–	318,912
– loans and advances to customers	562,292	428,365	13,430	10,602	10,596	(8,973)	1,016,312
Financial investments	647,365	74,411	993	121	61	–	722,951
– treasury and other eligible bills	234,567	18,160	–	–	–	–	252,727
– debt securities	412,798	56,251	993	121	61	–	470,224
Other assets	9,563	18,495	796	58	68	–	28,980
– endorsements and acceptances	4,478	11,831	632	41	59	–	17,041
– other	5,085	6,664	164	17	9	–	11,939

1 *Includes HK$72,641m (31 December 2009: HK$56,784m) of treasury and eligible bills and debt securities that have been classified as BBB- to BBB+ using the ratings of Standard & Poor's.*

52 Risk Management *(continued)*

31 December 2009	Neither past due nor impaired: Strong HK$m	Medium[1] HK$m	Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Items in the course of collection from other banks	9,456	1,694	1	–	–	–	11,151
Trading assets	177,847	24,131	1,425	–	–	–	203,403
– treasury and other eligible bills	80,010	1,781	889	–	–	–	82,680
– debt securities	85,524	18,313	321	–	–	–	104,158
– loans and advances to banks	11,316	629	215	–	–	–	12,160
– loans and advances to customers	997	3,408	–	–	–	–	4,405
Financial assets designated at fair value: debt securities	941	860	–	–	–	–	1,801
Derivatives	177,542	51,109	2,347	–	–	–	230,998
Loans and advances held at amortised cost	646,717	416,030	19,172	13,282	10,061	(9,851)	1,095,411
– loans and advances to banks	260,225	81,409	1,110	93	–	–	342,837
– loans and advances to customers	386,492	334,621	18,062	13,189	10,061	(9,851)	752,574
Financial investments	765,917	65,032	1,838	–	34	–	832,821
– treasury and other eligible bills	286,580	8,757	1,069	–	–	–	296,406
– debt securities	479,337	56,275	769	–	34	–	536,415
Other assets	9,002	22,057	1,292	37	81	–	32,469
– endorsements and acceptances	2,792	12,129	1,090	8	54	–	16,073
– other	6,210	9,928	202	29	27	–	16,396

52 Risk Management *(continued)*

Financial instruments which were past due but not impaired ageing analysis

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

Group

	Up to 29 days 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 2010						
Loans and advances held at amortised cost	**20,264**	**3,305**	**1,324**	**298**	**65**	**25,256**
– loans and advances to banks	**836**	**–**	**–**	**–**	**–**	**836**
– loans and advances to customers[1]	**19,428**	**3,305**	**1,324**	**298**	**65**	**24,420**
Financial investments	**121**	**–**	**–**	**–**	**–**	**121**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**121**	**–**	**–**	**–**	**–**	**121**
Other assets	**144**	**111**	**123**	**57**	**66**	**501**
	20,529	**3,416**	**1,447**	**355**	**131**	**25,878**
31 December 2009						
Loans and advances held at amortised cost	18,610	3,961	1,618	186	126	24,501
– loans and advances to banks	93	–	–	–	–	93
– loans and advances to customers[1]	18,517	3,961	1,618	186	126	24,408
Other assets	84	96	54	31	31	296
	18,694	4,057	1,672	217	157	24,797

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 2010						
Loans and advances held at amortised cost	**9,341**	**1,386**	**586**	**107**	**15**	**11,435**
– loans and advances to banks	**833**	**–**	**–**	**–**	**–**	**833**
– loans and advances to customers[1]	**8,508**	**1,386**	**586**	**107**	**15**	**10,602**
Financial investments	**121**	**–**	**–**	**–**	**–**	**121**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**121**	**–**	**–**	**–**	**–**	**121**
Other assets	**52**	**4**	**1**	**–**	**1**	**58**
	9,514	**1,390**	**587**	**107**	**16**	**11,614**
31 December 2009						
Loans and advances held at amortised cost	9,910	2,211	925	145	91	13,282
– loans and advances to banks	93	–	–	–	–	93
– loans and advances to customers[1]	9,817	2,211	925	145	91	13,189
Other assets	24	7	4	1	1	37
	9,934	2,218	929	146	92	13,319

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

52 Risk Management *(continued)*

Impaired loans and advances

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

Analyses of impairment allowances at 31 December 2010 and the movement of such allowances during the year are disclosed in note 19.

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b *Liquidity risk*

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

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

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

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

We adapt our liquidity and funding risk management framework in response to changes in the mix of business that we undertake, and to changes in the nature of the markets in which we operate. We also seek to continuously evolve and strengthen our liquidity and funding risk management framework. As part of this on-going process, the Group has refined the way in which it characterises core deposits. The characterisation takes into account our activities and operating environment in the entity originating the deposit, the nature of the customer and the size and pricing of the deposit. This exercise has resulted in a revised internal calculation of advances to core funding ratio (discussed more fully below), and comparatives have been restated accordingly.

We employ a number of measures to monitor liquidity risk. The emphasis on the ratio of net liquid assets to customer deposits, as reported in the Annual Report and Accounts 2009, has been reduced and a "stressed one month coverage ratio", an extension of our projected cash flow scenario analysis, is now used by the group as a simple and more useful metric to express liquidity risk.

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

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

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

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

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

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

Advances to core funding ratio

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on group banking entities which restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long term debt funding. This measure is referred to as the 'advances to core funding' ratio (previously referred to as the 'advances to deposits' ratio).

The ratio describes loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio. The distinction between core and and non-core deposits generally means that the group's measure of advances to core funding is more restrictive than that which can be inferred from the published financial statements.

Projected cash flow scenario analysis

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

52 Risk Management *(continued)*

Stressed one month coverage ratio

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

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

	Advances to core funding ratio		Stressed one month coverage ratio	
	2010	2009	**2010**	2009
	%	%	**%**	%
Year-end	**70.3**	55.5	**144.6**	153.2
Maximum	**70.3**	62.0	**165.4**	153.2
Minimum	**55.5**	55.5	**132.6**	134.3
Average	**63.6**	57.5	**148.8**	144.8

Contingent liquidity risk

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

Liquidity ratio under the Hong Kong Banking Ordinance

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

c *Market risk*

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

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

The management of market risk is principally undertaken in Global Markets through risk limits approved by the group's Executive Committee. Traded Credit and Market Risk, an independent unit within the Risk function, develops risk management policies and measurement techniques.

Risk limits are determined for each location and, within location, for each portfolio. Limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk limits at a portfolio level. Similarly, option risks are controlled through full revaluation limits in conjunction with limits on the underlying variables that determine each option's value.

52 Risk Management *(continued)*

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence (99% for the group). VAR is calculated daily.

The group uses a historical simulation model which derives plausible future scenarios from historical market data. Potential movements in market prices are calculated with reference to market data from the last two years. The model used assumes a 1-day holding period, as this reflects the way the risk positions are managed.

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

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

The group recognises these limitations by augmenting the VAR limits with other position and sensitivity limit structures, as well as with stress testing, both on individual portfolios and on a consolidated basis. The group's stress testing regime provides senior management with an assessment of the impact of extreme events on the market risk exposures of the group.

Trading

The group's control of market risk is based on restricting individual operations to trading within a list of permissible instruments authorised for each site by Traded Credit and Market Risk, and enforcing rigorous new product approval procedures. In particular, trading in the more complex derivative products is concentrated in offices with appropriate levels of product expertise and robust control systems.

In addition, at both portfolio and position levels, market risk in trading portfolios is monitored and controlled using a complementary set of techniques such as VAR and present value of a basis point, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

52 Risk Management *(continued)*

The total VAR for Global Markets was as follows:

	Group		Bank	
	2010	2009	**2010**	2009
	HK$m	HK$m	**HK$m**	HK$m
Total VAR				
Year end	**433**	296	**331**	248
Average	**466**	245	**377**	226
Maximum	**596**	339	**528**	298
Minimum	**271**	184	**230**	171
Total interest rate VAR				
Year end	**174**	258	**158**	235
Average	**264**	230	**249**	214
Maximum	**350**	312	**332**	282
Minimum	**139**	160	**144**	166
Total foreign exchange VAR				
Year end	**68**	28	**58**	35
Average	**44**	36	**45**	34
Maximum	**116**	82	**115**	74
Minimum	**19**	15	**15**	14
Total credit spread VAR[2]				
Year end	**264**	68	**173**	60
Average	**335**	84	**245**	80
Maximum	**464**	137	**347**	137
Minimum	**188**	50	**149**	48
Total trading VAR				
Year end	**136**	172	**122**	187
Average	**169**	139	**170**	137
Maximum	**255**	213	**242**	222
Minimum	**84**	92	**76**	87
Interest rate trading VAR				
Year end	**79**	127	**68**	133
Average	**148**	127	**150**	128
Maximum	**208**	173	**227**	176
Minimum	**76**	82	**67**	81
Foreign exchange trading VAR				
Year end	**64**	31	**53**	41
Average	**41**	33	**43**	32
Maximum	**118**	72	**122**	81
Minimum	**15**	13	**14**	14
Credit spread trading VAR				
Year end	**47**	68	**42**	60
Average	**66**	84	**62**	80
Maximum	**103**	137	**97**	137
Minimum	**39**	50	**37**	48
Equity trading VAR[1]				
Year end	**9**	26	**9**	26
Average	**15**	36	**15**	34
Maximum	**45**	104	**45**	104
Minimum	**3**	10	**3**	10

1 *In addition to equity trading positions managed by Global Markets, the group also has exposure to changes in equity prices and interest rates relating to guarantees given to customers who purchase certain HSBC investment contracts. As at 31 December 2010, a 10% decrease in equity prices would reduce profit before tax and net assets by HK$119m (2009: HK$123m) and a 100 basis points decrease in interest rates would reduce profit before tax and net assets by HK$27m (2009: HK$31m).*

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

52 Risk Management *(continued)*

Non-trading portfolios

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

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

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

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

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

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

52 Risk Management *(continued)*

Structural foreign exchange exposure

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

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

Foreign currency investments amounted to the foreign currency equivalent of HK$272,883m (85% of shareholders' funds) at 31 December 2010, an increase of HK$63,452m from HK$209,431m (80% of shareholders' funds) at 31 December 2009. Gains or losses on structural foreign currency exposures are taken to reserves.

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

	Group		Bank	
	LCYm	HK$m	LCYm	HK$m
At 31 December 2010				
Chinese renminbi	**122,017**	**143,909**	**52,598**	**62,035**
Indian rupees	**179,314**	**31,178**	**127,064**	**22,093**
At 31 December 2009				
Chinese renminbi	95,389	108,347	40,088	45,534
Indian rupees	150,789	25,073	108,625	18,062

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

d *Operational risk*

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

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

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

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

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

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

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e *Insurance risk*

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

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

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

52 Risk Management *(continued)*

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

Asset/liability management

A principal tool used by the group to manage its exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. The group actively manages its assets using an approach that considers asset quality, diversification, asset/liability matching, liquidity, volatility and target investment return. The goal of the investment process is to achieve the target level of investment return with minimum volatility. The Markets and Liquidity Risk Committee reviews and approves target portfolios on a periodic basis, establishes investment guidelines and limits, and provides oversight of the asset/liability management process.

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

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

Statement of financial position of insurance subsidiaries by type of contract

	Life linked contracts[1] HK$m	Life non-linked contracts[2] HK$m	Non-life insurance HK$m	Other assets[3] HK$m	Total HK$m
At 31 December 2010					
Financial assets:					
– financial assets designated at fair value	**28,652**	**21,753**	**417**	**917**	**51,739**
– derivatives	**–**	**474**	**3**	**3**	**480**
– financial investments	**–**	**127,213**	**1,280**	**7,896**	**136,389**
– other financial assets	**2,296**	**24,132**	**1,369**	**705**	**28,502**
Total financial assets	**30,948**	**173,572**	**3,069**	**9,521**	**217,110**
Reinsurance assets	**5,567**	**161**	**420**	**89**	**6,237**
PVIF[4]	**–**	**–**	**–**	**14,767**	**14,767**
Other assets	**4**	**1,923**	**190**	**3,766**	**5,883**
Total assets	**36,519**	**175,656**	**3,679**	**28,143**	**243,997**
Liabilities under investment contracts designated at fair value	**7,478**	**26,268**	**–**	**–**	**33,746**
Liabilities under insurance contacts	**28,920**	**146,130**	**2,920**	**–**	**177,970**
Deferred tax	**–**	**121**	**1**	**2,497**	**2,619**
Other liabilities	**–**	**–**	**–**	**2,705**	**2,705**
Total liabilities	**36,398**	**172,519**	**2,921**	**5,202**	**217,040**
Total equity	**–**	**–**	**–**	**26,957**	**26,957**
Total equity and liabilities	**36,398**	**172,519**	**2,921**	**32,159**	**243,997**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

	Life linked contracts[1] HK$m	Life non-linked contracts[2] HK$m	Non-life insurance HK$m	Other assets[3] HK$m	Total HK$m
At 31 December 2009					
Financial assets:					
– financial assets designated at fair value	23,689	16,996	274	2,741	43,700
– derivatives	9	154	–	–	163
– financial investments	–	107,550	1,498	6,528	115,576
– other financial assets	2,889	18,892	1,021	1,277	24,079
Total financial assets	26,587	143,592	2,793	10,546	183,518
Reinsurance assets	6,237	67	387	87	6,778
PVIF[4]	–	–	–	10,554	10,554
Other assets	5	1,647	168	2,146	3,966
Total assets	32,829	145,306	3,348	23,333	204,816
Liabilities under investment contracts designated at fair value	6,898	26,951	–	–	33,849
Liabilities under insurance contacts	25,846	116,449	2,633	–	144,928
Deferred tax	1	69	–	1,842	1,912
Other liabilities	–	–	–	2,621	2,621
Total liabilities	32,745	143,469	2,633	4,463	183,310
Total equity	–	–	–	21,506	21,506
Total equity and liabilities	32,745	143,469	2,633	25,969	204,816

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

Underwriting strategy

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

Reinsurance strategy

The group reinsures a portion of the insurance risks it underwrites in order to control its exposures to losses and protect capital resources. The group buys a combination of proportionate and non-proportionate reinsurance to reduce the retained sum assured so that it falls within specified insurance risk appetite. The group also utilises reinsurance to transfer out financial risk arising from guaranteeing minimum investment performance under a specific unit-linked insurance product, and uses reinsurance agreements with non-affiliated reinsurers to control its exposure to losses resulting from certain catastrophes.

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

52 Risk Management *(continued)*

Nature of risks covered

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

(i) Insurance contracts – non-linked products

The basic feature of non-linked insurance business is to provide guaranteed death benefit determined at the time of policy issue. For non-linked insurance products with a savings element, guaranteed surrender benefit, guaranteed maturity benefit, crediting rate guarantees and/or non-lapse guarantee features may be provided. Discretionary participation features allow policyholders to participate in the profits of the life fund by means of annual bonuses. The group has complete contractual discretion on the bonuses declared. It is the group's goal to maintain a smooth dividend scale based on the long-term rate of return. Annual reviews are performed to confirm whether the current dividend scale is supportable.

(ii) Insurance contracts – unit-linked products

The group writes unit-linked life insurance policies, which typically provide policyholders with life insurance protection and choice of investment in a variety of funds. Premiums received are deposited into the chosen funds after deduction of premium fees. Other charges for the cost of insurance and administration are deducted from the funds accumulated. Where there is a performance guarantee, the risk is managed through product design and, when permitted by regulation, reinsurance.

(iii) Investment contracts – retirement funds with guaranteed returns

The group underwrites retirement fund business which gives rise to contracts that are classified as investment contracts. Under each retirement scheme, employers and employees are given a choice of funds to place their contributions, on which the group provides an investment return guarantee for some specific funds. 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 guaranteed returns

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. Those funds with guarantees are covered by (iii) above; for the remainder, the group bears no risk.

(v) Non-life insurance contracts

The group assumes the risk of loss from persons and organisations relating to property, liability, life, accident, health, financial or other perils that may arise from an insurable event. The group manages the risk through underwriting limits, approval procedures for transactions that involve new products or that exceed set authority limits, risk diversification, underwriting guidelines, reinsurance and centralised management of reinsurance and monitoring of emerging issues.

Concentrations of insurance risks

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

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

The policyholders of the insurance contracts issued by the group, its associates and joint ventures, are mainly residents of Hong Kong, Macau, mainland China, Taiwan, Singapore, Malaysia, Vietnam, India and South Korea, where the majority is Hong Kong.

52 Risk Management *(continued)*

To determine the concentration of insurance risks and the reinsurance coverage required, scenario analyses are performed to investigate the potential financial impact on the group. Total loss is estimated based on the chosen stress level. Details of the group's reinsurance strategy are disclosed on page 178.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. An analysis of life insurance liabilities is therefore the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. The liabilities for non-linked contracts are set by reference to a range of assumptions which mainly include interest rate and mortality levels. The process used to determine the assumptions is intended to result in stable and prudent estimates of future outcomes. This is achieved by adopting relatively conservative assumptions which can withstand a reasonable range of fluctuation of actual experience. An annual review of the relevant experience is performed to ensure a margin exists between the assumptions adopted and the most likely estimate of future outcome. By definition, the group is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis. Details of the analysis of life insurance liabilities are disclosed in note 34. By contrast for analysis of non-life insurance risk, written premiums represent the best available measure of risk exposure as shown in the following table.

Analysis of non-life insurance risk – net written insurance premiums[1]

	2010 HK$m	2009 HK$m
Accident and health	**1,411**	1,291
Fire and other damage	**306**	235
Motor	**332**	262
Liability	**180**	141
Marine, aviation and transport	**111**	96
Other (non-life)	**369**	335
Total net written insurance premiums	**2,709**	2,360

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

Financial risks

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

The group is also exposed to investment return guarantee risk for certain investment contracts issued to policyholders for its long-term insurance business. The risk is that the yield on the assets held by the group to meet these guarantees may fall short of the guaranteed return. The framework for the management of this risk is to adopt a matching approach whereby assets held are managed to meet the liability to policyholders. An additional provision is established where analysis indicates that, over the life of the contracts, the returns from the designated assets may not be adequate to cover the related liabilities.

The following table analyses the assets held in the group's insurance underwriting subsidiaries at 31 December 2010 by type of liability, and provides a view of the exposure to financial risk:

52 Risk Management *(continued)*

Financial assets held by insurance manufacturing operations

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

	At 31 December 2009				
	Life linked contracts HK$m	Life non-linked contracts HK$m	Non-life insurance HK$m	Other assets HK$m	Total HK$m
Financial assets designated at fair value					
– Debt securities	277	13,032	274	2,741	16,324
– Equity securities	23,412	3,964	–	–	27,376
	23,689	16,996	274	2,741	43,700
Financial investments					
Held-to-maturity:					
– Debt securities	–	104,086	1,441	5,196	110,723
	–	104,086	1,441	5,196	110,723
Available-for-sale:					
– Treasury bills	–	–	–	–	–
– Debt securities	–	3,464	57	555	4,076
– Equity securities	–	–	–	777	777
	–	3,464	57	1,332	4,853
Derivatives	9	154	–	–	163
Other financial assets	2,889	18,892	1,021	1,277	24,079
	26,587	143,592	2,793	10,546	183,518

The table demonstrates that for linked contracts, the group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract. The assets held to support life linked liabilities represented 14.3% of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2010 (2009: 14.5%). The table also shows that approximately 69.7% of financial assets were invested in debt securities at 31 December 2010 (2009: 71.4%) with 16.9% (2009: 15.3%) invested in equity securities.

Market risk

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

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

Interest rate risk

The group's exposure 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 strategy accounts for a significant portion of the debt securities holdings and is managed to match expected liability payments. The group monitors this exposure through periodic reviews of its asset and liability positions. Estimates of cash flows, as well as the impact of interest rate fluctuations relating to the investment portfolio and insurance reserves, are modelled and reviewed regularly. The overall objective of these strategies is to limit the net changes in the value of assets and liabilities arising from interest rate movements.

For participating products, interest rate risk related to non-linked policies can also be mitigated through sharing of risk with policyholders under the discretionary participation mechanism.

A shift in interest yield curves as at 31 December 2010 in all territories in which the group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	31 December 2010		31 December 2009	
	Impact on profit for the year HK$m	**Impact on net assets HK$m**	Impact on profit for the year HK$m	Impact on net assets HK$m
+ 100 basis points shift in yield curves	**515**	**(194)**	385	78
– 100 basis points shift in yield curves	**(556)**	**173**	(349)	(35)

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

Equity risk

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

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

	31 December 2010		31 December 2009	
	Impact on profit for the year HK$m	**Impact on net assets HK$m**	Impact on profit for the year HK$m	Impact on net assets HK$m
10% increase in equity prices	**473**	**474**	67	141
10% decrease in equity prices	**(471)**	**(471)**	(67)	(141)

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

Foreign currency risk

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

52 Risk Management *(continued)*

Credit risk

The group's portfolio of fixed income securities, and to a lesser extent short-term and other investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in a borrower's ability to repay the debt. The group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Management has a credit policy in place and limits are established to manage credit quality and concentration risk. The following table presents the analysis of the treasury bills, other eligible bills and debt securities within the group's insurance business. The definition of the four credit quality classifications is included on page 163. 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. 96.5% (2009: 98.4%) of the assets included in the table are invested in investments rated as 'Strong'.

	Neither past due nor impaired						
	Strong HK$m	**Medium HK$m**	**Sub-standard HK$m**	**Past due not impaired HK$m**	**Impaired HK$m**	**Impairment allowances HK$m**	**Total HK$m**
31 December 2010							
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	**13,087**	**556**	**–**	**–**	**–**	**–**	**13,643**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**13,087**	**556**	**–**	**–**	**–**	**–**	**13,643**
Financial investments	**123,893**	**4,596**	**–**	**–**	**–**	**–**	**128,489**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**123,893**	**4,596**	**–**	**–**	**–**	**–**	**128,489**
Supporting shareholders funds[1]							
Financial assets designated at fair value	**898**	**19**	**–**	**–**	**–**	**–**	**917**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**898**	**19**	**–**	**–**	**–**	**–**	**917**
Financial investments	**7,755**	**110**	**–**	**–**	**–**	**–**	**7,865**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**7,755**	**110**	**–**	**–**	**–**	**–**	**7,865**
Total							
Financial assets designated at fair value	**13,985**	**575**	**–**	**–**	**–**	**–**	**14,560**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**13,985**	**575**	**–**	**–**	**–**	**–**	**14,560**
Financial investments	**131,648**	**4,706**	**–**	**–**	**–**	**–**	**136,354**
– treasury and other eligible bills	**–**	**–**	**–**	**–**	**–**	**–**	**–**
– debt securities	**131,648**	**4,706**	**–**	**–**	**–**	**–**	**136,354**

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

31 December 2009	Neither past due nor impaired Strong HK$m	 Medium HK$m	 Sub-standard HK$m	Past due not impaired HK$m	Impaired HK$m	Impairment allowances HK$m	Total HK$m
Supporting liabilities under life non-linked and non-life insurance contracts							
Financial assets designated at fair value	12,959	327	20	–	–	–	13,306
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	12,959	327	20	–	–	–	13,306
Financial investments	107,316	1,732	–	–	–	–	109,048
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	107,316	1,732	–	–	–	–	109,048
Supporting shareholders funds[1]							
Financial assets designated at fair value	2,733	8	–	–	–	–	2,741
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	2,733	8	–	–	–	–	2,741
Financial investments	5,744	7	–	–	–	–	5,751
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	5,744	7	–	–	–	–	5,751
Total							
Financial assets designated at fair value	15,692	335	20	–	–	–	16,047
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	15,692	335	20	–	–	–	16,047
Financial investments	113,060	1,739	–	–	–	–	114,799
– treasury and other eligible bills	–	–	–	–	–	–	–
– debt securities	113,060	1,739	–	–	–	–	114,799

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:

52 Risk Management *(continued)*

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
31 December 2010							
Linked insurance contracts	**1**	**5,566**	**–**	**–**	**–**	**–**	**5,567**
Non-linked insurance contracts	**444**	**66**	**–**	**71**	**–**	**–**	**581**
Total	**445**	**5,632**	**–**	**71**	**–**	**–**	**6,148**
Reinsurance debtors	**35**	**8**	**–**	**46**	**–**	**–**	**89**
31 December 2009							
Linked insurance contracts	4	6,233	–	–	–	–	6,237
Non-linked insurance contracts	412	42	–	–	–	–	454
Total	416	6,275	–	–	–	–	6,691
Reinsurance debtors	15	11	–	61	–	–	87

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 2010, the exposure to the third party was HK$5,566m (2009: HK$6,231m).

Liquidity risk

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

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

52 Risk Management *(continued)*

The following table shows the expected maturity of insurance contract liabilities at 31 December 2010:

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 2010					
Non-life insurance	**1,736**	**875**	**256**	**54**	**2,921**
Life insurance (non-linked)	**11,752**	**76,103**	**128,920**	**141,714**	**358,489**
Life insurance (linked)	**1,562**	**10,338**	**25,126**	**66,725**	**103,751**
	15,050	**87,316**	**154,302**	**208,493**	**465,161**
At 31 December 2009					
Non-life insurance	1,573	720	276	64	2,633
Life insurance (non-linked)	9,151	62,212	115,826	115,823	303,012
Life insurance (linked)	1,733	9,752	14,296	37,705	63,486
	12,457	72,684	130,398	153,592	369,131

Remaining contractual maturity of investment contract liabilities

	Linked investment contracts HK$m	Non-linked investment contracts HK$m	Investment contracts with DPF HK$m	Total HK$m
At 31 December 2010				
Remaining contractual maturity				
– due within 1 year	**41**	**58**	**84**	**183**
– due between 1 and 5 years	**–**	**–**	**86**	**86**
– due between 5 and 10 years	**316**	**–**	**–**	**316**
– due after 10 years	**–**	**–**	**–**	**–**
– undated[1]	**7,121**	**26,210**	**–**	**33,331**
	7,478	**26,268**	**170**	**33,916**
At 31 December 2009				
Remaining contractual maturity				
– due within 1 year	94	201	112	407
– due between 1 and 5 years	–	–	157	157
– due between 5 and 10 years	345	–	–	345
– due after 10 years	–	–	–	–
– undated[1]	6,459	26,750	–	33,209
	6,898	26,951	269	34,118

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.*

52 Risk Management *(continued)*

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

The group's life insurance business is accounted for using the embedded value approach, which, inter alia, provides a comprehensive framework for the evaluation of insurance and related risks. The value of the PVIF asset at 31 December 2010 was HK$14,767m (2009: HK$10,554m). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2010 can be stress-tested to assess the sensitivity of the value of life business to adverse movement of different risk factors.

The following table shows the effect on the PVIF as at 31 December 2010 of reasonably possible changes in the main economic and business assumptions:

	Impact on results	
	2010	2009
	HK$m	HK$m
+ 100 basis points shift in risk-free rate	**1,613**	1,296
– 100 basis points shift in risk-free rate	**(1,218)**	(773)
+ 100 basis points shift in risk discount rate	**(820)**	(640)
– 100 basis points shift in risk discount rate	**942**	734
+ 100 basis points shift in expenses inflation	**(45)**	(35)
– 100 basis points shift in expenses inflation	**39**	31
+ 100 basis points shift in lapse rate	**1,185**	1,444
– 100 basis points shift in lapse rate	**(1,044)**	(1,221)

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

Non-economic assumptions

Non-economic assumptions including, for non-life manufacturers, claims costs and expense rates and, for life manufacturers, mortality and/or morbidity, lapse rates and expense rates, are also used for the determination of the policyholder liabilities and PVIF. The sensitivity of profit for the year and net assets to reasonably possible changes in these non-economic assumptions at 31 December 2010 across all insurance underwriting subsidiaries is as follows:

	Impact on 2010 results		Impact on 2009 results	
	Profit after tax	**Net assets**	Profit after tax	Net assets
	HK$m	**HK$m**	HK$m	HK$m
20% increase in claims costs	**(183)**	**(183)**	(177)	(177)
20% decrease in claims costs	**183**	**183**	177	177
10% increase in mortality and/or morbidity rates	**(176)**	**(176)**	(137)	(137)
10% decrease in mortality and/or morbidity rates	**167**	**167**	130	130
50% increase in lapse rates	**351**	**351**	586	586
50% decrease in lapse rates	**(58)**	**(58)**	(422)	(422)
10% increase in expense rates	**(171)**	**(171)**	(112)	(112)
10% decrease in expense rates	**171**	**171**	112	112

Notes on the Financial Statements (continued)

52 Risk Management *(continued)*

f *Capital management*

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

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

Our capital management process is articulated in our annual group capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between the different components of capital. The group raises non-equity core capital and subordinated debt in accordance with HSBC Group's guidelines on market and investor concentration, cost, market conditions, timing, effect on composition and maturity profile. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the approved annual group capital plan. In accordance with HSBC Group's Capital Management Framework, capital generated by subsidiaries in excess of planned requirements is returned to the Bank, normally by way of dividends.

The Bank is primarily the provider of equity capital to its subsidiaries and these investments are substantially funded by the Bank's own capital issuance and profit retention. As part of its capital management process, the Bank seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

The principal forms of capital are included in the following balances on the consolidated balance sheet: share capital, retained profits, other reserves, preference shares and subordinated liabilities. Capital also includes the collective impairment allowances held in respect of loans and advances.

Externally imposed capital requirements

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

From 1 January 2009, the group migrated to the advanced internal ratings-based approach to calculate its credit risk for the majority of its non-securitisation exposures. The group continued to use the internal ratings-based (securitisation) approach to determine credit risk for its securitisation exposures. For market risk, the group used an internal models approach to calculate its general market risk and market risk relating to equity options. From 30 March 2009, the group adopted an internal models approach to calculate its market risk in respect of specific risk for the interest rate risk category. The group continued to use the standardised (market risk) approach for calculating other market risk positions and the standardised (operational risk) approach to calculate its operational risk.

During the year, the individual entities within the group and the group itself complied with all of the externally imposed capital requirements of the Hong Kong Monetary Authority.

53 Analysis of selected exposures

a *Holdings of asset-backed securities*

The group has holdings of asset-backed securities (‘ABSs’), including those represented by mortgage-backed securities (‘MBSs’) and by collateralised debt obligations (‘CDOs’).

The table below shows the group’s exposure to ABSs issued by entities which are not consolidated by any HSBC Group entities. The carrying amounts of these exposures are measured at fair value.

Group

	31 December 2010		31 December 2009	
	Gross and net principal exposure[1]	**Carrying amount[2]**	Gross principal[1]	Carrying amount[2]
	HK$m	**HK$m**	HK$m	HK$m
2010				
Sub-prime residential mortgage related assets				
MBSs and MBS CDOs				
– high grade (AA or AAA rated)	**46**	**38**	54	45
– C to A rated	**550**	**111**	562	74
	596	**149**	616	119
US government-sponsored enterprises’ mortgage related assets				
MBSs				
– high grade (AA or AAA rated)	**6,016**	**6,024**	4,071	4,071
Other residential mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	**2,541**	**2,413**	3,366	3,142
– C to A rated	**–**	**–**	1	1
– not publicly rated	**8**	**8**	8	8
	2,549	**2,421**	3,375	3,151
Commercial property mortgage-related assets				
MBSs				
– high grade (AA or AAA rated)	**–**	**–**	705	636
– C to A rated	**806**	**296**	785	140
	806	**296**	1,490	776
Leveraged finance-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**147**	**132**	145	127
Student loan-related assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**989**	**987**	1,515	1,508
Other assets				
ABSs and ABS CDOs				
– high grade (AA or AAA rated)	**840**	**826**	955	935
– C to A rated[3]	**50**	**16**	249	18
	890	**842**	1,204	953
	11,993	**10,851**	12,416	10,705

53 Analysis of selected exposures *(continued)*

The table below shows the geographic distribution of the group's exposures to ABSs shown above.

	31 December 2010		31 December 2009	
	Gross and Net Principal exposure[1]	**Carrying Amount[2]**	Gross Principal[1]	Carrying Amount[2]
	HK$m	**HK$m**	HK$m	HK$m
2010				
US	**8,566**	**7,574**	7,249	5,982
UK	**923**	**814**	1,105	918
Rest of the world	**2,504**	**2,463**	4,062	3,805
	11,993	**10,851**	12,416	10,705

1 *The gross principal exposure is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security. Net principal exposure is the gross principal amount of assets that is not protected by CDSs. It includes assets that benefit from monoline protection, except where this protection is purchased with a CDS.*

2 *Carrying amount of the net principal exposure.*

3 *At 31 December 2010, the group has no principal exposure to monoline insurers. At 31 December 2009,CDS gross protection of HK$190m was in place for an ABS holding included under other assets. The ABS matured during 2010.*

b *Leveraged finance commitments*

Leveraged finance commitments held by the group were HK$1,509m at 31 December 2010 (2009: HK$712m), of which HK$130m (2009: HK$545m) was funded.

c *Other involvement with SPEs*

The group enters into certain transactions with customers in the ordinary course of business that involve the establishment of SPEs. The purposes for which the SPEs are established include facilitating the raising of funding for customers' business activities or to effect a lease. The use of SPEs is not a significant part of the group's activities and the group is not reliant on SPEs for any material part of its business operations or profitability.

54 Ultimate holding company

The ultimate holding company of the Bank is HSBC Holdings plc, which is incorporated in England.

The largest group in which the accounts of the Bank are consolidated is that headed by HSBC Holdings plc. The consolidated accounts of HSBC Holdings plc are available to the public on the HSBC Group's web site at www.hsbc.com or may be obtained from 8 Canada Square, London E14 5HQ, United Kingdom.

55 Nature of business

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

56 Events after the balance sheet date

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

57 Approval of accounts

The accounts were approved and authorised for issue by the Board of Directors on 28 February 2011.

58 Accounting standards issued but not yet effective

The HKICPA has issued a number of amendments to HKFRSs and Interpretations which are not yet effective for the year ended 31 December 2010 and which have not been adopted in these financial statements.

HKFRS 9 'Financial Instruments' ('HKFRS 9') was issued in November 2009 and establishes new principles for the classification and measurement of financial assets. In November 2010, the HKICPA issued additions to HKFRS 9 dealing with financial liabilities. The main changes from the requirements of HKAS 39 are summarised below.

- All financial assets are classified into two measurement categories: amortised cost or fair value. These two categories replace the four categories under the current HKAS 39 'Financial Instruments: Recognition and Measurement'.
- Financial assets are measured at fair value through profit or loss if they do not meet the criteria specified for measurement at amortised cost or if doing so significantly reduces or eliminates an accounting mismatch. An entity has the option to designate changes in fair value of an equity instrument not held for trading at fair value through other comprehensive income with no recycling of gains or losses to the income statement.
- HKFRS 9 retains all the existing requirements for derecognition of financial instruments and most of the requirements for financial liabilities, except that for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts, fair value changes attributable to changes in own credit risk are to be presented in the statement of other comprehensive income, and are not subsequently reclassified to income statement.

HKFRS 9 is mandatory for annual periods beginning on or after 1 January 2013 with earlier application permitted. It is required to be applied retrospectively, but if adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. The group is presently studying the implications of applying HKFRS 9. It is impracticable to quantify the impact of HKFRS 9 as at the date of publication of these financial statements.

The HKICPA issued an amendment to HKFRS 7 'Financial Instruments: Disclosures' in October 2010 which requires additional disclosures for risk exposures arising from transferred financial assets. The amendment will be effective for annual periods beginning on or after 1 July 2011, with earlier application permitted. No disclosures are required for prior periods. The group is presently studying the implications of applying this amendment to HKFRS 7.

The HKICPA issued an amendment to HKAS 12 'Income Taxes' in December 2010, whereby deferred taxes on investment property, carried under the fair value model in HKAS 40, will be measured on the presumption that an investment property is recovered entirely through sale. The presumption is rebutted if the investment property is held within a business whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The amendment will be effective for annual periods beginning on or after 1 January 2012 with earlier application permitted. The group is currently assessing the financial impact of this amendment.

A number of other amendments to HKFRSs have been issued but are not yet effective and are not expected to have a significant effect on the group's financial statements:

- HKAS 24 (Revised 2009) 'Related Party Disclosures'
- Hong Kong (IFRIC) Interpretation 19 'Extinguishing Financial Liabilities with Equity Instruments'
- Amendment to Hong Kong (IFRIC) Interpretation 14 'HKAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'
- 'Improvements to HKFRSs' issued in May 2010
- Amendments to HKFRS 1 'First-time Adoption of Hong Kong Financial Reporting Standards'

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

We have audited the consolidated financial statements of The Hongkong and Shanghai Banking Corporation Limited set out on pages 27 to 191, which comprise the consolidated and the Bank's balance sheets as at 31 December 2010, the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory information.

Directors' responsibility for the consolidated financial statements

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

Auditor's responsibility

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

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

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

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

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the state of the affairs of the Bank and the group as at 31 December 2010 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

28 February 2011

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